

## *China and Regulatory Practices*

# **TITLE: Fall 2018 CFIUS Briefing**

## **New Legislation and New Challenges**

### **Takeaways**

- While there is increasing scrutiny, transactions continue to be reviewed and cleared by CFIUS, even where a Chinese entity is involved.
- Upcoming legislative changes will expand the definition of a “covered transaction” subject to CFIUS review and alter the review process.
- It is essential that both the buyer and seller contemplate CFIUS early on in the diligence stages of a proposed deal, and when engaged with CFIUS, provide complete, accurate, and comprehensive information in order to resolve a national security concern.

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 that will be effective immediately; and others which will be effective after CFIUS promulgates implementing regulations. The impact of FIRRMA is described in our updated CFIUS White Paper, available on request.

### **The 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. 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 by 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.

**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 41 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	
<b>Clearance rate</b>		<b>50%</b>

The same ratio applies to technology deals, with the numbers smaller and therefore the ratios less reliable in other sectors:<sup>1</sup>

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

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

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<sup>1</sup> The six semiconductor deals were Akzion and Nexperia (cleared); Xcerra, Global Communications and Lattice (failed) and Anaren (pending).

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.

### **Change Is Coming**

Once fully implemented, FIRRMA will also change the CFIUS landscape, altering the CFIUS review process and expanding the definition of a covered transaction. Importantly, FIRRMA will clearly treat as a covered transaction the purchase or lease of certain real estate in close proximity to military installations and certain other facilities (regardless of whether a “U.S. business” is involved). In addition, non-controlling “other investments” would be considered covered transactions in certain circumstances based on the type of business and investment. There will also be opportunities to submit a streamlined declaration as opposed to a more comprehensive notice, along with other process changes. It will be important to monitor how CFIUS plans on implementing FIRRMA via regulation, as well as whether the Committee looks to institute a pilot program evaluating certain changes. Moreover, the U.S. Government will be conducting an interagency process to identify “emerging and foundational technologies” that would be added to the definition of critical technologies and subject to U.S. export licensing requirements.

### **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.

(Read more on this topic at: [Fall 2018 CFIUS White Paper.](#))

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*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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