

KIRKLAND ALERT

October 12, 2018

U.S. Treasury Department Issues New Rule on Mandatory CFIUS Declarations

On October 11, 2018, the U.S. Department of the Treasury, as chair of the Committee on Foreign Investment in the United States (“CFIUS”), published an interim rule for a pilot program (the “Pilot Program”) to implement certain provisions of the *Foreign Investment Risk Review Modernization Act* (“FIRRMA”). Under the Pilot Program, some investments by foreign persons in certain U.S. businesses will be subject to *mandatory* declaration requirements that obligate transaction parties to submit a short-form notice of the transaction to CFIUS in advance of closing. The Pilot Program represents a fundamental change to the CFIUS process — which has historically been voluntary — and is poised to have significant impacts on cross-border dealmaking.

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The View from Washington

The Pilot Program reflects a [broad policy consensus](#) among the White House, Congress and national security stakeholders that the historic CFIUS process has not been sufficient to identify, review and mitigate foreign investments in U.S. businesses involving technologies perceived as “critical” to the defense industrial base and U.S. national security. In explaining the “urgent and compelling circumstances” for the Pilot Program, Treasury stated that rapid implementation of the Pilot Program is necessary to prevent foreign persons from “*influen[cing] the use of, and decisions made by U.S. businesses with respect to, critical technologies.*”¹ 31 C.F.R. § 801 (2018). Given that the Pilot Program’s rules will become effective in just four weeks, parties to transactions that could potentially fall within the Pilot Program’s scope must assess with urgency whether their transactions may require a mandatory notification to CFIUS.

Here are nine things to know about the Pilot Program.

1. This is an *interim* rule.

Treasury issued the rule on an interim basis, and its regulations are subject to revision. Treasury indicated that it will consider and respond to comments submitted regarding the interim rule.

2. The Pilot Program applies only to certain investments in 27 specified industries, and does not implement all of FIRRMA’s provisions.

Treasury emphasized that the Pilot Program was “*narrowly scope[d]*” to cover “*only those industries in which the threat of erosion of technological superiority from*

*some foreign direct investment requires immediate action.*² Accordingly, the Pilot Program's requirements apply only to certain investments in U.S. businesses operating in one or more of 27 industries specifically identified by Treasury in a separate list. These industries are spelled out by reference to their North American Industry Classification System ("NAICS") codes, and include many that directly support the U.S. defense industrial base (e.g., ball and roller bearing manufacturing, guided missile and space vehicle manufacturing, and aircraft manufacturing).

Declarations will be mandatory for any "pilot program covered transaction" in a "pilot program U.S. business."

3. CFIUS will require transaction parties to submit a declaration in connection with any "pilot program covered transaction" in a "pilot program U.S. business."

The Pilot Program sets forth a two-part test to assess if a mandatory declaration requirement applies to a transaction.

A. The transaction must be a Pilot Program covered transaction.

A transaction by a foreign person qualifies as such if:

- (i) The transaction does not confer control on the foreign person, but would afford the foreign person:
 - Access to any "material nonpublic technical information" possessed by the Pilot Program U.S. business (which shall not include financial information about the business);
 - Membership or observer rights on the board of directors or equivalent governing body of the Pilot Program U.S. business or the right to nominate an individual to a position on the U.S. business' board of directors or equivalent governing body;
 - Any involvement (other than through voting of shares) in substantive decision making of the Pilot Program U.S. business about the use, development, acquisition, or release of critical technology.
- (ii) The transaction could result in foreign "control" of the pilot program U.S. business.

This latter prong captures traditional control investments in and acquisitions of U.S. businesses operating in the 27 Pilot Program industries.

B. The U.S. business must qualify as a Pilot Program U.S. business.

Not every U.S. business with a nexus to one of the 27 specified industries would be a "pilot program U.S. business."³ Instead, the U.S. business that is the recipient of the foreign investment must be one that produces, designs, tests, manufactures, fabricates or develops a critical technology that is:

- (i) Utilized in connection with the U.S. business's activity in one or more Pilot Program industries; or
- (ii) Designed by the U.S. business specifically for use in one or more Pilot Program industries.

All foreign investors — regardless of country of origin — are subject to the Pilot Program's requirements.

In other words, a U.S. company that exclusively provides services to a client in an identified industry but does not produce, design, test, manufacture, fabricate or develop any critical technologies used in connection with the services, and has not designed any critical technology specifically for use in the identified industry, would not fall within the new definition. Foreign investments in such a company would accordingly not be subject to the Pilot Program's requirements.

Importantly, Treasury did not clarify what it would mean for a technology to be designed "*specifically... for use*" in a Pilot Program industry, nor did it specify whether upgrades or enhancements to critical technologies could cause such technologies to meet this bar.

4. All foreign investors — regardless of country of origin — are subject to the Pilot Program's requirements.

Certain [early drafts of FIRRMA](#) would have required notifications to CFIUS of investments by foreign persons from identified "*countries of concern*." The Pilot Program is agnostic as to the foreign investor's country of origin; all foreign investors are equally subject to the Pilot Program's requirements.

This broad applicability has an important intelligence-gathering function: Treasury stated that it intends to use the Pilot Program to "*gather data to help inform the full implementation of FIRRMA*."⁴ In the deal context, making all foreign investors subject to the Pilot Program's requirements may help to level the transactional playing field among foreign persons bidding for an asset.

5. "Critical technologies" will include "emerging" and "foundational" technologies.

In keeping with the focus on protecting U.S. technological leadership, a Pilot Program U.S. business may qualify as such based on its production, design, test, manufacture, fabrication, or development of either a technology traditionally identified as "critical" (e.g., defense articles and services subject to controls under the International Traffic in Arms Regulations (the "ITAR")) or a technology that is controlled by the U.S. Department of Commerce, Bureau of Industry and Security ("BIS") as an "*emerging and foundational*" technology. While BIS has yet to specify what technologies would be controlled as emerging and foundational, it is widely expected to do so in the coming weeks.

6. Declarations will require fulsome disclosure from and about transaction parties.

While the Pilot Program interim rule prescribes that declarations should be approximately five pages, the provisions setting forth the information required for a declaration exceed five pages in length. In some respects, the Pilot Program requires disclosure about transaction parties above and beyond what is currently required in the CFIUS regulations, including whether:

- The U.S. business has had any contracts with a U.S. government agency in the past ten years that included access to personally identifiable information of U.S. Government personnel;
- The U.S. business has received a grant or other funding from the Department of Defense or the Department of Energy, or participated in or collaborated on any defense or energy program or product involving one or more critical technologies or Pilot Program industries within the past five years; and
- The U.S. business, foreign person, or any parent or subsidiary of the foreign person has been convicted of a crime in the past ten years, in any jurisdiction.

7. CFIUS may impose penalties for failure to submit a declaration.

Any person who fails to comply with the Pilot Program's requirements may be subject to a civil monetary penalty of up to the value of the transaction.

8. The mandatory notification requirement will effectively prohibit transaction parties from structuring a deal for a simultaneous signing and closing.

Mandatory declarations must be filed at least 45 days prior to the expected completion date of the Pilot Program covered transaction, and transaction parties must have CFIUS' permission in order to re-submit a declaration based on material changes to transaction terms.

9. The Pilot Program will become effective on November 10, 2018.

Treasury clarified that the Pilot Program's requirements will not apply to:

- Transactions that will have closed before November 11, 2018, or
- Transactions for which a binding agreement was signed before October 11, 2018.

However, parties to Pilot Program covered transactions for which negotiations are ongoing will be subject to the Pilot Program's requirements, unless they are consummated prior to November 11, 2018.

Parties to pilot program covered transactions will effectively be unable to structure a deal for a simultaneous signing and closing.

Key Takeaways

- The Pilot Program heralds a new era for CFIUS. Given the fundamental policy concerns of protecting U.S. technological leadership and national security that have shaped FIRRMA's regulations to date, transaction parties should assume that CFIUS will interpret connections to Pilot Program industries broadly.
- It will be critical for buyers and sellers to understand a target's export control portfolio in order to assess whether a deal may be a Pilot Program covered transaction. CFIUS' focus on this space weighs in favor of heightened, precise self-diligence by a target well in advance of any transaction with a foreign person.
- This new rule is only the beginning of FIRRMA's roll-out. Treasury indicated that it would issue more guidance and additional regulations, and may promulgate additional pilot programs covering other types of transactions and industries.

This new rule is only the beginning of FIRRMA's roll-out.

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¹ U.S. Department of the Treasury, *Determination and Temporary Provisions Pertaining to a Pilot Program to Review Certain Transactions Involving Foreign Persons and Critical Technologies*, Oct. 10, 2018, *available at* 9, https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf

² *Id.*

³ *Id.* at 13.

⁴ *Id.* at 9.

Appendix: Pilot Program Industries

- Aircraft Manufacturing
- Aircraft Engine and Engine Parts Manufacturing
- Alumina Refining and Primary Aluminum Production
- Ball and Roller Bearing Manufacturing
- Computer Storage Device Manufacturing
- Electronic Computer Manufacturing
- Guided Missile and Space Vehicle Manufacturing
- Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing
- Military Armored Vehicle, Tank, and Tank Component Manufacturing
- Nuclear Electric Power Generation
- Optical Instrument and Lens Manufacturing
- Other Basic Inorganic Chemical Manufacturing
- Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing
- Petrochemical Manufacturing
- Powder Metallurgy Part Manufacturing
- Power, Distribution, and Specialty Transformer Manufacturing
- Primary Battery Manufacturing
- Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing
- Research and Development in Nanotechnology
- Research and Development in Biotechnology (except Nanobiotechnology)
- Secondary Smelting and Alloying of Aluminum
- Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing

- Semiconductor and Related Device Manufacturing
- Semiconductor Machinery Manufacturing
- Storage Battery Manufacturing
- Telephone Apparatus Manufacturing
- Turbine and Turbine Generator Set Units Manufacturing

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