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Treasury Department Issues Proposed CFIUS Regulations To Implement FINSA Amendments To Exon-Florio

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On April 23, 2008, the Treasury Department ("Treasury") issued proposed regulations to implement the Foreign Investment and National Security Act ("FINSA"), the statute Congress passed last year to reform the process by which the inter-agency Committee on Foreign Investment in the United States ("CFIUS") conducts national security reviews of mergers, acquisitions or takeovers of U.S. businesses by foreign persons. The period for public comment on the proposed regulations expired on June 9, 2008, and Treasury is currently reviewing the proposed regulations in light of the 25 comments it received. Treasury expects to publish final regulations implementing FINSA later this year. This article provides a review of the major procedural and substantive changes to the CFIUS process precipitated by the proposed regulations and considers their effect on U.S. goals of foreign investment and national security.

Background

In drafting the proposed implementing regulations, Treasury was charged with balancing the related, but oftentimes competing,

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priorities of safeguarding U.S. national security and promoting economic openness. In the post-9/11 world, CFIUS has faced tremendous pressure to scrutinize foreign acquisitions of U.S. businesses against broad and evolving concepts of national security, culminating in the passage and enactment of FINSA in July 2007. The growing economic power and U.S. investment activities of sovereign wealth funds and other state-controlled entities have only served to heighten apprehensions about the motivations of foreign investors. Highlighting these concerns, Sen. Robert Menendez (D-NJ) and several of his colleagues on the Senate Banking Committee recently urged CFIUS to review the proposed acquisition of a U.S. railroad company by a foreign hedge fund, emphasizing, "Foreign investment in the United States is often important to our economy, but the security of our citizens always comes first."

At the same time, Treasury Secretary Henry Paulson has acknowledged that the "U.S. economy is going through a rough period," and that America needs to "keep [its] markets open at home to investment from private firms and from sovereign wealth funds." Several policy analysts have similarly recognized that a strong economy is part of national security. In this context, expanding the depth and breadth of CFIUS review could create a barrier to foreign investment in the U.S. market during a period of economic downturn.

Given these political dynamics, the proposed regulations attempt to strike a balance between making the CFIUS process more transparent and predictable for foreign investors in undertaking acquisitions of U.S. businesses, and more flexible and discretionary for CFIUS in reviewing national security issues associated with such transactions. To this end, the proposed regulations make both procedural and substantive

amendments to the current CFIUS process, reflecting Secretary Paulson's position that "[n]ations can protect their security interests and simultaneously create world-class, competitive industries that offer opportunity to all their people."

Procedural Changes

In drafting the proposed regulations, Treasury avoided entirely rewriting CFIUS review procedures, instead favoring clarification and codification of long-adhered-to practices, to make the process more predictable and efficient while also ensuring the submission of accurate and complete information.

Pre-filing

The proposed regulations' first impact on the CFIUS process occurs before the formal filing of the notice, with Section 800.401 making explicit CFIUS's pre-FINSA practice of encouraging parties to engage in pre-filing consultations with the Committee. Such consultations may include participating in initial meetings with CFIUS officials and/or providing draft notices or information that will later be included in a formal notice. These preliminary contacts and submissions allow CFIUS to better understand the transaction and advise the parties on what additional information is needed to complete its review. Although pre-filing remains voluntary, the proposed regulations evidence CFIUS's preference for this process. Accordingly, some commenters requested more guidance from CFIUS on expectations for this pre-notification phase. On the whole, most were pleased with the pre-filing recommendation.

Information Requirements

Additionally, the proposed regulations increase the information that the parties are required to submit to CFIUS as part of the notice. For example, the proposed regulations require submission of corporate structure charts, personal identifier information for certain company officials, and identification



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of contracts between the parties and U.S. government agencies. Many of these new requirements codify questions that CFIUS had routinely asked parties after the submission of the notice, and their inclusion in the regulations should streamline the review process. However, at least one commenter highlighted the increased compliance costs incurred as an “unfortunate consequence” of these regulatory requirements, especially in cases where the questions are not relevant to the transaction at hand. Moreover, under the proposed regulations, parties have two business days to reply to additional information requests from CFIUS, risking dismissal of the notice unless they receive an extension from the Committee. Some commenters raised concerns about whether a two-business-day rule is reasonable, given the differences in time zones associated with international transactions.

Penalties

Finally, the proposed regulations authorize CFIUS to impose civil penalties of up to \$250,000 per violation for intentional or grossly negligent submission of material misstatements or omissions in a notice or submission of a false certification. Moreover, for violations of mitigation agreements reached with the U.S. government, CFIUS may seek civil penalties of up to \$250,000 per violation or the value of the transaction. The regulations defer to CFIUS to make penalty determinations on a case-by-case basis. Some concern has been raised about whether aggressive penalties will dissuade foreign parties from investing in the United States at all. In particular, one commenter noted that while penalties for false filings were capped at \$250,000 per violation, penalties for violations of mitigation agreements could reach the value of the transaction. The commenter suggested that CFIUS align the penalty structures for false filings and violations of mitigation agreements so that civil penalties would not exceed \$250,000 per violation.

Substantive Changes

The proposed regulations also make substantive changes to the CFIUS process. Thematically, these changes provide the Committee with significant discretion in scrutinizing foreign investments and evaluating national security risks.

“Control”

The concept of “control” is the cornerstone of the CFIUS process. Under FINSA, CFIUS is authorized to review “covered transactions,” meaning those that could result in “control” of a U.S. business by a foreign entity, to evaluate the effects of such transactions on the national security of the United States. FINSA does not define control, instead delegating this authority to CFIUS. With the proposed regulations, Treasury pre-

serves the pre-FINSA functional concept of control, defining it in general terms as the ability to “determine, direct, or decide important matters affecting an entity.” The proposed regulations eschew categorical bright-line tests, including the so-called “safe harbor” for acquisitions of 10 percent or less of a U.S. company’s voting securities, clarifying that this exemption applies only to transactions that are “solely for the purpose of investment.” Some commenters expressed concern that the rejection of a numerical threshold for control would unduly expand the universe of covered transactions and encourage investors to divest important rights that could otherwise be deemed control.

While Treasury’s definition of control remains imprecise, the proposed regulations do offer some additional guidance to parties regarding whether this threshold is met. For example, the proposed regulations list several factors that constitute indicia of control, such as the ability to select new business lines or the power to appoint senior officers. Moreover, the proposed regulations provide a list of minority shareholder protections that CFIUS generally will not consider as conferring control, including the power to prevent the sale of all of the assets of an entity and the power to prevent a firm from entering into contracts with majority investors. Given the importance of the concept of control, several commenters recommended that CFIUS expand the list of minority protections deemed insufficient to constitute control. In addition, some commenters encouraged CFIUS to create a mechanism for providing pre-filing determinations on the issue of control. Others cautioned that such preliminary determinations would hinder the CFIUS review process because they would necessarily be made on the basis of partial information, potentially leading to incorrect decisions on this critical issue.

“Foreign Government-Controlled Transactions”

FINSA creates a heightened level of scrutiny for “foreign government-controlled transactions,” subjecting them to a second-stage investigation by CFIUS unless the secretary of Treasury and lead agency assigned to the case jointly determine that the transaction will not impair national security. The proposed regulations broadly define a “foreign government-controlled transaction” as “any covered transaction that could result in control of a U.S. business by a foreign government.” As such, whether a transaction qualifies as a “foreign government-controlled transaction” will depend on CFIUS’s interpretation of the flexible definition of “control” in the proposed regulations. Because of the ambiguity associated with the definition of control and concerns about an “easy rise to arbitrariness” in its application,

several commenters asked Treasury to further clarify the meaning of “foreign government-controlled transaction.” In particular, comments from Chinese government and business entities, which represented nearly one-third of all comments submitted, argued that the current definition was over-inclusive and discriminatory, with one commenter noting that the proposed regulations reflected “enshrouded protectionism” and “self-evident hostility to ‘foreign government-controlled’ transactions.”

“Critical Infrastructure”

Under FINSA, transactions involving “critical infrastructure” are presumed to implicate national security. Although some U.S. and foreign industry representatives anticipated that CFIUS would clarify FINSA’s definition of “critical infrastructure,” the proposed regulations generally mirror the statutory definition, covering “systems and assets, whether physical or virtual, so vital to the United States that the[ir] incapacity or destruction . . . would have a debilitating impact on national security.” By adhering to FINSA’s definition of “critical infrastructure,” CFIUS assuaged concerns among many in the trade community that it would designate particular industries as “critical infrastructure” and ultimately make certain sectors of the U.S. economy off-limits to foreign investment. On the other hand, the proposed regulations leave in place what many view as a substantial expansion of CFIUS review under FINSA, providing for review that extends beyond traditional concepts of national security related to defense or intelligence-related assets. In this context, at least one commenter urged CFIUS to narrow the definition of “critical infrastructure” by providing a list of “safe harbor” industries excluded from review. For now, the proposed regulations ensure that national security reviews and determinations will occur on a case-by-case basis, injecting some uncertainty into the process but allowing CFIUS flexibility in assessing and addressing national security risks.

Conclusion

Treasury’s proposed implementing regulations reflect a careful balancing of U.S. priorities of national security and economic openness. While the comments on the proposed regulations highlight the difficulty of achieving both objectives, they also indicate that Treasury largely succeeded in creating a process in which the importance of both national security and foreign investment is recognized. Accordingly, although the final regulations may incorporate some minor changes suggested by the comments, it is unlikely that they will depart significantly from the proposed regulations, which have sought to take into account the dual, and often conflicting, goals of FINSA.