

CFIUS Pilot Program Implements FIRRMA Reforms Targeting Certain “Critical Technologies” and Requiring Mandatory Declarations

October 16, 2018

Introduction

The Treasury Department has issued [temporary regulations](#)¹ establishing a pilot program (“**Pilot Program**”) to implement two provisions of the [Foreign Investment Risk Review Modernization Act of 2018](#) (“**FIRRMA**”) that did not take effect upon the statute’s enactment in August 2018. First, the Pilot Program significantly expands the jurisdiction of the Committee on Foreign Investment in the United States (“**CFIUS**” or the “**Committee**”) by subjecting to CFIUS review certain non-controlling investments by foreign persons in U.S. businesses that involve “critical technologies.” Second, the Pilot Program implements mandatory declarations for specific types of transactions, marking the end of CFIUS filings being technically voluntary.

The Pilot Program responds to the concern that “some foreign direct investment threatens to undermine the technological superiority that is critical to U.S. national security”² and evinces the national security community’s focus on the loss of sensitive technologies to foreign countries outside the traditional defense industry context. Indeed, the Pilot Program extends to U.S. businesses operating in a wide range of industries, including guided missile manufacturing and aircraft manufacturing, but also including less obviously sensitive sectors such as manufacturing of computer storage devices, wireless equipment, biotechnology, and storage batteries. Non-controlling foreign investments in these industries may not only be subject to CFIUS jurisdiction for the first time, but, under the Pilot Program, certain of these investments are *required* to be submitted to CFIUS.³ The Pilot Program may be viewed as part of a broader effort to slow the perceived transfer of technology that could damage the “national security innovation base.”

The temporary regulations implementing the Pilot Program (the “**Pilot Program Regulations**”) become effective November 10, 2018 and will end no later than March 5, 2020, as detailed below. The preamble to the Pilot Program Regulations notes that the scope, procedures and terms used in the Pilot Program are specific to the Pilot Program and subject to change in the proposed final rule implementing FIRRMA, including potentially in response to comments on the Pilot Program Regulations, which are due by November 10, 2018.⁴

¹ The Foreign Investment and National Security Act, Public Law No. 110-49, 121 Stat. 246 (2007), which amended section 721 of the Defense Production Act of 1950, currently codified at 50 U.S.C. 4565.

² Department of the Treasury, Interim Rule, Determination and Temporary Provisions Pertaining to a Pilot Program To Review Certain Transactions Involving Foreign Persons and Critical Technologies, 83 Fed. Reg. 51322, 51324 (Oct. 11, 2018).

³ Interestingly, if coincidentally, the Pilot Program was announced the same day that an [alleged Chinese intelligence operative was arrested and charged with conspiring to steal trade secrets](#).

⁴ Although the Pilot Program Regulations are issued for public comment, and any comments received during the public comment period must be considered by the Treasury Department, the Pilot Program Regulations are ultimately exempt from the notice and comment provisions of the Administrative Procedure Act and any comments received need not be addressed in the Pilot Program (*cont.*)

The Pilot Program Regulations

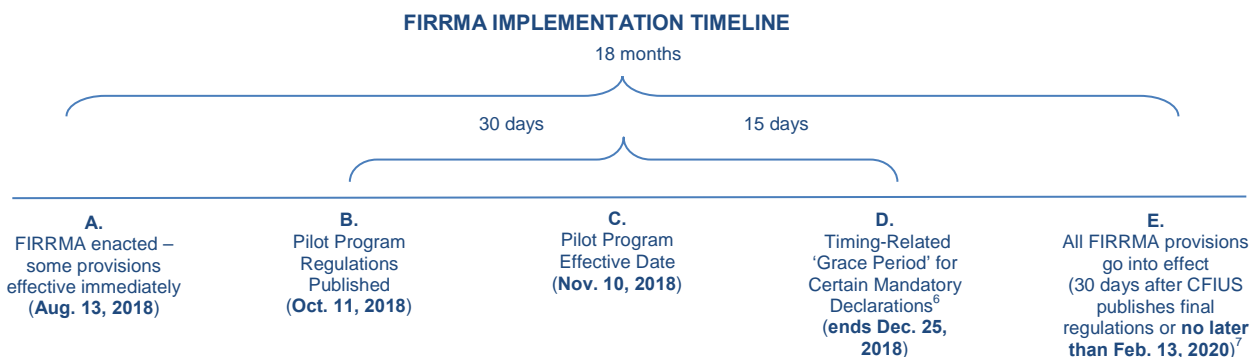
Legislative Context

As noted in our August [memorandum](#), FIRRMA meaningfully expanded the definition of “covered transaction” to capture a range of transactions that would previously have been outside of the Committee’s jurisdiction. In particular, FIRRMA authorizes CFIUS to review certain non-controlling investments in U.S. businesses, including investments by a foreign person in a U.S. business that produces, designs, tests, manufactures, fabricates, or develops one or more “critical technologies,” as defined in the statute. The Pilot Program Regulations represent a first step in implementing CFIUS’s expanded authority.

FIRRMA provided for a staggered rollout, with certain provisions effective immediately and others – including the expanded definition of covered transaction for investments in critical technologies – taking effect at the earlier of (1) February 13, 2020 (*i.e.*, 18 months after FIRRMA’s enactment) or (2) the date that is 30 days after publication in the Federal Register of a determination by the chairperson of the Committee that the regulations, organizational structure, personnel, and other resources necessary to administer the new provisions are in place.

In the interim, FIRRMA authorizes CFIUS to conduct pilot programs to implement any provision of FIRRMA with a delayed effective date. Relying on that authority, the Committee determined that the Pilot Program was necessary to address two “urgent and compelling” circumstances: the ability and willingness of some foreign parties to obtain equity interests in U.S. businesses in order to affect certain decisions regarding, or to obtain certain information relating to, critical technologies, and the rapid pace of technological change in certain U.S. industries.⁵

Below is a summary of the implementation timeline as discussed in FIRRMA and the Pilot Program Regulations.



(cont.)

Regulations. Accordingly, the Pilot Program Regulations can become effective 30 days following publication (*i.e.*, November 10, 2018). CFIUS may include in the final rule implementing FIRRMA responses to comments received on the Pilot Program Regulations. 83 Fed. Reg. 51324.

⁵ See 83 Fed. Reg. at 51324.

⁶ Although the Pilot Program Regulations generally require parties to submit the mandatory declarations discussed below no later than 45 days before completion of the transaction, parties may submit such declarations by November 10, 2018 for transactions that are expected to be completed between November 10, 2018 and December 25, 2018.

⁷ The Pilot Program will end if and when the final regulations implementing FIRRMA become effective, or by March 5, 2020.

Applicability of the Pilot Program

In General

Under the Pilot Program Regulations, CFIUS has jurisdiction to review any “pilot program covered transaction,” consisting of (i) certain types of investments in a “pilot program U.S. business” (referred to as “pilot program covered investments”) and (ii) any transaction that could result in foreign control of a Pilot Program U.S. business.

The key concepts of this rule are discussed below.

- **Pilot Program Covered Investment.** A Pilot Program covered investment is a non-controlling⁸ investment by a foreign person in an unaffiliated Pilot Program U.S. business⁹ that affords the foreign person (i) access to the “material nonpublic technical information” of the U.S. business; (ii) membership or observer rights on the board of directors or equivalent body of the U.S. business or the right to nominate an individual to a position on the board or its equivalent; or (iii) involvement (other than through voting shares) in substantive decision-making of the U.S. business related to the use, development, acquisition, or release of “critical technology.”
- **Pilot Program U.S. Business.** A Pilot Program U.S. business is any U.S. business that produces, designs, tests, manufactures, fabricates, or develops a critical technology that is (i) used by the U.S. business in one or more “pilot program industries” or (b) designed by the U.S. business specifically for use in one or more such industries.
- **Critical Technologies.** In general, “critical technologies” refers to controlled exports of various forms, including defense articles or defense services included on the United States Munitions List set forth in the State Department’s International Traffic in Arms regulations and items on the Commerce Control List to the extent that the items are controlled (i) pursuant to multilateral regimes or (ii) for reasons relating to regional stability or surreptitious listening. This term also includes “emerging and foundational technologies” identified by the Commerce Department pursuant to section 1758 of the new Export Control Reform Act of 2018 (“ECRA”).¹⁰
- **Pilot Program Industries.** The Pilot Program industries are listed in Annex A to the Pilot Program Regulations and represent 27 industries for which the Treasury Department has determined that the threat of erosion of technological superiority from foreign direct investment requires immediate action.¹¹ The Appendix to this memo lists the 27 Pilot Program industries.
- **Material Nonpublic Technical Information.** This term refers to information that is not available in the public domain, and is necessary to design, fabricate, develop, test, produce, or

⁸ “Control” in the context of the Pilot Program Regulations “generally follows the definition of control under existing CFIUS regulations, with the additional requirement that the U.S. business in question must be a pilot program U.S. business.” 83 Fed. Reg. at 51325.

⁹ An “unaffiliated pilot program U.S. business” means, with respect to a foreign person, a Pilot Program U.S. business in which that foreign person does not directly hold more than fifty percent of the outstanding voting interest or have the right to appoint more than half of the members of the board of directors or equivalent governing body.

¹⁰ The ECRA, like FIRRMA, was incorporated into the John S. McCain National Defense Authorization Act for Fiscal Year 2019 and signed into law in August 2018. The ECRA does not provide a definition of “emerging and foundational technologies.” An advance notice of proposed rulemaking from the Department of Commerce to implement this provision of the ECRA is expected shortly.

¹¹ 83 Fed. Reg. at 51324. As noted above, not all investments in Pilot Program industries are Pilot Program covered investments.

manufacture critical technologies, including processes, techniques, or methods. Financial information regarding the performance of a U.S. business is expressly excluded.

CFIUS approval of a Pilot Program covered investment does not automatically bestow approval for incremental Pilot Program covered investments by the same foreign person in the same U.S. business. If, for example, a foreign person were to acquire a four percent, non-controlling interest in a Pilot Program U.S. business, pursuant to a transaction filed with and approved by CFIUS, and then subsequently acquire an additional four percent non-controlling interest in the same U.S. business that afforded additional access to material nonpublic technical information, the parties to the investment would be required to file with CFIUS again.

Definition of Foreign Person

FIRRMA requires CFIUS to further define the term “foreign person” for purposes of its expanded jurisdiction over non-controlling investments by establishing criteria to limit the scope of such covered investments to those made by “certain categories of foreign persons.”¹² Those criteria must consider the foreign person’s connection to a foreign country or foreign government and whether the connection could affect U.S. national security.

At the Pilot Program stage, however, the Treasury Department has determined that the Pilot Program should apply on a global basis, and the Pilot Program does not exempt any country from the mandatory declaration requirement described below. The Treasury Department explains that applying the Pilot Program on a global basis without limiting the scope of “foreign person” is appropriate because “foreign investors that may present national security concerns are becoming increasingly sophisticated in structuring investments in a manner that may obfuscate those concerns, including by utilizing entities in other jurisdictions.”¹³ Results from the Pilot Program, with its global applicability, are meant to inform the Committee’s ultimate approach in defining foreign person as required by FIRRMA.¹⁴

Timing Issues

The Pilot Program Regulations become effective November 10, 2018. The Pilot Program Regulations do not apply to the following transactions:

- Transactions that are completed before November 10, 2018. A transaction is deemed completed for purposes of the Pilot Program when an ownership interest, including a contingent equity interest, is conveyed, assigned, delivered, or otherwise transferred to a person, or a “change in rights” occurs.
- Transactions in which any of the following occurred before October 11, 2018: (1) the parties executed a binding written agreement or other document establishing the material terms of the transaction; (2) a party made a public offer to shareholders to buy shares of a Pilot Program U.S. business; or (3) a shareholder solicited proxies in connection with an election of the board of directors of a Pilot Program U.S. business or requested the conversion of convertible voting securities.

¹² CFIUS is also required to define foreign person for purposes of real estate transactions newly covered as a result of changes made by FIRRMA.

¹³ 83 Fed. Reg. at 51324.

¹⁴ *Id.*

Investments Made Through Investment Funds

Consistent with FIRRMA, the Pilot Program Regulations establish separate rules for investments in U.S. businesses made through investment funds.¹⁵ An indirect, non-controlling investment in a Pilot Program U.S. business made by a foreign person through a fund will not constitute a covered transaction under the Pilot Program, even if it affords the foreign person membership as a limited partner or equivalent on an advisory board or committee of the fund, provided that:

- The fund is managed exclusively by a general partner, managing partner, or equivalent who is not the foreign person;
- The advisory board or committee does not have the ability to approve, disapprove, or otherwise control (i) investment decisions or (ii) decisions by the general partner (or equivalent) related to entities in which the fund is invested;
- The foreign person does not otherwise have the ability to control the fund, including authority to (i) approve or control investment decisions; (ii) approve or control decisions by the general partner (or equivalent) related to entities in which the fund is invested; or (iii) dismiss, select, or determine the compensation of the general partner (or equivalent); and¹⁶
- The foreign person does not have access to material nonpublic technical information as a result of participation on the advisory board or committee.

Mandatory Declarations

In General

The Pilot Program Regulations require that parties to a transaction covered by the Pilot Program file a declaration with the Committee—the first instance of such a requirement in CFIUS’s history. Failure to do so can subject the parties to a “civil penalty not to exceed the value of the” transaction. Thus, parties to any transaction that could even arguably constitute a Pilot Program covered transaction – even one they reasonably believe would not affect U.S. national security – will have strong incentives to submit a declaration. Although FIRRMA provides that mandatory declarations should be expected to be no longer than five pages, the Pilot Program Regulations require fairly substantial information in such a declaration, including many of the categories of information already required in full joint voluntary notices. Some of the information required to be included in declarations, moreover, is not expressly tied to the critical technology of the U.S. business. Other notable features of declarations under the Pilot Program include the following:

- Parties to a declaration must provide a list of the addresses or geographic coordinates of all “locations” of the Pilot Program U.S. business, including “headquarters, facilities, and operating locations.” This requirement extends beyond existing requirements for joint voluntary notices.
- Parties to a declaration must provide a “statement as to whether the Pilot Program U.S. business has any contracts (including any subcontracts, if known) that are currently in effect or were in effect within the past three years with any U.S. Government agency or component, or in

¹⁵ An “investment fund” is any entity that is an “investment company,” as defined under section 3(a) of the Investment Company Act or that would be an “investment company” but for one or more of the exemptions provided in section 3(b) or 3(c) of the Investment Company Act.

¹⁶ The mere right to *vote* on compensation or dismissal of the general partner, where the foreign person cannot make this determination unilaterally, is not sufficient.

the past 10 years if the contract included access to personally identifiable information of U.S. Government personnel.” This requirement also extends beyond existing requirements for joint voluntary notices. It is not clear from this regulation what form of “statement” CFIUS will require, although we would anticipate that parties will frequently be asked to provide a list or additional description of applicable contracts and subcontracts, if any.

- The foreign person filing a declaration need not provide personally identifiable information, as it would in a joint voluntary notice. The Pilot Program Regulations do require, however, that where the ultimate parent of the foreign person is a public company, the foreign person provide the name and nationality of any shareholder with an interest of greater than five percent in such parent.

After CFIUS receives a declaration and the CFIUS staff chair accepts it as complete,¹⁷ the Committee must take action within 30 days. CFIUS may either (i) request that the parties file a notice; (ii) inform the parties that CFIUS cannot complete action on the basis of the declaration (and that the parties may file a complete notice); (iii) initiate a unilateral review of the transaction through an agency notice; or (iv) notify the parties that CFIUS has completed all action.

In lieu of submitting a declaration, parties to a Pilot Program covered transaction may elect instead to file a full written notice.

Timing

Unless excluded as described under “Timing Issues,” Pilot Program covered transactions that are expected to be completed between November 10, 2018 and December 25, 2018 must file a mandatory declaration by November 10, 2018, or promptly thereafter. Parties to Pilot Program covered transactions that are expected to be completed after December 25, 2018 must file the mandatory declaration 45 days before the completion date of the transaction.

Additional FIRRMA Regulations

On the same day that it issued the Pilot Program Regulations, the Treasury Department also issued an [interim rule](#) making “largely technical” amendments to the Committee’s existing regulations.¹⁸ These amendments implement provisions of FIRRMA that became effective immediately and make other updates consistent with FIRRMA. As with the Pilot Program Regulations, comments are due on these amendments by November 10, 2018.

¹⁷ CFIUS may reject a declaration for a variety of reasons, including if, at any time after the declaration is submitted, the parties fail to provide follow-up information requested by the Staff Chairperson within two business days. Pilot Program Regulations § 801.406(a)(3).

¹⁸ Department of the Treasury, Interim Rule, Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 83 Fed. Reg. 51316 (Oct. 11, 2018).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John B. Reynolds, III	202 962 7143	john.reynolds@davispolk.com
Kenneth L. Wainstein	202 962 7141	ken.wainstein@davispolk.com
Jeanine P. McGuinness	202 962 7150	jeanine.mcguinness@davispolk.com
Will Schisa	202 926 7129	will.schisa@davispolk.com
Ryan Johansen	212 450 3408	ryan.johansen@davispolk.com
Joseph Kniaz	202 962 7036	joseph.kniaz@davispolk.com
Britt Mosman	202 962 7151	britt.mosman@davispolk.com

Appendix – Pilot Program Industries

Industry	NAICS Code
Aircraft Manufacturing	336411
Aircraft Engine and Engine Parts Manufacturing	336412
Alumina Refining and Primary Aluminum Production	331313
Ball and Roller Bearing Manufacturing	332991
Computer Storage Device Manufacturing	334112
Electronic Computer Manufacturing	334111
Guided Missile and Space Vehicle Manufacturing	336414
Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing	336415
Military Armored Vehicle, Tank, and Tank Component Manufacturing	336992
Nuclear Electric Power Generation	221113
Optical Instrument and Lens Manufacturing	333314
Other Basic Inorganic Chemical Manufacturing	325180
Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing	336419
Petrochemical Manufacturing	325110
Powder Metallurgy Part Manufacturing	332117
Power, Distribution, and Specialty Transformer Manufacturing	335311
Primary Battery Manufacturing	335912
Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing	334220
Research and Development in Nanotechnology	541713
Research and Development in Biotechnology (except Nanobiotechnology)	541714
Secondary Smelting and Alloying of Aluminum	331314
Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing	334511
Semiconductor and Related Device Manufacturing	334413
Semiconductor Machinery Manufacturing	333242
Storage Battery Manufacturing	335911
Telephone Apparatus Manufacturing	334210
Turbine and Turbine Generator Set Units Manufacturing	333611