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CFIUS: Evolution Yields to Revolution

While 2017 was an evolutionary year for the Committee on Foreign Investment in the United States (“CFIUS”), 2018 portends to be a revolutionary year. A number of factors, including a new President, growing concerns over Chinese investments in the United States, and an unprecedented number of filings, resulted in evolving CFIUS practices as a matter of policy and necessity. The policy evolution culminated in the November 2017 bipartisan and bicameral introduction of the Foreign Investment Risk Review Modernization Act of 2017 (“FIRRMA”), which could bring revolutionary changes to the law and CFIUS practice in 2018 and beyond.

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BRIEF INTRODUCTION TO CFIUS AND THE CFIUS PROCESS

CFIUS is an interagency committee of the U.S. government that has the authority to review so-called “covered transactions”—i.e., transactions by or with any foreign person that could result in control of a U.S. business by a foreign person. Thus, CFIUS has jurisdiction over the acquisition of a U.S.-based company by a foreign person and the acquisition of a non-U.S.-based company by a foreign person if the non-U.S.-based company has operations in the United States that constitute a U.S. business. Although CFIUS has been in existence since a 1975 Executive Order, CFIUS was formally established in statute more than a decade ago in connection with enactment of the Foreign Investment and National Security Act of 2007 (“FISIA”), which amended section 721 of Defense Production Act of 1950.

As a practical matter, CFIUS is most interested when a transaction within its jurisdiction raises national security concerns. Such concerns may be raised in a variety of ways, such as if: (i) the U.S. business operates in an industry considered to be part of the critical infrastructure of the United States; (ii) the U.S. business manufactures or sells sensitive or export-controlled products or possesses sensitive technology; (iii) the U.S. business is a sole source provider or has contracts with the U.S. government; (iv) the U.S. business engages in classified work and maintains either personnel or facility security clearances; (v) the U.S. business possesses sensitive personally identifiable information; or (vi) the U.S. business’s facilities are located in close proximity to sensitive military facilities. CFIUS may impose and enforce agreements or conditions to mitigate any national security concerns raised by transactions reviewed by CFIUS.

The CFIUS process is a joint, voluntary process that parties to the transaction initiate based on the perceived risk that the President of the United States might require divestment post-closing if there are non-mitigated national security concerns associated with the transaction. CFIUS monitors public information regarding foreign investment in the United States to identify investments that were not notified to CFIUS but that CFIUS believes could raise national security concerns. The risk of not submitting a notice to CFIUS is that CFIUS could, following closing, request that the parties submit a notice and review the transaction, which could result in the President requiring that the buyer divest itself of the U.S. business.

2017: EVOLUTION

In December 2016, President Obama blocked a Chinese investment firm from acquiring the U.S. business of Aixtron, a German manufacturer of semiconductor equipment. That development augured an evolution in CFIUS policy and practice throughout 2017 that consolidated and magnified trends from previous years. In 2017, that evolution resulted in:

- **A Significant Increase in the Number of Notices.** CFIUS initiated 238 reviews during 2017, compared to 172 during 2016. This unprecedented number of reviews could have been due, in part, to transaction parties’ perception of increased CFIUS risk under the Trump Administration.
- **Longer Review Periods.** During 2017, CFIUS took significantly longer to start its statutorily mandated review timeline following submission of draft pre-file notices. Moreover, CFIUS asked more and different questions during the pre-filing stage and the formal review period.
- **More Investigations.** The number of transactions subjected to the additional 45-day investigation period (following the initial 30-day review period) increased during 2017, with approximately 70 percent of the transactions entering the investigation phase, compared to 46 percent of notices reviewed in 2015 and 2016.
- **Increase in the Number of Withdrawals and Refilings.** Notices were withdrawn and refiled with CFIUS approximately 35 times during 2017, compared to 12 times in 2014, 13 in 2015, and 27 in 2016. Refiling restarts the statutory clock and provides CFIUS with additional time to review a transaction or for the parties to negotiate mitigation measures. If the investigation period ends without clearance and the parties decide not to withdraw and refile the notice, they have two options: (i) withdraw the notice and abandon the transaction; or (ii) force CFIUS to send the transaction to the President for a decision. In the latter case, CFIUS typically would prepare a memorandum to the President recommending that the transaction be blocked.
- **More Blocked and Abandoned Transactions.** During 2017, President Trump blocked another Chinese investment in the U.S. semiconductor industry. In addition, more

transactions notified to CFIUS were abandoned due to the inability to mitigate national security concerns associated with the transactions. Although information regarding transactions notified to CFIUS often is not made public, we believe at least 18 transactions were abandoned during 2017, compared to five in 2015 and 12 in 2016. Parties abandoned transactions due to a variety of U.S. government concerns, including proximity to sensitive U.S. government facilities, access to sensitive personal information, and the transfer of sensitive know-how.

- **Heightened Scrutiny of Chinese Investments.** Certain kinds of Chinese investments in the United States faced an uphill battle at CFIUS during 2017. A number of Chinese investments were abandoned or experienced challenges obtaining CFIUS clearance. CFIUS appears to be focused primarily on: (i) investments involving Chinese state-owned or -controlled investors; (ii) Chinese investments in industries or assets that the U.S. government believes are sensitive, such as investments that allow Chinese investors to have access to the U.S. financial system, sensitive personal information, or certain U.S. technology, including technology that could advance the Chinese semiconductor industry, even if the technology would not require a license for export to China; and (iii) ensuring that Chinese investments do not disrupt the U.S. government supply chain and do not result in Chinese ownership or control of assets located in close proximity to sensitive U.S. government facilities or other areas of strategic importance to the U.S. government. There was no categorical ban or block on Chinese transactions, however: during 2017, Chinese investments in less-sensitive industries or assets received CFIUS clearance.
- **More Mitigation.** During 2017, CFIUS imposed mitigation measures more often. CFIUS imposed mitigation in approximately 20 percent of the transactions it reviewed during 2017, an increase from the previous year's total of approximately 10 percent of transactions.

2018: REVOLUTION

Those evolutionary trends from 2017 are likely to continue. In parallel, FIRRMA, if enacted, would revolutionize CFIUS law

and practice. FIRRMA, with bipartisan and bicameral support in Congress and the backing of key Trump Administration officials, stands a good chance to become law in 2018. Enactment of FIRRMA would, in turn, result in the promulgation of implementing regulations in ensuing years.

Current Framework and FIRRMA

A decade has passed since the enactment of FINSA and the promulgation of its implementing regulations. Many in Congress and in the administration argue that technological and other changes have rendered the current CFIUS framework insufficient to address the complexity of the global economy and U.S. national security interests, particularly in light of increased investment from China. Senate Majority Whip John Cornyn (R-TX), who introduced FIRRMA in the Senate, has stated that the “context for this legislation is about China.”

FIRRMA seeks to modernize and strengthen the CFIUS process “to more effectively guard against the risk to the national security of the United States posed by certain types of foreign investment.” The relevant Senate and House committees have held multiple hearings regarding CFIUS in recent months, with several taking place in January 2018. Members from both parties and in both chambers have focused on FIRRMA as the legislative means of addressing concerns with the U.S. government's ability to protect against national security threats resulting from foreign investment. Administration officials had discussed what became FIRRMA with its drafters, and in recent months FIRRMA has increasingly received the explicit support of senior officials from the Departments of the Treasury, Defense, and other departments and agencies.

FIRRMA

As we previously reported [here](#), FIRRMA would significantly reform the law and process of CFIUS by, among other changes: (i) expanding the scope of transactions within the jurisdiction of CFIUS; (ii) creating exemptions for certain transactions involving certain countries; (iii) making notifications for certain types of transactions mandatory, rather than voluntary; (iv) extending the CFIUS review period; (v) imposing filing fees for notices; and (vi) codifying and expanding the factors that CFIUS may consider in connection with its national security reviews.

Expanded Jurisdiction. FIRRMA expands the definition of “covered transaction” to include the following:

- The contribution (other than through an ordinary customer relationship) by a U.S. critical technology company of both intellectual property and associated support to a foreign person through any type of arrangement, such as a joint venture;
- The purchase or lease by a foreign person of real estate located in close proximity to a U.S. military installation or to other sensitive U.S. government property;
- Any non-passive investment by a foreign person in a U.S. critical technology company or critical infrastructure company;
- Any change in the rights of a foreign person related to a U.S. business, if that change could result in foreign control of the U.S. business or a non-passive investment in a U.S. critical technology company or critical infrastructure company; and
- Any other transaction, transfer, agreement, or arrangement structured to evade or circumvent the CFIUS review process.

Three of these provisions have garnered particular attention. First, expanding the jurisdiction of CFIUS to include the contribution by a U.S. critical technology company of intellectual property and associated support to a foreign person could significantly increase the reach of CFIUS, permitting it to review a wide range of joint venture and technology licensing arrangements with foreign parties that are not currently subject to CFIUS jurisdiction. That provision is drafted very broadly. It is currently the focus of intense interest by numerous companies and industry groups, many of which favor narrowing or clarifying the language. If enacted in its current form, the stakes of the ensuing regulatory process would be particularly high, as the regulations could play a critical role in defining the meaning and requirements of that statutory provision.

Similarly, certain FIRRMA provisions significantly expand the jurisdiction of CFIUS, including those giving CFIUS the authority to review: (i) purchases and leases of real estate located in close proximity to a U.S. military installation or to other sensitive U.S. government property and (ii) any non-passive investment by a foreign person in a U.S. critical technology or critical infrastructure company. Those provisions, like the others described above that expand CFIUS jurisdiction, do not require actual or potential control over a U.S. business by a foreign person. They

are also drafted broadly and further heighten the importance of the subsequent implementing regulations.

Exemptions for Certain Transactions Involving Certain Countries. FIRRMA authorizes CFIUS to exempt certain transactions from the expanded definition of “covered transaction” if each foreign person that is a party to the transaction is organized in or otherwise subject to the jurisdiction of countries to be set out in implementing regulations, using criteria such as: (i) whether the United States has a mutual defense treaty in effect with that country; (ii) whether the United States has in effect with that country a mutual arrangement to safeguard national security as it pertains to foreign investment; and (iii) the national security review process for foreign investment in that country.

Mandatory Declarations for Certain Covered Transactions. FIRRMA authorizes parties to a covered transaction to submit a short-form “declaration” containing basic information regarding the transaction instead of a traditional, extensive CFIUS notice. Although implementing regulations will be necessary to understand the exact scope of the declarations, FIRRMA indicates that they should be abbreviated notifications that generally do not exceed five pages.

Under FIRRMA, declarations would be *mandatory* for the following transactions, a significant change from the current, voluntary process:

- The acquisition of at least 25 percent of a U.S. business by a foreign person in which a foreign government owns at least a 25 percent interest; and
- Transactions that CFIUS will specify in regulations implementing FIRRMA based on a number of factors, including: (i) the technology, industry, or economic sector in which the U.S. business operates; (ii) the difficulty of remedying the harm to national security resulting from the transaction; and (iii) the difficulty of obtaining information regarding the transaction through other means.

FIRRMA provides that a mandatory declaration would have to be submitted at least 45 days before completion of the transaction. Any party required to submit a declaration could instead decide to submit a full CFIUS notice, which must be

submitted at least 90 days before completion of the transaction. CFIUS would be able to impose penalties if parties fail to comply with declaration requirements.

After receiving a declaration, CFIUS may: (i) request that the parties file a full notice; (ii) inform the parties that CFIUS is not able to complete action based on the declaration and that the parties may submit a full notice for CFIUS to complete action; (iii) initiate a unilateral review of the transaction; or (iv) notify the parties that CFIUS has completed all action with respect to the transaction.

FIRRMA states that CFIUS will “endeavor” to take one of these actions within 30 days of receiving a declaration but does not make the 30-day time period mandatory. Given the uncertainty associated with timing for review of a declaration, and because CFIUS ultimately may request a full notice in response to a declaration, parties may decide to forgo the declaration step and submit a full notice.

Extended Review Period. Under FIRRMA, the initial review period for notices would increase from 30 days to 45 days. In addition, in extraordinary circumstances, CFIUS would be able to extend the 45-day investigation period by an additional 30 days. This would increase the total time for most transactions from 75 days to 90 days and could result in a 120-day review period in extraordinary circumstances.

Filing Fees. FIRRMA authorizes CFIUS to assess a fee equal to one percent of the value of the transaction, subject to a maximum fee of \$300,000. There currently is no fee for filing a CFIUS notice.

Additional National Security Factors. FIRRMA adds a number of national security factors that CFIUS may consider in connection with its review. CFIUS has considered many of the new factors in recent years, even though they had not previously been codified in legislation. The factors include:

- Whether the transaction is likely to reduce the technological and industrial advantage of the United States relative to any country of special concern;
- The degree to which the transaction is likely to increase the cost to the U.S. government of acquiring or maintaining the equipment and systems necessary for defense, intelligence, or other national security functions;

- The potential national security-related effects of the cumulative market share of any one type of infrastructure, energy asset, critical material, or critical technology by foreign persons;
- Whether any foreign person that would acquire an interest in a U.S. business or its assets as a result of the covered transaction has a history of complying with U.S. laws and regulations and of adhering to contracts or other agreements with the U.S. government;
- The extent to which the transaction is likely to expose personally identifiable information, genetic information, or other sensitive data of U.S. citizens to a foreign government or foreign person that may exploit that information in a manner that threatens national security;
- Whether the transaction is likely to create any new or exacerbate any existing U.S. cybersecurity vulnerabilities;
- Whether the transaction is likely to result in a foreign government gaining a significant new capability to engage in malicious cyber-enabled activities against the United States;
- Whether the transaction involves a country of special concern that has a demonstrated or declared strategic goal of acquiring a type of critical technology that the U.S. business possesses;
- Whether the transaction is likely to facilitate criminal or fraudulent activity affecting the national security of the United States; and
- Whether the transaction is likely to expose any information regarding sensitive national security matters or sensitive procedures or operations of a federal law enforcement agency with national security responsibilities to a foreign person not authorized to receive that information.

FIRRMA Timing and Other Considerations

Although still uncertain, it appears increasingly likely that FIRRMA will be enacted this year. If so, it would be the first significant legislative change to CFIUS in more than a decade. After President George W. Bush signed FINSA into law in 2007, it took the Department of the Treasury more than a year to promulgate implementing regulations. The complexity of FIRRMA

and potential breadth of some of its provisions suggest that the promulgation of implementing regulations in this instance will take at least that much time and will be particularly important in shaping the law and process of CFIUS. Many provisions of FIRRMA will not take effect until after the CFIUS chairperson determines that the regulations, organizational structure, personnel, and other resources necessary to administer the provisions are in place.

In the National Defense Authorization Act for Fiscal Year 2018, which was signed into law on December 12, 2017, Congress mandated that the Secretary of Defense submit a report to the appropriate committees of Congress regarding interagency vetting of foreign investments affecting national security. The Secretary of Defense is required to submit an interim report within 90 days, meaning the interim report is due by mid-March 2018. The report's purpose is to assess and develop a plan and recommendation to the agencies that comprise CFIUS regarding how to improve the foreign direct investment process and identify potential vulnerabilities.

We expect that the report will focus on collaboration and coordination regarding the potential impairment of U.S. national security, increasing information-sharing across the U.S. government internally and with foreign ally governments, and mitigating potential threats to critical U.S. infrastructure and technologies from foreign state-owned or state-controlled entities. This interim report may influence Congress's final drafting of FIRRMA, will almost certainly influence CFIUS's drafting of the FIRRMA regulations, and should provide broader guidance to businesses concerned about upcoming CFIUS reforms and regulations.

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Targets of U.S. foreign direct investment and investors from around the world witnessed an evolution in the CFIUS process in the past year. This includes companies operating in high-tech industries, such as artificial intelligence, robotics, smart appliances, high-end consumer electronics, and the semiconductor industry, as well as early-stage tech companies

developing emerging technologies, and companies that have access to personally identifiable information. Yet the potential statutory changes to CFIUS in 2018, and resultant implementing regulations, could create far more significant reforms this year and beyond. If it becomes law, FIRRMA would change the voluntary CFIUS process to a mandatory process in some instances, lengthen the initial review period, and substantially expand CFIUS's jurisdiction and, thus, the number of matters it reviews. Both investors and potential targets should consider how those potential upcoming changes could affect their foreign direct investment strategy. We will continue to monitor these and related developments.

LAWYER CONTACTS

For further information, on CFIUS-related matters, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Laura Fraedrich
Washington
+1.202.879.3646
lfraedrich@jonesday.com

Paul V. Lettow
Washington
+1.202.879.3916
[pvlettow@jonesday.com](mailto:pvetlow@jonesday.com)

D. Grayson Yeargin
Washington
+1.202.879.3634
gyeargin@jonesday.com

Chase D. Kaniecki
Washington
+1.202.879.3734
ckaniecki@jonesday.com

Sara L. Rafferty
Washington
+1.202.879.4655
srafferty@jonesday.com

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