Fried Frank International Trade and Investment *Alert*™

CFIUS Finalizes Regulations to Implement FIRRMA

On January 17, 2020, the U.S. Department of the Treasury issued the final regulations to implement the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), legislation that significantly expanded the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS). Though the final regulations largely retain the substance of the 2019 proposed regulations, there are several key differences. In particular, the regulations include an interim rule establishing a new definition for "principal place of business," which will be helpful for foreign-domiciled investment funds that are ultimately controlled from the United States by U.S. persons. The pilot program that imposed a mandatory declaration filing requirement for certain transactions involving critical technologies has been incorporated into the final regulations. However, the final regulations exempt certain investors from the mandatory CFIUS, including U.S.-owned and controlled investment funds, investors acquiring critical technologies that are only controlled for encryption reasons, excepted investors, and entities already subject to foreign ownership, control, or influence (FOCI) mitigation. Additionally, CFIUS has published the initial list of excepted foreign states -- which includes only Australia, Canada, and the United Kingdom -- and marginally liberalized the excepted investor provisions that allow filing exemptions for non-control transactions involving certain entities closely tied to the excepted foreign states.

The release of the final regulations was accompanied by a fact sheet, FAQs, and a press release. A separate set of final regulations covers CFIUS's expanded jurisdiction over real estate transactions. The final regulations will become effective on February 13, 2020.

Below is a more detailed summary of these aspects of the final regulations, as well as other differences from the proposed regulations.

New Definition of "Principal Place of Business"

CFIUS established a new definition for "principal place of business" as part of the final regulations. The definition of "foreign entity," a key part of a CFIUS jurisdictional analysis, references an entity organized under the laws of a foreign state if "its principal place of business is outside the United States." Previously, CFIUS regulations did not define "principal place of business." Parties considering a CFIUS filing applied various legal tests such as the "nerve center" test from case law to determine whether an entity's principal place of business was inside or outside the United States, but the contours of CFIUS jurisdiction remained unclear. The new definition of "principal place of business" is:

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the primary location where an entity's management directs, controls, or coordinates the entity's activities, or, in the case of an investment fund, where the fund's activities and investments are primarily directed, controlled, or coordinated by or on behalf of the general partner, managing member, or equivalent.

This definition offers welcome clarity to U.S.-owned and controlled entities that have subsidiaries or other entities in non-U.S. jurisdictions. This is particularly helpful to U.S.-based private equity firms. It was previously unclear how CFIUS viewed private equity investment funds that are domiciled in the Cayman Islands or other jurisdictions but ultimately controlled by U.S.-based management. Now, it appears that these funds would no longer be considered subject to CFIUS jurisdiction as "foreign entities" solely by virtue of a fund or its general partner's foreign organization.

Notably, CFIUS included a clause in this definition prohibiting an entity from claiming that its principal place of business is the United States for CFIUS purposes while also representing to any other U.S. or foreign government that its principal place of business is outside the United States in a separate filing or submission. CFIUS issued this definition as an interim final rule, which means that although the definition goes into effect on February 13, 2020 with the rest of the regulations, CFIUS will accept public comments until that time and may change the definition based on those comments.

Excepted Investors and Excepted Foreign States

FIRRMA introduced the concept of excepted investors and excepted foreign states, which provide an exception from CFIUS's expanded jurisdiction over "covered investments" (non-control investments in U.S. TID businesses) and certain real estate transactions for investors that meet a series of criteria from foreign states on an approved list of countries published by CFIUS. The proposed rules did not list the excepted foreign states, but provided strict qualifications for what entities would qualify as excepted investors. The final regulations loosen these qualifications slightly, allowing for more entities to potentially take advantage of this new safe harbor.

CFIUS has designated Australia, Canada, and the United Kingdom as excepted foreign states based on "certain aspects of their robust intelligence-sharing and defense industrial base integration mechanisms with the United States." Other foreign states remain eligible to become excepted foreign states based on determinations by CFIUS. Notably, CFIUS must make a determination whether to retain these countries as excepted foreign states after two years based on their "national security-based foreign investment review processes and bilateral cooperation with the United States on national security-based investment reviews."

The definition of "excepted investor" has been changed to have less stringent criteria, particularly:

- 75% or more of the members and 75% or more of the observers of the board of directors (or its equivalent) must be U.S. nationals or nationals of one or more excepted foreign states (and not also nationals of any other foreign state that is not an excepted foreign state); previously, this requirement applied to 100% of the members and observers of the board of directors;
- Each person that holds 10% or more of the outstanding voting interest of the entity must be a U.S. national or a national of one or more excepted foreign states (and not also a national of any other foreign state that is not an excepted foreign state); previously, this threshold was only 5%; and

- For publicly traded entities whose shares are listed on an exchange that is not located in the United States or an excepted foreign state, 80% or more of the entity's shares must be held by parties from the United States or an excepted foreign state; previously, this threshold was 90%.

Though this definition has been loosened somewhat, allowing for more Australian, Canadian, and UK companies to avoid CFIUS jurisdiction in some circumstances when acquiring a non-controlling interest in a U.S. TID business, it remains a relatively narrow definition. In the commentary accompanying the published final regulations, CFIUS detailed several comments requesting a broader interpretation or definition of excepted investor, all of which it rejected. Entities from these three countries should carefully analyze whether this definition applies to them. Additionally, it is important to note that qualification as an excepted investor only exempts that entity from expanded CFIUS jurisdiction under FIRRMA over "covered investments," or non-controlling investments in U.S. TID businesses. Excepted investors remain subject to CFIUS jurisdiction over acquisitions of a controlling interest in a U.S. business, which the regulations now refer to as "covered control transactions."

Changes to Mandatory Declarations and Transition of the Pilot Program

The final regulations retain the majority of the mandatory declaration process from the pilot program and formally implement FIRRMA's requirement that certain covered transactions where a foreign government is acquiring a "substantial interest" in U.S. critical technology/infrastructure/data businesses are subject to mandatory declaration filing requirements. The final regulations also include important exemptions from mandatory declaration requirements.

The pilot program on critical technologies remain in effect through February 12, 2020, the day before the final regulations become effective. After that date, the final regulations will be the authority for both traditional CFIUS filings and declarations. The final regulations retain the current mandatory declaration requirement that covered transactions (both control transactions and non-control "covered investments") involving a U.S. business that produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies.

The application of this mandatory declaration requirement, however, is now subject to several exemptions outlined in the final regulations:

- Covered control transactions by excepted investors (as excepted investors will be entirely exempt from CFIUS jurisdiction over non-control "covered investments");
- All covered transactions involving entities that already hold a facility security clearance pursuant to NISPOM regulations and are subject to a foreign ownership, control, or influence (FOCI) mitigation agreement;
- All covered transactions by an investment fund managed exclusively by a general partner, managing member, or equivalent, that is not a foreign person, and the fund otherwise meets the requirement for the investment fund safe harbor; and
- All covered transactions involving a U.S. business that is considered a TID U.S. business solely because it produces, designs, tests, manufactures, fabricates, or develops critical technologies that are considered critical technologies only due to encryption.

Additionally, parties must file a mandatory declaration for any covered transaction that results in the acquisition of a substantial interest in a TID U.S. business by a foreign person in which the national or subnational governments of a single foreign state have a substantial interest. The definition of

"substantial interest" remains unchanged: in the context of an acquisition of an interest by a U.S. business by a foreign person, the threshold is 25% or more (direct or indirect), and in the context of a foreign person in which a foreign state has an interest, the threshold is 49% or more (direct or indirect). However, CFIUS included an important revision in the final regulations that narrows the applicability of this mandatory declaration requirement: in the proposed rule, in the case of entities with a general partner or managing member (or their equivalent), a foreign state was considered to have a substantial interest if it held 49% or more of the voting interest in the general partner/managing member or if it was a limited partner and held 49% or more of the voting interest of all the limited partners. In the final regulations, only a 49% or more interest in the general partner/managing member qualifies as a substantial interest by a foreign state. This narrows the scope of potential mandatory CFIUS jurisdiction applicable to certain investment funds with significant foreign government investors who are only passive limited partners. Like the revisions to the pilot program, the regulations exempt the same covered transactions by investment funds that meet the criteria for the safe harbor.

Currently, the regulations define "critical technology" based on certain sectors identified by North American Industry Classification System (NAICS) codes. CFIUS noted in the final regulations that the Treasury Department anticipates issuing a notice of proposed rulemaking that revises this definition from one based upon NAICS codes to one based upon the reasons for export controls. It did not provide any timing for this proposal.

Real Estate

CFIUS also issued final regulations that update the proposed regulations that specifically apply to real estate transactions where the main set of CFIUS regulations would not otherwise apply. The final regulations include clarifications to the definitions that outline the scope of the new real estate regulations and add an additional exception to the definition of excepted real estate transaction. Additionally, the excepted investor/excepted foreign state concept from the main CFIUS regulations is also present in the new real estate regulations, with the same definitions and foreign states.

The final regulations remove references to "maritime ports" and "airports" and instead combine these two concepts into the new definition of "covered port." The definition of "covered port" includes any port (whether maritime or air) listed on one of five lists maintained by the Department of Transportation and published on its website. In the event that a port is added to one of these lists after the regulations become effective, it is not deemed to be a "covered port" for CFIUS purposes until 30 days after the port's addition.

Given the complexity of determining whether a potential transaction involves real estate that is within the geographical scope of the new regulations, the FAQs indicate that the Treasury Department is developing a tool that will assist in understanding their geographic scope. Until that tool is released, the Department of Commerce's online TIGERweb tool is available and allows the public to view maps that include certain relevant features, such as military installations, urbanized areas, and urban clusters, and the Bureau of Ocean Energy Management maintains resources online which may assist in transactions in or near the offshore areas covered by these regulations.

Other Matters

Filing Fees

FIRRMA authorizes CFIUS to set filing fees for written notices. The final regulations do not address these fees, and the FAQs note that a separate proposed rule will be published on filing fees at a later date.

Genetic Information

The final regulations have narrowed the type of information that constitutes "genetic information" as part of the definition of "sensitive personal data." Previously, the definition cross-referenced the definition of "genetic information" from the Health Insurance Portability and Accountability Act (HIPAA), which is quite broad. This was removed for a narrower definition including only the "results of an individual's genetic tests, including any related genetic sequencing data, whenever such results constitute identifiable data." The definition of "genetic test" is linked to the definition in the Genetic Information Non-Discrimination Act of 2008 (GINA). "Sensitive personal data" does not include data derived from U.S. government databases that is routinely provided to private parties for research purposes.

Timing Changes

Beginning February 13, 2020, timing changes in the CFIUS process will go into effect that will add more certainty to the CFIUS timeline for many filings. If the parties stipulate in a full CFIUS notice (whether draft or final) that the transaction is a covered transaction, CFIUS will now provide comments or accept the filing within ten days. If the parties are willing to stipulate, this will now add more certainty to the potential length of the CFIUS process. Oftentimes, parties to complex transactions have an unexpected amount of delay waiting for comments on draft or final notices or waiting for CFIUS to formally accept the final notice. If the question of CFIUS jurisdiction is not in doubt, it may behoove parties to include a stipulation in order to accelerate the CFIUS timeframe.

Voluntary Declarations

CFIUS will now accept declarations voluntarily submitted by parties to a transaction in lieu of a traditional notice. Previously, the only declarations accepted by CFIUS were those required by the mandatory declaration provision of the pilot program. Similar to the traditional joint voluntary notice, CFIUS will publish a standard template form on or before the final regulations become effective.

Conclusion

The final regulations do not significantly differ from the proposed rule implementing FIRRMA. However, they do provide some relief to certain investors, most notably U.S.-controlled private investment funds. Yet once effective, they will significantly broaden the overall jurisdiction of CFIUS. Additionally, the expansion of CFIUS jurisdiction to non-controlling investments means that the analysis of whether CFIUS has jurisdiction over a transaction is more complex than ever before, and parties to a transaction that involves foreign entities should begin their CFIUS analysis and planning as early as possible.

Any company involved in international mergers and acquisitions, private equity funds, or U.S. real estate transactions should become familiar with these rules. If you have any questions regarding FIRRMA, the final regulations, or their changes to the CFIUS regime, please reach out to the contacts listed below.

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This alert is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions about the contents of this alert, please call your regular Fried Frank contact or the attorneys listed below:

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