JONES DAY

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EXON-FLORIO ALERT: REGULATIONS IMPLEMENTING FINSA TAKE EFFECT

The U.S. Department of Treasury has issued final regulations to implement Section 721 of the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 ("Section 721"). The long-awaited regulations, which took effect on December 22, 2008, govern investigations by the Committee on Foreign Investment in the United States ("CFIUS"). The final regulations declare a narrow focus on national security alone, eschewing a broader application to economic security and other national interests. Treasury officials also have published additional guidance concerning the types of transactions and the specific national security concerns that CFIUS has scrutinized in recent years.

While the latest reforms have preserved the basic substance and timelines for CFIUS review of foreign-investment transactions, the implementing regulations effect significant changes to the scope of submissions required of companies submitting to the process. As a practical matter, the new regulations increase the burden of submitting to the CFIUS review process, but most notified transactions will clear CFIUS review within the initial 30-day review period. Attentive planning for the CFIUS review process, including early coordination with CFIUS's constituent agencies that may engage in independent reviews of a notified transaction, and organized collection of information for inclusion in the voluntary notice are essential to an efficient review.

HISTORY

The Exon-Florio amendment to the Defense Production Act ("DPA"), enacted in 1988, authorized the President to investigate the impact of foreign acquisitions of U.S. businesses on national security and to suspend or prohibit acquisitions that might threaten the national security. In 1988, President Reagan delegated the investigative authority to CFIUS, an interagency group established in 1975 to monitor and coordinate U.S. policy on foreign investment in the United States. In 1991, the Treasury Department, as chair of CFIUS, issued

regulations to implement Exon-Florio. In 1992, the so-called "Byrd amendment" required CFIUS to investigate mergers, acquisitions, or takeovers by persons controlled by or acting on behalf of a foreign government if the transaction resulted in control of a person engaged in interstate commerce in the U.S. that could affect national security.

Prior to 2005, CFIUS remained generally unknown until it cleared the Dubai Ports World/P&O transaction. The ensuing uproar resulted in widespread calls for reforms of Exon-Florio and the CFIUS review process. Since that time, the previously obscure agency has received a comparative flood of voluntary notices.

The resulting uproar also increased congressional scrutiny of the CFIUS review process. Thus, on July 11, 2007, Congress passed the Foreign Investment and National Security Act of 2007 ("FINSA"), which recognized CFIUS, directed it to review the national security implications of foreign acquisitions of U.S. assets, and reformed the CFIUS review process. Furthermore, although the CFIUS review process remains voluntary, FINSA authorized CFIUS to initiate reviews on its own, and CFIUS has been increasingly proactive in requesting information or encouraging notification from parties to covered transactions. President Bush signed FINSA into law on July 26, 2007, and it became effective on October 24, 2007. The Treasury Department issued proposed regulations in April 2008 and received more than 30 comments covering 200 substantive issues.

NATIONAL SECURITY AND CRITICAL INFRASTRUCTURE

The preamble to the final regulations emphasizes that CFIUS will maintain a narrow focus on potential risks to U.S. national security and will not expand its purview to encompass broader concerns of economic security or general national interests. The DPA and related regulations have never defined the term "national security," and the final regulations implementing FINSA are no exception. Following publication of the final regulations, the Department of the Treasury issued limited guidance on how CFIUS conducts its analyses within the list of national security factors contained within the DPA. CFIUS evaluates national security risk as a function of two factors: (1) the potential threat—the capability or intention to exploit or cause harm—presented by the foreign person, and (2) any vulnerability linked to the U.S. business to be acquired. CFIUS will consider information provided by the parties, as well as public and government sources.

The Treasury Department guidance also describes the types of transactions that CFIUS in past years reviewed and determined to have raised national security concerns. These include acquisitions of U.S. businesses that:

- Provide products and services to federal, state, and local authorities, including specifically sole-source suppliers.
- Have access to classified information, often within the defense, security, and law enforcement sectors.
- Manufacture weapons, munitions, aerospace, or radar systems.
- Provide goods or services with broad applicability to a variety of U.S. government agencies with national security functions, including goods or services related to information technology, telecommunications, energy, natural resources, and industrial products.
- Participate in the U.S. energy sector, including U.S. businesses that comprise major energy assets or those that are involved in exploitation of natural resources, transportation, and transmission of power.
- Involve transportation, maritime shipping, port terminal operations, and aviation maintenance, repair, and overhaul.
- Affect the U.S. financial system.
- Involve the production of advanced technologies that may be useful in defending, or in seeking to impair, U.S. national security, including the design and production of semiconductors and other equipment with dual commercial and military application, such as cryptography, data protection, internet security, and network intrusion detection.
- Engage in research and development, production, or sale of technology, goods, software, or services subject to U.S. export control.

The final regulations adopt a similarly fact-specific approach to designating "critical infrastructure," rather than characterizing particular classes of assets as comprising critical infrastructure. The final regulations thus define "critical infrastructure" as "a system or asset, whether physical or virtual, so vital to the United States that the incapacity or

destruction of the particular system or asset of the entity … would have a debilitating impact on national security." The final regulations, however, define "critical technology" by reference to International Traffic in Arms Regulation ("ITAR") items, the Commerce Control List, Assistance to Foreign Atomic Energy Activities regulations, and the Select Agents and Toxins regulations.

COVERED TRANSACTIONS

The final regulations refine the scope of "covered transactions" that fall within CFIUS's authority. A covered transaction under Section 721 is any transaction by or with a foreign person that could result in control of a U.S. business by a foreign person.

Whether a transaction is a covered transaction depends largely upon whether a foreign person will have the ability to exercise control over the acquired business. The final rules preserve CFIUS's traditional reliance on a functional concept of "control," focusing on the authority the foreign person will have, rather than on ownership position. The concept of control has been among the most controversial and generated a substantial number of comments to the proposed rules. While the final regulations do not relieve the burden of uncertainty that arises from the need to assess the issue of "control" on a case-by-case basis, the final regulations expand the illustrative list of "important matters" indicative of control, provide a number of illustrations identifying specific minority shareholder rights that in themselves do not result in control, and also identify factors CFIUS will consider when evaluating convertible voting instruments.

"Control" is defined as "the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity." Examples of "important matters" include:

- The sale, lease, mortgage, pledge, or other transfer of any of the tangible or intangible principal assets of the entity, whether or not in the ordinary course of business.
- The reorganization, merger, or dissolution of the entity.
- The closing, relocation, or substantial alteration of the production, operational, or research and development facilities of the entity.
- Major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of the entity.
- The selection of new business lines or ventures that the entity will pursue.
- The entry into, termination of, or nonfulfillment by the entity of significant contracts.
- The policies or procedures of the entity governing the treatment of nonpublic technical, financial, or other proprietary information of the entity.
- The appointment or dismissal of officers or senior managers.
- The appointment or dismissal of employees with access to sensitive technology or classified U.S. government information.
- The amendment of the Articles of Incorporation, the constituent agreement, or other organizational documents of the entity with respect to the matters described above.

The final rules also enumerate several types of transactions that are not covered transactions and clarify CFIUS's treatment of passive investments. With regard to the latter, the final regulations specify that minority equity investments of 10 percent or less may be covered transactions, unless the investment is undertaken solely for the purpose of investment and does not involve indicia of control, such as board representation. Other excluded transactions include:

- Start-up investments, known as "greenfield" investments.
- Asset acquisitions where the assets acquired do not constitute a U.S. business or person.
- Long-term leases where the foreign lessee does not make substantially all business decisions, as if it were the owner, for the operation of the leased U.S. business.
- Underwriting, commercial loans, or insurance-related transactions (a) that the foreign person makes in the ordinary course of business; and (b) that do not result in financial or governance rights characteristic of an equity investment, rather than a loan.

- Incremental acquisitions following the conclusion of CFIUS's review of a covered transaction.

Outside these excluded categories, the final regulations specify several minority shareholder protections that, standing alone, will not confer or constitute control for purposes of determining whether a transaction is a covered transaction. These include:

- The power to prevent the sale or pledge of all or substantially all of the assets of an entity or a voluntary filing for bankruptcy or liquidation.
- The power to prevent an entity from entering into contracts with majority investors or their affiliates.
- The power to prevent an entity from guaranteeing the obligations of majority investors or their affiliates.
- The power to purchase additional interest in an entity to prevent the dilution of an investor's pro rata interest in that entity in the event that the entity issues additional instruments conveying interests in the entity.
- The power to prevent the change of existing legal rights or preferences of the particular class of stock held by minority investors, as provided in the relevant corporate documents governing such shares.
- The power to prevent the amendment of the Articles of Incorporation, the constituent agreement, or other organizational documents of an entity with respect to the matters described above.

TIMING OF REVIEWS

Voluntary notification to CFIUS triggers an initial 30-day review. Historically, most transactions are cleared after this 30-day review period. However, CFIUS may, and in certain limited circumstances is required to, initiate a formal 45-day investigation. For example, a 45-day investigation is required for transactions in which the buyer is a foreign government or is controlled by or acting on behalf of a foreign government or the transaction involves the acquisition of "critical infrastructure," unless Treasury and the lead agency agree that no investigation is needed. A 45-day investigation is also required if the lead agency recommends such an investigation and CFIUS "concurs."

Under the prior regulations, at the conclusion of a 45-day investigation, CFIUS was required to submit a report and recommendation to the President, who then had 15 days to decide whether to exercise the authority to block the transaction. Under the recently issued Executive Order 13456, the 15-day presidential review period remains for the following transactions: "(i) The Committee recommends that the President suspend or prohibit the transaction; (ii) The Committee is unable to reach a decision on whether to recommend that the President suspend or prohibit the transaction; or (iii) The Committee requests that the President make a determination with regard to the transaction." Thus, CFIUS enjoys broader discretion than before in determining whether a transaction must be submitted to the President for review following a 45-day investigation.

The final regulations strongly encourage pre-filing consultations with the Staff Chair and explicitly extend confidentiality to pre-filing submissions. Informal contacts with the CFIUS Staff and CFIUS member agencies expected to take an interest in a particular transaction have long been the standard of practice before CFIUS. While the final regulations urge parties to provide at least five business days for preliminary review, in practice, providing two weeks' notice or more is not uncommon. Because the 30-day review period will not commence until the CFIUS Staff Chair has determined that the notice is complete and notifies the parties that CFIUS has accepted the submission, efforts to disregard or abbreviate the pre-filing period stand a small chance of success. Furthermore, failure to provide adequate time for CFIUS to vet a transaction prior to filing the formal notice carries an unprecedented risk of generating a 45-day investigation, as CFIUS is no longer required to refer all transactions undergoing a 45-day investigation to the President for a final decision.

CONTENTS OF A VOLUNTARY NOTICE

The new regulations substantially expand the information that reporting parties must include in the voluntary notice (although as a practical matter, CFIUS has routinely requested much of this information for some time now). Among the most substantial new information requirements are the following:

- Detailed personal identification information for all directors and officers of the foreign entity involved in the transactions, as well as its ultimate and any intermediate parents, and for shareholders with greater than 5 percent interest in the acquiring entity or its ultimate parent.
- Identification of any financial institutions involved in the transaction, including as advisors, underwriters, or a source of financing.
- Information about federal licenses and permits.

In light of this expanded scope for a voluntary notice, many commenters expressed a desire that the informal pre-filing provide more than a head start to CFIUS's initial review. These commenters encouraged CFIUS to provide companies with a binding determination, during the informal contact period, as to whether a particular transaction results in control and therefore is subject to CFIUS's jurisdiction. The final regulations do not include any mechanism for such a determination. However, the supplementary information included with the final regulations encourages parties to discuss with Staff potential modifications to the content of the notice during the pre-filing period; this should help minimize the possibility that Staff will request further information after the notice is formally filed.

CIVIL PENALTIES

FINSA authorized CFIUS and its constituent agencies acting on its behalf to enter into agreements or impose conditions on covered transactions to mitigate any risks to U.S. national security and to impose civil penalties for violating a mitigation agreement or otherwise violating Section 721. The final regulations provide that the amount of civil penalties that may be imposed for a material misstatement, omission, or false certification to CFIUS, or breach of a mitigation agreement, may not "exceed $250,000 per violation or the value of the transaction, whichever is greater." The final regulations provide a limited right to petition the Committee for reconsideration of any penalty imposed and vest the United States with jurisdiction to seek recovery in federal court.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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