

# Client Alert

October 2018

## CFIUS Adopts “Pilot Program” Implementing Various Aspects of FIRRMA; Mandatory Clearance Requirement to Take Effect

### Overview

As we explained in our August 2018 [e-alert](#) regarding the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), that law made a number of changes in the procedures applicable to national security reviews of foreign investments in the United States. Some of the provisions of FIRRMA were immediately effective but many provisions were the subject of future rulemaking and would not become effective until that process was complete. On October 10, 2018, the US Department of Treasury published a set of “pilot program” rules, without notice or opportunity for public comment, that implement on a temporary basis certain of the FIRRMA provisions that had required further rulemaking.<sup>1</sup> The interim rulemaking covers four main areas: (1) an expansion of the authority of the Committee on Foreign Investment in the United States (CFIUS) for certain transactions not involving control; (2) mandatory filings with CFIUS prior to completion for certain transactions involving critical technologies; (3) a new “safe harbor” for private equity type investments; and (4) an abbreviated process for seeking CFIUS clearance.

The new pilot program rules become effective on November 10, 2018, and will be applicable to *all transactions* except transactions that are completed before November 10, 2018, and other transactions where any of the following has occurred before October 11, 2018: (a) the parties had executed a written, binding agreement establishing the material terms; or (b) a party had made a public offer to buy the shares of a business otherwise covered by the pilot program rules; or (c) a shareholder had solicited proxies in connection with the election of directors or the conversion of convertible securities of a business otherwise covered by the pilot program rules. The pilot program rules are “interim” and will expire on March 5, 2020, unless final rules are adopted prior to that date.

### Expansion of Covered Transactions

Under the law and regulations in effect prior to FIRRMA and the pilot program, a transaction was subject to CFIUS’s authority only if it could result in “control” of a US business by a foreign person. Control was defined broadly; however, the control definition carved out investments where the investor acquired less than 10 percent of the stock and did so “solely for the purpose of passive investment” (which was defined as not planning or intending exercise control).<sup>2</sup> The official commentary included in the rules also indicated, as an example, that a foreign person acquiring a 13 percent interest in the shares of a US

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<sup>1</sup> Despite being implemented without notice or opportunity for comments, comments are now being accepted on the interim rule and will be considered in the process of promulgating any final rule.

<sup>2</sup> See 31 CFR §§ 800.204, 800.223, 800.302(b).

business and having the right to appoint one member of its seven-member board of directors and certain permitted shareholder protections would not control the business absent other facts.<sup>3</sup>

The pilot program creates a new type of transaction—called “a pilot program covered transaction”<sup>4</sup>—that is subject to CFIUS’s authority. This category includes some transactions that would be “covered transactions” under the non-pilot program rules as well as some transactions that would not be subject to such rules. A pilot program covered transaction has to satisfy three criteria:

- First, the US business involved must be producing, designing, testing, manufacturing, fabricating or developing a “critical technology.”<sup>5</sup> A critical technology is defined as: (a) defense articles or defense services controlled by the International Traffic in Arms Regulations; (b) items controlled by the Export Administration Regulations (1) pursuant to multilateral regimes relating to national security, chemical and biological weapons proliferation, nuclear nonproliferation and missile technology or (2) for reasons relating to regional stability or surreptitious listening; (c) specially designed nuclear equipment, parts and components, materials, software and technology; (d) nuclear facilities, equipment and material; (e) certain poisonous agents and toxins; and (f) emerging and foundational technologies.<sup>6</sup>
- Second, the critical technology must be either utilized in connection with the US business’s activities in one or more of 27 specifically identified “pilot program industries”<sup>7</sup> or designed by the US business for use in one or more such industries. These industries are designated by North American Industry Classification System (NAICS) codes. With only a few exceptions, all of these targeted industries involve manufacturing, alloying or smelting of some kind. The nonmanufacturing sectors are nuclear electric power generation and research and development of nanotechnology and biotechnology. The applicable NAICS codes and the relevant descriptions are set forth on *Annex A*.
- Third, the transaction must be one that could result in the foreign party’s acquiring “control” of the US business under the non-pilot program rules or that constitutes a “pilot program covered investment.”<sup>8</sup> A pilot program covered investment is defined as an equity interest (contingent or otherwise) that does not amount to control but that affords the foreign party (a) access to any material nonpublic technical information<sup>9</sup> in the possession of the US business; (b) membership or observer rights on the board of directors or equivalent governing body of the US business (or the right to nominate an individual to a position on such governing body); or (c) any involvement, other than through voting of shares, in substantive decision-making of the US business regarding the use, development, acquisition or release of critical technology.

Thus, where critical technology in one of the specified 27 industries is involved, CFIUS’s authority to review a transaction has been expanded to include equity investments of any size that provide certain access or rights to information or involvement but nevertheless something less than control. This reflects the government’s concern that certain foreign buyers are acquiring noncontrolling interests in businesses

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<sup>3</sup> See 31 CFR § 800.204, example #5. The pilot program rules give a counter-example and reach a different conclusion where the foreign person merely has an observer on the US business’s board. See 31 CFR § 801.302, example #1.

<sup>4</sup> See 31 CFR §§ 801.210, 801.302.

<sup>5</sup> See 31 CFR § 801.204.

<sup>6</sup> Items (a) through (e) of this definition refer to existing lists of export-controlled items. Item (f) is new and will require further determination by various government agencies of technologies that are essential to national security under section 1758 of the John S. McCain National Defense Authorization Act for Fiscal Year 2019.

<sup>7</sup> See 31 CFR § 801.212.

<sup>8</sup> See 31 CFR § 801.209.

<sup>9</sup> Such information is defined in the pilot program rules as information that is not publicly available and is necessary to design, fabricate, develop, test, produce or manufacture critical technologies, including processes, techniques or methods. It does not include financial information. See 31 CFR § 801.208.

with important technologies and are doing so for the purposes of gaining knowledge of and insight into those technologies.<sup>10</sup>

Importantly, the pilot program rules make clear that even where a foreign buyer has sought and obtained CFIUS clearance for a particular investment, a further submission to CFIUS will be required if the buyer later obtains additional information rights, board or observer rights or involvement in decision-making of the type described in Rule 801.209 (even without a change in the equity investment).<sup>11</sup> Thus, for example, if a buyer had obtained CFIUS clearance for a small minority investment in a pilot program covered transaction with no or minor information rights, and later obtains additional information rights or a board or observer seat, a new CFIUS filing would be required.

## Mandatory Filing with CFIUS

Under the law and regulations in effect prior to FIRRMA and the pilot program, it was entirely lawful to close a transaction without first seeking or obtaining approval from CFIUS, though taking such an approach could be unwise. If a foreign buyer acquired control of a US business that could affect US national security without obtaining CFIUS clearance, there was no violation of law but there was always the risk that CFIUS would demand the parties file a post-closing CFIUS notice as well as the risk that the president could force the buyer to divest its acquired interest at any time. Closing a transaction without CFIUS clearance did not cause the parties to be subject to penalties and the risks of completing such a transaction appear to have fallen primarily on the buyer.

Under the pilot program rules, CFIUS has established for the first time a *mandatory filing* with CFIUS for all pilot program covered transactions.<sup>12</sup> For transactions closing between November 10 and December 25, 2018, the pilot program rules require that a filing with CFIUS be made on November 10, 2018, or promptly thereafter; if the closing is after December 25, 2018, the filing must be made at least 45 days before completion. The required filing can be either an abbreviated declaration<sup>13</sup> or the more fulsome, standard notification. Under the pilot program, if the buyer and seller fail to file a declaration or notice prior to closing, each could be assessed a penalty of an amount up to the value of the transaction in question for failing to obtain CFIUS clearance before closing. Thus, the failure to seek clearance for pilot program covered transactions poses risks for *both the buyer and the seller*.

## Private Equity Safe Harbor

By expanding CFIUS's authority to include noncontrolling investments by foreign persons, directly or indirectly, in particular industries, FIRRMA opened up the possibility that a foreign investor in a private equity fund investing in a US business could constitute a pilot program covered transaction and be subject to mandatory review by CFIUS. The private equity industry successfully lobbied for a safe harbor exception so that foreign investors in private equity investment vehicles would not give rise to pilot program covered transactions *where the investment vehicle meets certain conditions*.

The relevant rule provides that an indirect investment by a foreign person in a US business through an investment fund<sup>14</sup> where the foreign person serves on an advisory board or committee will not be considered a pilot program covered investment if four criteria are met:

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<sup>10</sup> Investments in US airlines that are "air carriers" under Title 49 of the United States Code are not pilot program covered investments. See 31 CFR § 801.305. However, such investments could still be subject to review by CFIUS under the non-pilot program rules.

<sup>11</sup> See 31 CFR § 801.302(b).

<sup>12</sup> FIRRMA specifically authorized CFIUS to adopt regulations that differentiated between the nationality of foreign buyers as it relates to critical technologies. However, CFIUS did not take advantage of this authority in the pilot program rules.

<sup>13</sup> See discussion in "ABBREVIATED DECLARATION PROCESS" below.

<sup>14</sup> An "investment fund" is defined as an entity that is an investment company as defined in section 3(a) the Investment Company Act of 1940, or would be such an investment company but for the exemptions included in sections 3(b) and 3(c) of that Act. See 31 CFR § 801.207.

- First, the investment fund is managed—exclusively—by a general partner or equivalent that is not the foreign person;
- Second, the advisory board or committee of the fund does not have the ability to approve, disapprove or otherwise control, directly or indirectly, the fund’s investment decisions;
- Third, the foreign person does not have the ability (i) to approve, disapprove or otherwise control, directly or indirectly, the fund or its investment decisions or (ii) to unilaterally dismiss, prevent the dismissal of, select or determine the compensation of the general partner or equivalent of the fund; and
- Fourth, the foreign person does not have access to material nonpublic technical information as a result of its participation on the advisory board or committee.

## Abbreviated Declaration Process

Insofar as any pilot program covered transaction is concerned, the parties will have the choice to either file the standard “notice” under the non-pilot program rules (though added items of information will be required related to various issues specifically related to pilot program covered transactions) or a shorter-form “declaration” under new rules specifically designed for the pilot program.

If the parties choose to file under the declaration provisions of the pilot program, the filing must be submitted electronically.<sup>15</sup> In theory, declarations are intended to be brief—containing five or fewer pages—though we will have to see whether these submissions can in fact be condensed to such a length. Once CFIUS has reviewed the submission and determined that it is complete, a 30-day period will start for the committee to review the submission. During this period, CFIUS may request further information and may reject a declaration for various administrative reasons.

At or before the end of such period, CFIUS is supposed to take one of the following actions: (1) request that the parties file a full notification to CFIUS under the non-pilot program rules; (2) inform the parties that CFIUS is not able to complete action on the basis of a declaration and that they may file a notice under the non-pilot program rules; (3) initiate a unilateral review; or (4) notify the parties that CFIUS has concluded all action under the pilot program rules with respect to the transaction.

Because going through the declaration process does not replace the notification process when CFIUS is not satisfied during the 30-day period that no national security issue exists, it will likely result in a longer wait for a final determination than going through the non-pilot program notification process from the very start. Indeed, the potential time savings for a transaction that obviously does not have any national security issues (about 15 days) may be outweighed by the extra review time that could result by starting with a declaration rather than a notification (about 30 days). Thus, parties will have to make a careful determination about whether to proceed with a declaration or a notification. Generally speaking, we believe that parties will take the declaration route for pilot program transactions only in a situation where they believe strongly that their transaction does not pose any potential threats to national security.

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<sup>15</sup> The pre-FIRRMA rules permitted and still permit electronic filing or filing in paper form. See Rule 800.

## Annex A

### NAICS Codes for Pilot Program Industries

**Aircraft Manufacturing**

(NAICS Code: 336411);

**Aircraft Engine and Engine Parts Manufacturing**

(NAICS Code: 336412);

**Alumina Refining and Primary Aluminum Production**

(NAICS Code: 331313);

**Ball and Roller Bearing Manufacturing**

(NAICS Code: 332991);

**Computer Storage Device Manufacturing**

(NAICS Code: 334112);

**Electronic Computer Manufacturing**

(NAICS Code: 334111);

**Guided Missile and Space Vehicle Manufacturing**

(NAICS Code: 336414);

**Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing**

(NAICS Code: 336415);

**Military Armored Vehicle, Tank and Tank Component Manufacturing**

(NAICS Code: 336992);

**Nuclear Electric Power Generation**

(NAICS Code: 221113);

**Optical Instrument and Lens Manufacturing**

(NAICS Code: 333314);

**Other Basic Inorganic Chemical Manufacturing**

(NAICS Code: 325180);

**Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing**

(NAICS Code: 336419);

**Petrochemical Manufacturing**

(NAICS Code: 325110);

**Powder Metallurgy Part Manufacturing**

(NAICS Code: 332117);

**Power, Distribution and Specialty Transformer Manufacturing**

(NAICS Code: 335311);

**Primary Battery Manufacturing**

(NAICS Code: 335912);

**Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing**

(NAICS Code: 334220);

**Research and Development in Nanotechnology**

(NAICS Code: 541713);

**Research and Development in Biotechnology (except Nanobiotechnology)**

(NAICS Code: 541714);

**Secondary Smelting and Alloying of Aluminum**

(NAICS Code: 331314);

**Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing**

(NAICS Code: 334511);

**Semiconductor and Related Device Manufacturing**

(NAICS Code: 334413);

**Semiconductor Machinery Manufacturing**

(NAICS Code: 333242);

**Storage Battery Manufacturing**

(NAICS Code: 335911);

**Telephone Apparatus Manufacturing**

(NAICS Code: 334210);

**Turbine and Turbine Generator Set Units Manufacturing**

(NAICS Code: 333611)