China and Regulatory Practices

Fall 2018 CFIUS White Paper

New Legislation and New Challenges

Many US-China deals are still getting done, but there is no question the challenges facing those deals has increased over recent months. Relatively few transactions have emerged from the CFIUS process since earlier this year; some have cleared and some have not. Our review of publicly available information indicates that the clearance rate for US-China deals since the Trump Administration took office has fallen from about 55% earlier this year to about 50%, but two very high-profile deals received approval (an acquisition by COSCO which involved a pier in Long Beach Harbor, and China Oceanwide's acquisition of Genworth Financial). We continue to believe that careful selection of target assets, early risk assessment, and transparent filings with CFIUS will still allow many if not most deals to get through.

In the meantime, Congress included in the FY19 National Defense Authorization Act legislation agreed by both houses called the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). This legislation made some changes to the CFIUS process will be effective immediately, and others which will be effective after CFIUS promulgates implementing regulations. The impact of FIRRMA is described below.

The CFIUS National Security Review Process

CFIUS, shorthand for the Committee on Foreign Investment in the United States, is the US national security review system under which the US government can review any foreign acquisition of a US business based on its potential impact on national security. Once regulations following FIRRMA are promulgated, acquisitions of real estate will also be reviewable, even if they do not technically involve a "US business." Note that FIRMMA also gives CFIUS the authority to implement pilot programs, and the Committee and may also issue interim regulations and guidance.

For now, CFIUS filings are voluntary, although if parties do not make a filing, CFIUS retains jurisdiction indefinitely to request a filing and review the transaction, even after it closes. FIRRMA will make the filing of a short-form "declaration" mandatory in some circumstances, once implementing regulations are promulgated by CFIUS. After review, CFIUS can require changes to the transaction. In rare cases, CFIUS will recommend to the President that a deal be blocked. If the parties do not voluntarily file, CFIUS retains the power to review, require changes, or recommend divestiture or other changes to a foreign party's holdings after closing. False statements in submissions, and violations of mitigation agreements, are punishable by fines.

As outlined below, CFIUS was established in 1975 and for many years was not a major concern for most international transactions. In recent years the concern has heightened, and under President Trump, CFIUS sometimes seems to have become a weapon in the political wars being fought in the United States. As a result, foreign acquirers and investors must evaluate the impact of CFIUS early in every deal whether the target includes assets or operations in the United States.

History of CFIUS

The Committee on Foreign Investment in the United States is an inter-agency committee that operates under the direction of the President. It is chaired by the Secretary of the Treasury and includes the heads of Justice, Homeland Security, Commerce, Defense, State and Energy as well as the US Trade Representative (USTR) and the director of the Office of Science and Technology Policy. There are other offices that are advisors to the Committee, including the National Security Council.

CFIUS was established in 1975. The original policy rationale was protection of "critical national infrastructure." However, in 1988, the addition of the Exon-Florio amendments to the Defense Production Act of 1950 (currently codified in Section 721 of the Foreign Investment and National Security Act) gave the President non-reviewable authority to block foreign acquisitions on national security grounds. This authority was delegated by the Reagan Administration to CFIUS. The Congressional Research Service has written that "CFIUS was [thereby] transformed from a purely administrative body with limited authority to review and analyze data on foreign investment to one with a broad mandate and significant authority to advise the President on foreign investment transactions and to recommend that some transactions be blocked."

The Foreign Investment and National Security Act of 2007 (FINSA) greatly increased the significance of CFIUS to companies doing international transactions. The Act was passed after the Dubai Ports World scandal and amended the CFIUS process to give Congress greater oversight; expanded the meaning of "national security" to include critical infrastructure; and required CFIUS to investigate (not merely review) all covered transactions deals where the foreign buyer is owned or controlled by a foreign power.

The FINSA regulations of 2009 reinforced the authority of CFIUS under FINSA. Some commentators have noted that although FINSA did strengthen the hand of CFIUS, it also imposed more predictability on the process and attempted to remove some of the politics. But the rise of China's economy—and the rise of economic nationalism in the United States—have reinjected politics into the process.

Reforms to CFIUS process were added as Title XVII of the FY2019 National Defense Authorization Act (NDAA), mostly to increase the efficiency of the process. The additions were a result of legislation called the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which was attached to the NDAA.

As a statistical matter, most cross-border transactions are never submitted to CFIUS, and there are some, but not many, cases where CFIUS has exercised its power to require a review after a transaction closes. In the current climate, however, China-related transactions are in the spotlight, and parties bypass CFIUS at their risk.

Also, as a statistical matter, most—perhaps 90% or more—transactions submitted to CFIUS are cleared. Since the Trump inauguration, the statistics have been much less positive for China-related deals. As discussed in more detail below, China deals are still getting done, but parties must be smarter in picking their deals and in prosecuting their CFIUS applications.

What Transactions are Subject to CFIUS?

Not all foreign investments in the US are covered by CFIUS. Whether a transaction is subject to the jurisdiction of CFIUS, and whether parties are well advised to voluntarily file an application with CFIUS, requires a case-by-case evaluation of the facts involved in the transaction, including the nature of the transaction, the identities of the parties, and the type of US business being acquired.

"Covered Transactions"

CFIUS only applies to "covered" transactions which could present national security implications. "Covered transactions" are defined as:

- any proposed or completed merger, acquisition, or takeover,
- by or with any foreign person (foreign national, government or entity, or an entity controlled by any of the foregoing),[1]
- which does or could result in "control,"
- of a "US business" by that foreign person

FIRRMA will add two other categories of transaction to those "covered" by CFIUS, once implementing regulations are promulgated by the Committee:

- certain non-controlling investments by certain foreign persons ("other investments")
- transactions, by investors from certain identified countries, involving the acquisition of real estate in close proximity to military installations and certain other facilities

If a transaction is a "covered transaction," then CFIUS has the jurisdiction to examine it for purposes of determining whether it presents a risk to US "national security." That term is not precisely defined and as applied, its meaning has evolved over time. Just what constitutes "national security" will be discussed later in this briefing.

"Merger, Acquisition or Takeover"

For now, CFIUS only applies to acquisitions of interests in US businesses—thus, it applies to acquisitions, mergers, takeovers, investments, and other business combinations. It does not currently apply to other types of business transactions, such as strategic alliances, marketing and distribution arrangements, debt financings (unless they are coupled with sufficient indicia of control or convertible into equity ownership), licensing agreements, or other non-acquisitory transactions unless the arrangement involves contribution of a US business.

Until regulations mandated by FIRRMA are released (or potentially CFIUS institutes a pilot program implanting this provision), CFIUS does not apply to the purchase of raw or undeveloped land or other greenfield investments, because even if there may be an "acquisition" involved (of land, land use rights, a building, etc.), there may be no acquisition of a "US business." However, as noted above, FIRRMA will extend the coverage of CFIUS to include transactions, by investors from certain identified countries, involving the acquisition of real estate in close proximity to military installations and certain other facilities. This is discussed further below.

In an attempt to work around the constraints of CFIUS, many parties to US-China transactions in recent months have explored the use of joint ventures, long-term debt financing, or licensing arrangements as a way to postpone or avoid entirely the need to consider a CFIUS filing. However, if such an arrangement amounts in substance to the acquisition of a "US business," then it would be covered even if its form is not an "acquisition."

"Foreign Person"

CFIUS only applies when the acquirer is a "foreign person." This seems like a point only lawyers could love, but the question is not whether the acquirer is a "foreign entity," but rather whether it is a "foreign person."

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[1] For purposes of this briefing paper, "foreign" will mean "non-US" and "domestic" will mean US.

A "foreign person" is defined in the CFIUS regulations (31 CFR 800.216) as a "foreign national," "foreign government," "foreign entity" or any entity over which control is exercised or exercisable by any of the foregoing. This leads to some interesting permutations:

- An entity organized in a foreign country and controlled by foreign nationals or a foreign government is clearly both a "foreign entity" and a "foreign person." However, *a "foreign entity" nevertheless might not be a "foreign person"* if it is ultimately controlled by US individuals or entities, and no foreign individual, entity or government has any significant ability to control it.

- At the same time, *an entity organized in the US* is clearly not a "foreign entity," but it *nevertheless could be a "foreign person"* if there is a sufficient degree of control exercised over that entity by a foreign individual, entity or government.

Thus looking only at where an entity is organized does not answer the question. It is necessary to look "under the hood" and determine who or what controls the entity in question. What constitutes sufficient indicial of control is another difficult question and is discussed below.

"Control"

"Control" is defined as the ability to direct or decide important matters affecting an entity, as shown by ownership of voting interests, board representation, proxy voting, special shares, contractual arrangements, formal or informal arrangements to act in concert or other means. (Note that after the regulations mandated by FIRRMA are promulgated, certain non-controlling investments will also be covered.)

Examples of "important matters" are provided in the CFIUS regulations. Side agreements or disproportionate voting rights could cause a minority interest holder to control the business. However, the regulations specify certain minority shareholder protections that do not convey control, such as the power to prevent the sale of all or substantially all of the company's assets. "Customary minority protections" that are often given to venture capital and other investors in US businesses may, or may not, amount to a sufficient degree of control to trigger CFIUS.

If the terms of an investment permit a party to gradually acquire greater control, eventually resulting in "control," it may be prudent to report the transaction at the outset—for example, a convertible debt financing, the issuance of warrants or options, etc.

Finally, loans and other credit arrangements, without more, do not amount to "control"; however, if a debt transaction gives a foreign party the right to acquire control over a business in the event of default or other circumstances, this may indicate a CFIUS filing. Given the somewhat murky definition of "business," a blanket lien could, for example, amount to acquisition of control.

Non-Controlling Investments

FIRRMA added to the scope of "covered transactions" certain types of non-controlling investments by specified foreign persons. Although these provisions will not be effective until implementing regulations are promulgated (or perhaps earlier if CFIUS institutes a pilot program), investors should be aware of the expanded reach of the national security review process.

The new legislation imposes a three-part test that focuses on the type of business, the type of investment, and the type of country. All three parts of the test must be met.

Sensitive business. The business in which the non-controlling investment is being made:

- Owns, operates, manufactures, supplies or services *critical infrastructure*;
- Produces, designs, tests, manufactures, fabricates, or develops on or more *critical technologies*; or
- Maintains or collects *sensitive personal data* of US citizens that may be exploited a manner that threatens national security.

Access to sensitive information or substantive influence. The investment gives the foreign person:

- Access to material non-public technical information;
- A board seat or observer rights; or
- Any involvement, other than through voting of shares, in substantive decision-making of the US business relating to the three areas of sensitivity above (sensitive personal data of US citizens, critical technologies, or critical infrastructure).

Certain foreign countries. CFIUS is required to develop regulations limiting the definition of a "foreign person" in the context of non-controlling but nevertheless covered transactions—in other words, only certain categories of foreign persons will be subject to the increased coverage for non-controlling investments. The regulations remain to be written as of 2018 and therefore the expansion to non-controlling investments is not yet effective.

"US business"

Surprisingly, it is not always clear whether the target of an acquisition is a "US business." Again, there are several permutations.

- **US target with US operations.** The acquisition of 100% of a company is clearly the acquisition of a business. Thus acquisition of 100% of, or a controlling interest in, a US company with operations in the US clearly triggers CFIUS, regardless of whether the target is controlled by US or foreign nationals (because the inquiry with regard to the target is not whether it is foreign or domestic, but whether its business includes a "US business").
- **US target with no US operations.** This would be an unusual fact pattern, but it focuses the question on whether the target of the acquisition is a "US business."
- **Foreign target with no US operations.** By definition, a transaction with a target that has no "US business" is not a "covered transaction."
- **Foreign target with some US business.** The foreign parent of a US subsidiary is not necessarily *itself* a US business. However, a transaction with a foreign target that has some US business *does* implicate CFIUS as regards that US business. This was the case in the recent blocked acquisition of Aixtron. In that case, a Chinese company proposed to acquire a German semiconductor company with US subsidiaries, design center and other operations. CFIUS ultimately blocked the deal with respect to the US business, meaning the PRC entity was prohibited from acquiring the US assets.
- **Acquisition of assets only.** The acquisition of assets (as opposed to an operating company) may, or may not, trigger CFIUS. This will require a case-by-case analysis of whether the assets are sufficient to constitute a "business." Buying a piece of equipment, or raw land, or even technology, might not constitute the acquisition of a "business." However, if the acquisition also involves the transfer of business operations, personnel, and the like, then an asset acquisition could still be the acquisition of a "business."

- **Joint ventures, licensing arrangements and other structures.** As noted above, these non-acquisition structures require the parties to consider both whether the nature of the deal is substantively equivalent to an "acquisition," regardless of its form; and whether the transaction gives a degree of control to a "foreign person" over a "US business." Thus the formation by a US party and a PRC party of a joint venture in China would not be a covered transaction if both parties simply inject cash; but if the US party injects a "business," even this transaction could be captured by CFIUS.

Real Estate in Sensitive Locations Will Be Covered

The 2018 FIRRMA legislation added to the scope of "covered transactions" acquisitions by foreign persons from certain identified countries of real estate in close proximity to military installations and certain other facilities. Formerly, the acquisition of raw real estate (which was not a "US business") was not covered. The list of foreign countries will be promulgated in the enabling regulations.

Effect on Private Equity Funds

The 2018 FIRRMA legislation provides some clarity with respect to an investment fund which is managed by US persons, but has foreign persons and limited partner investors. The legislation clarified for purposes of non-controlling "other investments" transactions made by investment funds would not be considered covered transactions when they are managed by US persons and foreign limited partners have no control over the fund. This means not only that the foreign limited partner cannot control investment decisions but that the foreign person cannot unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general partner.

Transactions Not Covered

Certain "passive investments" have not been captured by CFIUS, on the theory they are by definition non-controlling. After the FIRRMA regulations are promulgated, some "non-controlling" investments will nevertheless be covered; see the discussion above.

Under the current regulations, "passive investments" are transactions:

- conducted "solely for the purpose of investment," defined as those (i) in which the transaction does not involve owning more than 10% of the voting securities of the target; or (ii) those made directly by a bank, trust company, insurance company, investment company, pension fund, employee benefit plan, mutual fund, finance company, or brokerage company "in the ordinary course of business for its own account

- where the foreign party "has no intention of determining or directing the basic business decisions of the issuer"

Both tests must be met. In some senses the analysis is circular because an investment which provides "control" is not likely to be seen as "passive."

Pure financing transactions are not covered. Treasury Regulations provide that that the extension of a loan or a similar financing arrangement by a foreign person to a US business will not be considered a covered transaction and will not be investigated, unless the loan conveys a right to the profits of the US business or involves a transfer of management decisions.

Greenfield investments are generally not subject to CFIUS regulations. Examples include Tianjin Pipe's steel pipe mill in Texas, Suntech Power's solar panel assembly plan in Arizona and American Yuncheng's gravure cylinder plant in South Carolina.

Other transactions not covered include:

- stock splits or pro rata stock dividend that does not involve a change in control;

- an acquisition of any part of an entity or of assets that do not constitute a US business;

- an acquisition of securities by a person acting as a securities underwriter, in the ordinary course of business and in the process of underwriting; and

- an acquisition pursuant to a condition in a contract of insurance relating to fidelity, surety, or casualty obligations if the contract was made by an insurer in the ordinary course of business."

"National Security"

In some countries, regulations are "list-based;" that is, the government publishes a list of matters, parties, or sectors that are covered by the regulations. China's Foreign Investment Catalog takes this approach, and the US has similar lists in export control, environmental, and other areas.

CFIUS is not "list-based." Rather, it has a broad, and not specifically defined mandate to protect the national security of the United States. What constitutes "national security" evolves over time and is subject to the political environment in the United States. This is by design: Congress intended to give CFIUS wide and flexible authority to review foreign investment in the US.

That said, Section 721 of FINSA does contain a list of factors that CFIUS is to take into account. The list is reproduced in Appendix A and is useful but so broad that it only provides general guidance in the context of a given transaction. The Treasury Department also published guidance in 2010.[2]

Based on this guidance and observations of actual cases before CFIUS, it is possible to list some of the major areas parties should analyze in light of the national security mandate of CFIUS:

- **Foreign government-controlled parties.** In these cases CFIUS must not only review, but must also "investigate" the transaction if it could "affect the national security of the US" and the effect is not adequately mitigated.

- **Where the transaction affects critical infrastructure.** In this area, the statues "sets a high standard, defining critical infrastructure as: "any systems and assets, whether physical or cyber-based, so vital to the United States that the degradation or destruction of such systems or assets would have a debilitating impact on national security, including national economic security and national public health or safety.

- **Where the transaction is in a sensitive sector or involves sensitive technology.** Non-government related businesses where there are national security implications, such as energy, transportation, businesses that impact the US financial system, products or services subject to ITAR or US export controls, or involving critical infrastructure. Recently the semiconductor sector has clearly been regarded by CFIUS as "sensitive." CFIUS has also expressed an interest in robotics, artificial intelligence, augmented reality, and drones even where the technology may currently be classified as "EAR99."

- **Where the target has government contracts or has received federal support.** US businesses that provide products or services to the US government, either as prime contractors or subcontractors, or as suppliers to prime contractors,

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[2] Available online at https://www.treasury.gov/resource-center/international/foreign-investment/Documents/GuidanceSummary_12012008.pdf and https://www.treasury.gov/resource-center/international/foreign-investment/Documents/CFIUSGuidance.pdf.

where the US agency has functions relevant to national security—e.g., information technology, telecommunications, energy, natural resources, and industrial products), where the target has security clearances or classifications, or deals with classified information or contracts, or where the target has received R&D or other government funding or subsidies.

- **Where the target has access to classified information.** If the target's employees or other representatives have security clearances or access to classified information, a CFIUS filing is likely to be prudent.

- **Risk of interruption in supply.** CFIUS often will inquire whether the foreign acquirer, acting independently or under instructions from its home government, can delay, deny or place conditions upon the provision of output from the target, where that output is critical to US national security.

- **Risk of leakage of sensitive technology.** CFIUS is concerned about the risk of leakage of sensitive technology, and will look at how much damage would be done if the technology were deployed against US assets, and how readily available the technology is and therefore whether it makes sense to block a specific deal.

- **Risk of access to personal identifier information.** CFIUS has raised concerns where a foreign acquirer could obtain access to personal identifier information, such as consumer financial information. Such risks are especially present where the US business may have personal identifier information of US Government employees.

- **Risk of spying.** In certain cases, CFIUS will be concerned about the risk that the acquisition would put the foreign acquirer in a position to acquire intelligence, sabotage or otherwise affect US national security concerns. It is therefore important to examine the proximity of a US business to sensitive locations and critical infrastructure (e.g., bridges, tunnels, power plants, etc.).

- **Track record of foreign party's home country.** CFIUS will take into account whether the foreign party's home country has a bad record regarding non-proliferation or other national security concerns.

- **Track record and reputation of the foreign party itself.** CFIUS will also consider the track record of the foreign party and its personnel themselves.

- **Blacklisted countries.** A transaction with a blacklisted country (North Korea, etc.) would be prohibited anyway and therefore would never reach CFIUS. But CFIUS may ask about the foreign investor's dealings with countries subject to US sanctions, on the notion that technology could leak; these concerns conceivably could lead to mitigation agreements or even a recommendation to suspend or prohibit a transaction.

- **Size of transaction.** The size of the transaction is *not* a factor considered by CFIUS.

- **Hi-tech sector.** Although national security concerns often arise in high-technology businesses, this is not a factor considered by CFIUS in and of itself—although clearly many hi-tech sectors are national-security sensitive. However, even low-technology businesses can touch on national security or other concerns, or can be located in proximity to sensitive installations. Hotels and food processing are two examples of low-tech businesses which have been subject to CFIUS review.

CFIUS Process

As described in detail below, parties must first decide if they believe the transaction is potentially covered by CFIUS. Once implementing regulations under the 2018 FIRRMA legislation are promulgated, the filing will be *mandatory in certain circumstances*, including where the acquiror has a substantial government ownership, the acquisition is substantial, and sensitive sectors or information are involved. This is discussed below.

The parties are encouraged to consult informally before making a decision to file or not file. If the parties file a notification, CFIUS has 30 days to review and can request additional information. In many cases, the process ends there. In a minority of cases—but almost always where the acquirer is Chinese—CFIUS will trigger a second, 45-day investigation period. In either situation, CFIUS can request negotiation of a mitigation agreement. In rare cases, CFIUS will recommend to the President that the deal be blocked. Note that due to an overwhelming number of cases and limited resources, there can be significant timing delays in this process, including the time required to provide comments on a draft notice, as well delaying the point in which CFIUS "starts the clock" on the 30-day review period. CFIUS could also request the parties withdraw and re-file the notice to allow for further review time.

Informal consultation is encouraged.

Parties are strongly encouraged to consult informally with CFIUS before any filing, whenever they believe there may be national security implications. A draft notice can be filed with CFIUS to guide these discussions at any time more than five days before the filing of a formal notice. CFIUS will provide comments and questions on the draft filing to be incorporated into the formal notification.

Draft notice

A draft notice can be filed with CFIUS to guide these discussions at any time more than five days before the filing of a formal notice. Under FIRRMA, CFIUS must provide comments or accept a formal notice no later than 10 business days after submission if the parties stipulate the transaction is a covered transaction.

Declarations (new under FIRRMA)

FIRRMA adds the concept of a CFIUS "declaration" that can be filed in lieu of a formal notice. The intent is to provide a shorter filing where parties want the benefit of the safe harbor and believe no national security concerns are implicated. A declaration will be *mandatory* where:

- a foreign person in which a foreign government has a "substantial interest" (a to-be defined term);
- acquires a "substantial interest" in a US business; and
- the acquisition involves "critical infrastructure, critical technology or sensitive personal data" (these are the three categories used in the non-controlling interest provisions, see discussion above; or

At the option of CFIUS, the Committee may require declarations for any covered transactions that involve a "critical technology" company.

Filing of formal notification

The notice (called a "joint voluntary notice") must include information about the parties, the transaction, the parties' market share, any involvement with the US government, sensitive or military technology or facilities, the completion date and net value of the deal. The foreign investor must provide detailed information about itself and its control persons, including biographical information. Certifications must be provided as to completeness and accuracy. All information submitted is confidential.

Filing Fee (new under FIRRMA)

FIRRMA added permission for CFIUS to assess and collect a filing fee for written notices, not to exceed the lesser of 1% of the value of transaction or $300,000. Filing fees are not required for declarations, though parties would presumably be subject to the fee if CFIUS requests the parties submit a written notice following a declaration.

45-day review period (new under FIRRMA)

Once a formal notification is made to CFIUS, the Committee has 45 days to review (formerly 30 days), during which time it can request additional information from and consultations with the parties. CFIUS will notify the parties as to the starting date of the 45-day period. If there is unanimous agreement to stop at this point, the process ends. Most reviews conclude after the 45-day review.

60-day investigation period (new under FIRRMA)

If CFIUS is unable to resolve a national security concern during the review period, it can initiate a 45-day investigation. Under FIRRMA, this 45-day investigation period can be extended by a 15-day period only in "extraordinary" circumstances. It is not clear whether the parties will still be able to withdraw and re-file if more time is needed.

Rejection of filing

It is possible for CFIUS to "reject" the filing by the parties; in one case, CFIUS rejected a filing on the grounds that it had information contradicting the information on the filing, which is supposed to be "complete and accurate." CFIUS suggested the parties might wish to check their facts and resubmit.

Changes to the transaction

CFIUS and the parties can negotiate a "mitigation agreement" to address any concerns. This may involve changes to the transaction, compartmentalization of sensitive operations or technology, or the like.

Recommendation to the President

CFIUS has the authority to recommend to the President that a transaction be blocked. If so, the President has 15 days to make a decision. This is rare. The President must find there is "credible evidence" that national security would be impaired, and that other US laws are not sufficient to protect the national interest.

Ongoing jurisdiction

If the parties do not file, CFIUS retains jurisdiction indefinitely to review any transaction, before or after completion.

Possible mitigation measures

Mitigation measures might include:

- Restricting access to potentially sensitive technologies, data or other information to a small group of US citizens;
- Creating clear policies and procedures for the handling of any potentially sensitive information;
- Developing a process for keeping appropriate US government personnel aware of any security concerns, including any business decisions that may implicate national security considerations; and

- Establishing a committee or some other apparatus within the company that is responsible for ensuring compliance with any actions taken. Any such committee should be appropriately supported by the company's board of directors.

Penalties

A person that either intentionally or through gross negligence submits a material misstatement or omission in a notice or makes a false certification to CFIUS may be subject to a civil penalty up to $250,000 per violation. A person that either intentionally or through gross negligence violates a material provision of a mitigation agreement with, or a material condition imposed by, the United States may be subject to the greater of (i) a civil penalty up to $250,000 per violation or (ii) the value of the transaction.

The Current Climate

The US policy approach to international investment traditionally has been to establish and support an open and rules-based system that is in line with US economic and national security interests. For deals notified to CFIUS, each transaction must be viewed individually in light of the specific facts and circumstances at play to determine whether there are any national security concerns that cannot be appropriately mitigated by the Committee. As an inter-agency committee, different US Government components may have competing viewpoints as to whether a transaction poses an unresolvable national security concern. For example, while certain US Government agencies, such as the Department of Defense (DOD) and Department of Homeland Security (DHS) may strongly advocate against foreign investment to protect a particular national security concern, other agencies committed to promoting open cross-border investment with limited government intervention would argue in support of economic investment in US companies.

In some cases, there may be particular US businesses or assets where there is no possibility of mitigating a national security concern. This often emerges when examining "proximity" issues, meaning where a US business may have certain assets located near sensitive US Government facilities or other critical infrastructure. Here, the possibility of surveillance or other actions by certain foreign actors may pose an unresolvable national security concern. More recently, the US Department of Defense (DOD) in particular has expressed a growing concern over certain types of Chinese investment in the US technology sector. In particular, DOD seeks to strengthen protections on "sensitive" technologies in order to decrease the risk of technology transfers that would directly enable key means of foreign military advantage and/or displace the United States' current technological edge. Highlighted emerging technology sectors include artificial intelligence, virtual reality, robotics, and financial technology.

Still, many investments either do not present a national security concern or if so, can be mitigated through a national security agreement with CFIUS. As the CFIUS review process is strictly confidential, there are undoubtedly many transactions involving Chinese acquirers that have cleared CFIUS with little fanfare. In the public domain, there have been several transactions cleared during the Trump Administration that continue to demonstrate the US is not completely closed off to Chinese investment. For example, in 2017 Zhengzhou Coal Mining Machinery Group Ltd. (Zhengzhou) and Zhongan Zhaoshang Equity Investment LLP (controlled by China Renaissance Capital Investment) received CFIUS clearance in connection with acquisition of Robert Bosch Starter Motors Generators Holding GmbH, which included a US business and manufactures starter motors and generators for cars. In November 2017, CFIUS reviewed and cleared Bison Capital's 20 million share investment in Cinedigm Corp., a media content distributor. Finally, in December 2017, Naura Microelectronics Equipment Co. Ltd. received CFIUS clearance in connection with a deal to buy US semiconductor manufacturing equipment company Akrion Systems LLC. And in 2018, CFIUS cleared an acquisition by the shipping company COSCO of assets including a pier in Long Beach Harbor; and the acquisition of Genworth Financial by China Oceanwide Holdings. Both involved creative "mitigation measures" to protect perceived US national security issues. For example, COSCO agreed to transfer ownership of the Long Beach Terminal to a trust maintained by an independent U.S. person, while in the Genworth case, the parties agreed to retain a third party to manage and protect the personal data of Genworth's U.S. policyholders.

The above demonstrates that where there is no "show stopper" issue, transactions continue to be reviewed and cleared CFIUS, even where a Chinese entity is involved. Mitigation, including so-called "third-party mitigation" efforts are more important than ever. It remains critical to properly review and assess a transaction from both the buyer and seller perspective, and be prepared to address potential concerns. Moreover, we have found that a lack of transparency can often stall or potentially lead to the downfall of particular transactions. Accordingly, it is essential that both the buyer and seller provide CFIUS with complete, accurate, and comprehensive information in order to resolve a national security concern.

The Data and the Strategy

The Data

Analysis of the data since the Trump Inauguration indicates what transactions can be done, and what approaches have and have not worked. This analysis is only based on transactions for which reports were found through March 1, 2018.

Most deals are not submitted. It is important to note that half to two-thirds of China-US transaction likely are never submitted to CFIUS. The Rhodium group tracked 141 Chinese direct investment deals in the US in 2017—virtually all of them M&A transactions. Our data identifies about 40 which were put before CFIUS during that period. CFIUS retains jurisdiction to require an application even after a deal closes; in at least two recent deals this occurred, and clearance was given. Our recommendation, however, is to proceed only when a transaction appears manageable, and in those cases, file a CFIUS application.

Our analysis is conservative. Information about China transactions before CFIUS is not publicly available, and CFIUS is almost completely leak-free. As of August 2018, we have identified 37 China-related transactions before CFIUS during the Trump Administration. Of those, 18 were cleared; 18 were not cleared; the remainder are pending. The government's testimony before Congress suggests there were more deals than this actually cleared by CFIUS, so our analysis must be seen as conservative.

Analysis of China-US deals under Trump. Of 41 China-related deals we have identified as being before CFIUS during the Trump Administration, 36 appear to have completed the review process, with half clearing:

Status	Count	Rate
Cleared	18	
Failed	18	
Post-closing div.	1	
Total actions	36	
Clearance rate		**50%**

The same ratio applies to technology deals, with the numbers smaller and therefore the ratios less reliable in other sectors:

Sector	Cleared	Failed	Pending	Total
Semiconductors	2	3	1	**6**
Other technology	6	5	0	**11**
Media	2	1	1	**4**
Financial	4	3	0	**7**
Pharma	2	0	1	**3**
Real Estate	1	1	0	**2**
Energy	0	2	0	**2**
Other	1	3	2	**6**
Total	**18**	**18**	**5**	**41**

Sector	Cleared	Failed
Semiconductors	40%	60%
Other technology	55%	45%
Media	67%	33%
Financial	57%	43%
Pharma	100%	0%
Real Estate	50%	50%
Energy	0%	100%
Other	25%	75%

Risk Assessment

We recommend bringing your CFIUS analysis forward at the same time as your business analysis. There is no reason to avoid US deals altogether. If a transaction is attractive as a business proposition, our Risk Assessment can tell you if a deal will be *easy*, *manageable*, or *problematical*. If a deal is problematical, you may want to reconsider. If it is manageable, a proactive approach should allow the deal to clear CFIUS review.

CFIUS reviews each transaction on a case-by-case basis, examining both the foreign acquirer and the US business at issue. While a "voluntary" process, it is often prudent for the parties to submit a notification to CFIUS where the transaction is "covered" and could pose a national security risk. Our Risk Assessment program looks at a range of issues which our experience and the data shows CFIUS will examine.

Initial Considerations

- **Is the Transaction Covered?** Currently, covered transactions include where a foreign person acquires "control" of a US business. While there is a carve-out for passive investments of 10% or less, this analysis can become quite complex. Additional considerations should be given to convertible interests, as well as lending transactions where the lender acquires certain rights.

- **Is there a US business?** This means any activities in US interstate commerce, no matter where the entity is located. Thus, acquisitions of non-US companies can still be subject to CFIUS.

- **Is there a foreign person?** Complex questions can arise where there are multiple parties and/or foreign entities owned by US nationals, requiring persons include an intricate examination of the particular deal.

Analysis of the US Business

- **US Government Nexus.** This includes direct and indirect sales to the US Government, as well as US Government funding for research and development.

- **Controlled Technologies.** Export controls are an important factor, though CFIUS is also concerned with certain emerging technologies that may not otherwise be controlled.

- **"Proximity" Concerns.** It is especially important to review whether there are any US assets located in or near sensitive US Government facilities and/or US critical infrastructure.

- **Personal Identifier Information.** Consider whether the company possesses sensitive personal identifier information on US Government employees and/or US citizens more broadly.

Analysis of the Foreign Acquirer

- **Home country.** Is the buyer from a country posing a national security concern?

- **Foreign-government ownership.** CFIUS will more closely scrutinize transactions involved acquirers owned by a foreign government.

- **Foreign acquirer's link to foreign military.** Such a link could pose an increased risk of technology transfer or other actions posing a security threat.

Evaluation of "national security" risk factors

The mandate of CFIUS is to examine potential transactions for potential "national security" risks. While there are certain statutory factors to consider, CFIUS has broad discretion in determining what constitutes a national security risk and the Committee's focus changes over time. Based on our experience and the data, we know that at least the following areas will be of concern to CFIUS in addition to those mentioned above. Our Risk Assessment takes these into account, both to analyze the potential risk and to consider possible mitigation efforts.

- Target's access to classified or sensitive information, personnel or facilities

- Target's involvement in government contracts or funding, especially with the US military

- Whether the transaction affects critical infrastructure (such as roads, harbors, ports, power generation, etc.)

- Whether the buyer's home country has a bad "track record" in the industry concerned—in the case of China, the most common concerns are "leakage" of technology to the PRC government and especially the military, and sales from China to countries subject to comprehensive sanctions, such as North Korea or Iran

- Whether the buyer itself is disfavored—some Chinese buyers have placed themselves at a long-term disadvantage with CFIUS by not being transparent in their applications; others have acquired a negative reputation for other reasons; these buyers will have a difficult time getting a transaction approved

In addition to the more straightforward determination of whether a proposed investment is feasible, the Risk Assessment will guide the parties through the subsequent deal negotiation and drafting phase. For example, the US target may insist on a reverse termination fee tied to CFIUS. In addition, the parties may seek to incorporate detailed terms in deal documents

specifying what the foreign business may or may not agree to in order to obtain CFIUS clearance. Ultimately, the Risk Assessment proves to be a valuable tool in helping companies analyze issues before it's too late.

Proactive Approach

We recommend a custom-designed, proactive approach to CFIUS. This can include informal consultations and even early clearance of a deals based on a non-binding letter of intent. During the application process itself, we anticipate and work with US government officials to answer their concerns and make it possible for them to say "yes."

Preparing for the approach. The Risk Assessment process should have given the parties a thorough understanding of the issues that are likely to arise when the transaction is put before CFIUS. It is critical that the parties are fully transparent with counsel in this process and that they alert counsel to any changes in either the business being acquired or the makeup of the buyer. Both these key elements must be "locked down" before approaching CFIUS.

Confidentiality. Communications with CFIUS are entirely confidential. As a matter of experience, neither we nor other practitioners are aware of any significant, or even minor, breaches of this confidentiality by the US government. Parties can have a. high degree of confidence that any communications, and any applications made with CFIUS, will not be made public unless the parties themselves do so.

Informal consultations. Once the parties are close to agreement on the basic terms of a deal, and certainly by the time they sign a letter of intent, it is possible to confer informally with CFIUS. At that meeting, the buyer will describe itself, including most importantly its controlling stakeholders and any relationship, formal or informal, with the PRC government. Any financing sources should be described (financial institutions, private lenders, government funding) and specifically identified if possible. On the target side, the business to be acquired, including any technology or sensitive aspects of the business, must be fully understood and described. An informal meeting with CFIUS will not result in "pre-approval," but can provide important, early guidance as to whether the transaction is manageable or—for some reason not known to the parties—will be problematical.

Early clearance. It is possible to make a formal CFIUS filing on the basis of a non-binding letter of intent, binding letter of intent, or other document that is short of the definitive transaction agreement. We have cleared several transactions in this manner. The advantage is that parties can complete the entire CFIUS process and remove this element of risk, before investing the time and money required to negotiate definitive agreements, and in most cases before any public announcement of the transaction is made. Parties should be highly confident that the transaction will in fact proceed, assuming CFIUS clearance, since CFIUS will have limited patience with having done the work to clear a deal only to have the parties walk away from it. This could hamper any future CFIUS application by either of the parties.

Proactive, collaborative approach. The government officials involved in the CFIUS process are all dedicated public servants who take seriously their responsibility to protect the national security of the United States. They are all expert in their fields, from financial and trade experts, to economists, engineers and scientists. They are not, however, businesspeople and they obviously know only as much about how the business at issue operates as the parties tell them. The best approach is to anticipate the national security concerns CFIUS will have, and present possible solutions when making the application. If new concerns are raised, the parties are advised not to challenge validity of the Committee's concerns, but rather work openly and collaboratively with the government to solve its concerns. The parties themselves are in the best position to propose creative solutions to whatever concerns are raised, and therefore in the best position to help CFIUS say "yes."

Be open to structural changes. Sometimes parties will proceed with a CFIUS application even when the Risk Assessment has identified the transaction as "problematical." Occasionally—although very rarely in our experience—a transaction that appeared manageable will be blocked by CFIUS for unexpected reasons. In those situations, the parties may want to have a "Plan B" for their business relationship that will not require CFIUS review. Various debt structures, joint ventures, and licensing transactions, are all outside the scope of CFIUS review and may achieve the parties' objectives, either as an end in

themselves or as a temporary measure pending a change in the regulatory climate.

Pillsbury's China and Regulatory Practices represent dozens of companies engaged in transactions between or involving the United States and the People's Republic of China. For additional information, please contact:

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Appendix "A"

Section 721 of the Defense Production Act, as amended by FINSA, lists the following factors to be taken into account by CFIUS:

a. the potential effects of the transaction on the domestic production needed for projected national defense requirements;

b. the potential effects of the transaction on the capability and capacity of domestic industries to meet national defense requirements (including the availability of human resources, products, technology, materials and other supplies and services);

c. the potential effects of a foreign person's control of domestic industries and commercial activity on the capability and capacity of the US to meet the requirements of national security;

d. the potential effects of the transaction on US international technological leadership in areas affecting US national security;

e. the potential national security-related effects on US critical technologies;

f. the potential effects on the long-term projection of US requirements for sources of energy and other critical resources and material;

g. the potential national security-related effects of the transaction on US critical infrastructure (including major energy assets);

h. the potential effects of the transaction on the sales of military goods, equipment or technology to countries that present concerns related to terrorism, missile proliferation, chemical, biological or nuclear weapons proliferation or regional military threats;

i. the potential that the transaction presents for transshipment or diversion of technologies with military applications (including the relevant country's export control system);

j. whether the transaction could result in the control of a US business by a foreign government or by an entity controlled by or acting on behalf of a foreign government;

k. the relevant foreign country's record of adherence to nonproliferation control regimes and record of cooperating with US counterterrorism efforts; and

l. other appropriate factors.