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CFIUS Implements FINSA Amendments To Exon-Florio Foreign Investment Law

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The Foreign Investment and National Security Act (“FINSA”), which Congress passed last year for the purpose of reforming the process by which the inter-agency Committee on Foreign Investment in the United States (“CFIUS”) conducts national security reviews of proposed acquisitions of U.S. businesses by foreign persons under the Exon-Florio amendment to the Defense Production Act, contemplates that implementing regulations would become effective no later than April 21, 2008. However, Assistant Treasury Secretary for International Affairs Clay Lowery recently announced that CFIUS would not meet the statutory deadline for finalizing regulations, but would target publication of proposed regulations by the end of April 2008, with a 30-day period of public comment. In the meantime, President Bush issued an executive order expanding CFIUS membership and revising CFIUS procedure to reflect some of the major concepts of FINSA. CFIUS has since been observing the requirements of the executive order and applying some of the FINSA principles, even as Treasury works to develop regulations to implement FINSA. This article discusses how CFIUS has changed its practices since FINSA went into effect and what the implementing regulations will mean for FINSA’s twofold goal of encouraging foreign investment and safeguarding national security.

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Background

FINSA was enacted in response to U.S. public and political criticism of several high-profile transactions that raised concerns about the sufficiency and effectiveness of CFIUS procedures for protecting national security in the face of foreign investment. When FINSA went into effect, the Administration touted it as striking the right balance between making the United States open to foreign investment and protecting the nation’s security. On the one hand, FINSA promotes the attractiveness of the United States as a destination for foreign investment by making the CFIUS process more transparent and predictable through the codification of certain CFIUS practices. On the other hand, FINSA reflects a deliberate recalibration of CFIUS procedures by expanding the scope of national security reviews and enhancing congressional oversight of the CFIUS process. FINSA gives CFIUS the authority to review “covered transactions,” meaning “any merger, acquisition or takeover . . . by or with any foreign person which *could* (emphasis supplied) result in foreign control of any person engaged in interstate commerce in the United States.” It adds to the factors that CFIUS may consider in determining whether a proposed foreign investment transaction threatens national security, and it mandates that acquisitions of “critical infrastructure” and “foreign government-controlled transactions” proceed to a 45-day investigation. In addition, while FINSA preserves the secretary of Treasury as the chairperson of CFIUS, it requires the appointment of a lead agency in each case and provides for greater involvement of the intelligence community in the review process by appointing the director of national intelligence as a nonvoting *ex officio* member of the Committee.

In recognition of post-FINSA concerns about a paradigm shift in national security considerations that would reflexively trump

foreign investment, President Bush issued an executive order on January 23, 2008, in which he reaffirmed the importance of international investment to the U.S. economy. The executive order enhances the role of economic agencies by naming the United States trade representative as an additional member of CFIUS and designating the director of the Office of Management and Budget, the chairman of the Council of Economic Advisors, and the assistant to the president for economic policy to perform supporting roles for the Committee. The executive order also implements the FINSA requirement to appoint a lead agency or agencies in each case, codifies CFIUS risk-mitigation practices, and requires member agencies to communicate with parties through or in the presence of the lead agency or chairperson.

FINSA In Practice

CFIUS has completed over 30 reviews since FINSA went into effect six months ago. CFIUS practice in those cases has reflected a recognition of many principles embedded in FINSA. CFIUS’s application of FINSA’s provisions heretofore may inform the content of the implementing regulations insofar as they relate to the scope and administration of CFIUS review.

Current CFIUS regulations define “control” functionally, in terms of the ability of the acquirer to make certain important decisions affecting the acquired entity. *See* 31 C.F.R. § 800.204(a). CFIUS practice over the past six months has preserved some of the current exclusions of certain transactions based on the “control” test. In this regard, the regulations exempt from CFIUS review passive investment and establish a “safe harbor” for acquisitions of 10 percent or less of a U.S. company’s voting securities. *See* 31 C.F.R. § 800.302(d)(1). Several recent passive investments by sovereign wealth funds (“SWFs”) reportedly avoided CFIUS review on this



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basis, including the Abu Dhabi Investment Authority's purchase of 4.9 percent of Citigroup and Singapore's Temasek Holdings' purchase of 9.4 percent of Merrill Lynch. CFIUS regulations also exempt joint ventures from review where control is shared equally by the partners. See 31 C.F.R. § 800.301(b)(5). In at least one case post-FINSA, CFIUS determined that it did not have jurisdiction to review a transaction in which a U.S. corporation and a foreign corporation established a U.S. joint venture and shared control equally.

Other cases suggest that CFIUS may abandon traditional corporate standards of control, as reflected in the current regulations, and pursue a more flexible concept whereby it will assert jurisdiction to review and take action in transactions where the foreign investor acquires less than a majority of the domestic company's voting securities. For example, CFIUS reviewed the proposed acquisition of 3Com Corporation by Bain Capital Investors, LLC, a private equity fund, which involved a minority investment by a Chinese telecom company. The parties abandoned the deal reportedly because CFIUS intended to take action to prohibit the transaction.

Moreover, in the post-FINSA world, CFIUS review of "foreign government-controlled transactions" appears to be more robust. Under FINSA, CFIUS is required to conduct investigations of "foreign government-controlled transactions" following the initial 30-day review unless the secretary of the Treasury and the head of the lead agency assigned to the case make a determination that the transaction does not threaten to impair national security. In testimony before the House Committee on Financial Services on March 5, 2008, Under Secretary for International Affairs David H. McCormick stressed that Treasury had already implemented this elevated level of CFIUS review.

Implementing Regulations

Treasury officials have indicated that the Department is working steadily and vigorously on drafting the FINSA regulations. It is expected that the regulations will focus on several key issues, including provisions that clarify the meaning of "control," "foreign government-controlled transactions" and "critical infrastructure." These provisions will be especially significant in defining the reach of CFIUS under FINSA.

"Control"

In response to its October 11, 2007, request for comments on issues relating to CFIUS review and the implementation of FINSA, Treasury received several submissions from the private sector seeking clarification of the definition of "control" and urging Treasury to make the standards for CFIUS review more objective. At least one commenter encouraged Treasury to institute threshold demarcations to exclude certain

minority investments from CFIUS jurisdiction altogether and to clarify that all passive investments are outside the ambit of CFIUS review. On the other hand, many government officials separately have called on Treasury to avoid adopting bright-line thresholds to establish "control." In a joint letter to the Treasury Department on March 13, 2008, Reps. Barney Frank, Carolyn Maloney and Luis V. Gutierrez, all of whom serve on the House Financial Services Committee, specifically asked Treasury to explain the role of the 10 percent investment threshold as a test of control, expressing concerns about creating a false impression that certain investments are insulated from CFIUS review.

CFIUS previously has declined to adopt a control test based on objective standards, such as particular percentages of stock ownership or the composition of the board of directors. Treasury may use the implementing regulations as an opportunity to eliminate the current "safe harbor" provisions under the Exon-Florio law or to present more precisely the elements that provide indicia of control. Either of these changes could expand the number of "covered transactions" subject to review.

"Foreign Government-Controlled Transactions"

Private-sector representatives and government officials alike have expressed their expectation that the implementing regulations will clarify the application of FINSA to "foreign government-controlled transactions," defined as "covered transactions" that could result in the control of a U.S. person by a foreign government or entity controlled by a foreign government. In this context, business groups have submitted comments cautioning that not all foreign government-controlled entities are created equally. In particular, some comments highlighted the risks of treating commercial companies as "foreign government-controlled" in instances where government control is limited to veto rights over foreign acquisitions through "golden shares" in the company, analogizing such control to that exerted by the U.S. government through CFIUS review. Moreover, one commenter suggested that some foreign pension funds should not be considered "foreign government-controlled" at all and recommended that CFIUS develop specific criteria for evaluating whether an entity's investment decisions are subject to government influence or control.

In their March 13 letter to Treasury, Reps. Frank, Maloney and Gutierrez also called on CFIUS to provide guidance for distinguishing among different types of foreign government-controlled investments. Specifically, they asked the Department to describe the factors that CFIUS would consider in determining whether to exempt a foreign government-controlled transaction from an investigation, as provided under FINSA. Presented in the context of broader concerns surrounding SWFs, the representatives recommended that the reg-

ulations delineate positive factors, such as a commercial investment mandate and corresponding policies and procedures, for consideration in the application of the exception and as a means of exerting pressure on funds to follow best practices. Given that Treasury recently met with the governments of Singapore and the UAE to discuss adoption of best practices for their SWFs, it is possible that CFIUS may consider incorporating some of these standards, including transparency and corporate governance, into the implementing regulations.

"Critical Infrastructure"

FINSA creates a presumption whereby transactions involving "critical infrastructure" are considered to implicate national security concerns. FINSA defines "critical infrastructure" as "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." FINSA requires Treasury to issue guidance by April 21, 2008, describing transactions that CFIUS has reviewed that have raised national security considerations, with a particular focus on transactions involving foreign government control of critical infrastructure.

Although FINSA defines the term "critical infrastructure" more narrowly than statutes in the homeland security context, some comments that Treasury received reflected concerns that this category may be extended to encompass systems or assets affecting economic security, public health or public safety. Other comments urged Treasury to narrow the meaning of "critical infrastructure" by excluding from it certain categories of infrastructure, such as physical infrastructure systems and assets for which there are viable alternatives. In the meantime, the only example that FINSA provides of "critical infrastructure" is "major energy assets." It remains to be seen whether Treasury will specifically designate other industries, such as banking, telecommunications or transportation, as falling under the category of "critical infrastructure," or whether it will choose to develop a more flexible definition of the term to capture a potentially wider range of national security concerns.

In conclusion, by clarifying the meaning of key terms under FINSA, such as "control," "foreign government-controlled transaction" and "critical infrastructure," CFIUS will establish the scope of its national security review under the new law. The parameters that CFIUS places on its review authority and the practices it uses to conduct its review may result in a shift in the balance of U.S. goals of economic openness and national security. In delaying the implementing regulations, CFIUS is undoubtedly attempting to formulate definitions and procedures that serve both interests.