TREASURY ISSUES FINAL REGULATIONS REVAMPING CFIUS AUTHORITY

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On January 13, 2020, the U.S. Department of the Treasury ("**Treasury**") published two final rules ("**Final Rules**," found here and here) that implement most of the remaining provisions of the Foreign Investment Risk Review Modernization Act of 2018 ("**FIRRMA**"). FIRRMA significantly enhances and expands the authority of the Committee on Foreign Investment in the United States ("**CFIUS**" or the "**Committee**") to conduct national security reviews of foreign direct investment in the United States, including certain non-controlling investments and real estate transactions that previously fell outside CFIUS jurisdiction. CFIUS issued FAQs and a Fact Sheet describing the Final Rules, which will become effective on February 13, 2020.

CFIUS issued proposed rules ("**Proposed Rules**") in September 2019, which we covered in our prior alert. The Final Rules are substantively unchanged from the Proposed Rules, except for certain noteworthy modifications and additions that we explain below.

I. OVERVIEW

The following are the most salient points regarding the Final Rules described in this Alert:

- The Final Rules expand the scope of "**covered transactions**" subject to CFIUS jurisdiction to include:
  - "**Covered control transactions**," which are transactions that could result in control of a U.S. business directly or indirectly by a foreign person (the traditional basis of CFIUS review jurisdiction); and
  - "**Covered investments**," which are non-controlling investments in "TID" (technology, infrastructure, and data) U.S. businesses ("**TID U.S. business**") that afford a foreign person: (1) access to material nonpublic technical information regarding critical technologies and critical infrastructure, (2) board membership and/or observer rights, or (3) substantive decision-making of the TID U.S. business regarding critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens.
  - **Changes in rights** that give a foreign person control over a U.S. business, and **transactions structured to evade CFIUS review**.
- Notifying CFIUS of a covered transaction remains voluntary except in two circumstances:
  - CFIUS has retained the mandatory notification requirement under the Critical Technologies Pilot Program (introduced in November 2018) for certain covered control acquisitions and non-controlling covered investments in TID businesses engaged in the production, design, testing, manufacturing, fabricating, or developing of critical technologies.

- An additional category of mandatory notifications has been added for transactions that result in the acquisition of a "substantial interest" in a TID U.S. business by a foreign person in which a foreign government has a "substantial interest."

- CFIUS jurisdiction is extended to certain purchases, concessions, and leases of real estate ("**covered real estate transactions**") that are located in or operated as part of an airport or maritime port, or that are proximate to certain identified U.S. military and intelligence assets. The CFIUS real estate rules, which are incorporated into a new 31 C.F.R. Part 802, are described in Section III below.
- Australia, Canada, and the United Kingdom are the first designated "**excepted foreign states**," which means that certain "**excepted investors**" from these countries are excluded from CFIUS's jurisdiction to review covered investments and covered real estate transactions. This exemption does not apply for covered control transactions. CFIUS also has reduced board membership and share ownership thresholds from the Proposed Rules so that more firms can qualify as excepted investors.
- To simplify the CFIUS process, parties to covered transactions and covered real estate transactions will now have the option of notifying CFIUS via a short-form declaration, rather than a lengthy Joint Voluntary Notification ("**JVN**").
- While FIRRMA authorizes CFIUS to collect filing fees, Treasury has deferred this decision to a separate rule to be issued in the future.

II. REVISION AND ENHANCEMENT OF CFIUS JURISDICTION: COVERED TRANSACTIONS

a. Non-Controlling Covered Investments

Probably the most significant impact of FIRRMA and the Final Rules is to expand CFIUS jurisdiction to certain covered investments in a TID U.S. business that do not result in control by a foreign person. For purposes of these rules, a TID U.S. business is defined as a U.S. business that:

- produces, designs, tests, manufactures, fabricates, or develops one or more "**critical technologies**," defined as encompassing most items subject to specific licensing controls under U.S. export control laws including "emerging" and "foundational" technologies identified through an ongoing review process by the Department of Commerce's Bureau of Industry and Security ("**BIS**");
- performs certain defined functions with respect to "**covered investment critical infrastructure**," defined as a subset of critical infrastructure set forth in an annex to the Final Rule; or
- maintains or collects, directly or indirectly, certain types and quantities of "**sensitive personal data**" of U.S. citizens, which is identifiable data that is incorporated into products or services within certain categories such as financial, health, geolocation, genetic, and biometric data.

Not all investments by foreign persons in a TID U.S. business will trigger CFIUS jurisdiction. Rather, the investment must afford the foreign investor (other than an excepted investor, as described further below) one of the following rights with respect to an unaffiliated TID U.S. business:

- Access to "**material nonpublic technical information**," defined as information that (a) "[p]rovides knowledge, know-how, or understanding not available in the public domain, of the design, location, or operation of critical infrastructure, including without limitation vulnerability information such as that related to physical security or cybersecurity," or (b) "[i]s not available in the public domain and is necessary to design, fabricate, develop, test, produce, or manufacture a critical technology, including without limitation processes, techniques, or methods";
- Board membership or observer status or nomination/appointment rights with respect to the TID U.S. business; or
- Any involvement other than through voting of shares in substantive decision making of the TID U.S. business regarding the use, development, acquisition, safekeeping, or release of sensitive personal data of U.S. citizens; the use, development, acquisition, or release of critical technologies; or the management, operations, manufacture, or supply of covered critical infrastructure.

b. Adoption of the Critical Technology Pilot Program, with Modifications

The Final Rules make permanent the mandatory declaration requirement under the CFIUS Critical Technology Pilot Program, but with certain new exceptions including for the following (note that these transactions are still covered by CFIUS jurisdiction and subject to review at CFIUS's discretion):

- Covered transactions resulting in an indirect investment by a foreign person in an entity with a valid facility clearance that is subject to an approved foreign ownership, control, or influence ("**FOCI**") mitigation instrument under the National Industrial Security Program;
- Covered investments in a TID U.S. business that has status as a TID U.S. business solely because it produces, designs, develops, tests, manufactures, or fabricates export-controlled encryption technology that is eligible for License Exception ENC under the Export Administration Regulations, 15 C.F.R. Part 730 et seq.; and
- Covered transactions by an investment fund managed exclusively and controlled by U.S. nationals.

c. Excepted Investor Carve-Out

Covered investments made by certain excepted investors will be carved out from CFIUS review jurisdiction. An excepted investor is, with certain limitations, a national, entity, or government of certain exempted countries ("**excepted foreign state**"). CFIUS has initially identified Australia, Canada, and the United Kingdom as excepted foreign states due to their robust intelligence-sharing and defense industrial base integration mechanisms with the United States. Within two years of the effective date of the Final Rules, and then every two years following that, CFIUS is required to adjust the list of excepted foreign states based on a review of countries' processes for analyzing foreign direct investments for national security risks and coordination with the United States.

There are certain situations where the "excepted investor" carve-out will not apply. One carve-out is where equity shares and board seats held by persons who are not U.S. persons or from an excepted foreign state are above a certain threshold. In response to comments on the Proposed Rules, CFIUS has lowered these thresholds as follows:

Board members/observers required to be from the United States or an excepted foreign state	75% (was 100% in the Proposed Rules)
Maximum share ownership permitted each discrete investor (or group of investors under common control, acting on concert, or related) not from the United States or an excepted foreign state	10% (was 5% in the Proposed Rules)
Minimum ownership percentage that must be held by investors from the United States or excepted foreign states	80% (was 90% in the Proposed Rules)

Another carve-out from the excepted investor definition applies if the foreign investor or any of its parents or subsidiaries has in the past five years received a written Finding of Violation or Penalty Notice from Treasury's Office of Foreign Assets Control, received written notice of debarment from the Department of State's Directorate of Defense Trade Controls, been the subject of a final order issued under export control laws by BIS, or been convicted of or entered into a deferred prosecution or non-prosecution agreement with the Department of Justice, among other legal violations.

Note that the excepted investors carve-out will not apply to "covered control transactions," *i.e.*, if the investment in fact results in control of a U.S. business by the foreign investor.

d. Investment Fund Clarification

The Final Rules implement without material modification the clarification on the status of investments in the Proposed Rules. In particular, an indirect investment in a TID U.S. business by a foreign person through an investment fund is not considered a covered investment if the fund is managed exclusively by a general partner (or equivalent) who is not a foreign person, the fund's advisory board (or equivalent) does not have the ability to control the fund's investment decisions, the foreign person does not have certain powers over the fund and the

fund's general partner, and the foreign person does not gain access to material non-public technical information as a result of participation on the fund's advisory board.

e. Voluntary Versus Mandatory Notifications to CFIUS

The CFIUS notification process remains mostly voluntary, with parties having the option to notify CFIUS of a transaction and obtain a safe harbor against subsequent review if CFIUS clears the transaction. There are two exceptions where notifying CFIUS is mandatory. The first is with respect to certain covered transactions involving a U.S. business that produces, designs, develops, tests, manufactures, or fabricates a critical technology, as discussed above. The other is where a foreign government (other than from an excepted foreign state) obtains a substantial interest directly or indirectly in a TID U.S. business. For purposes of this provision, the substantial interest test is met where an entity in which a foreign government owns 49% or more of voting interest acquires 25% or more of the voting interest in a TID U.S. business.

f. Further Expansion of the Definition of Covered Transactions

The Final Rules implement FIRRMA's expansion of the definition of “covered transactions” to include changes in rights where a foreign person obtains control over a U.S. business when additional equity or other ownership interest is not obtained, and any other transaction, transfer, agreement, arrangement, or structure the design of which is intended to evade or circumvent CFIUS jurisdiction.

III. EXPANSION OF CFIUS JURISDICTION: REAL ESTATE

As noted, the Final Rules implement FIRRMA by formally establishing CFIUS's expanded jurisdiction to covered real estate transactions, creating a new subset of CFIUS regulations (31 C.F.R. Part 802). This rule fills what was regarded as a significant gap in foreign investment national security reviews as it allows CFIUS to target purely real estate transactions that do not fit within the definition of a covered transaction.

a. What are Covered Real Estate Transactions?

CFIUS jurisdiction extends to three categories of “covered real estate transactions”:

- Any purchase, lease, or concession [1] to a “foreign person” of properties constituting “**covered real estate**” (defined below) that afford the foreign person at least three “qualifying property rights" whether or not those rights are exercised. These rights include the right to: (i) physically access the real estate, (ii)

exclude others from physically accessing the real estate, (iii) improve or develop the real estate, or (iv) attach fixed or immovable structures or objects to the real estate.

- Any purchase, lease, or concession by a foreign person of covered real estate that, through a subsequent change in the rights that a foreign person has with respect to that real estate, results in the foreign person having at least three of the qualifying property rights.
- Any other transactions, transfers, agreements, or arrangements, the structure of which is designed or intended to evade or circumvent the application of the CFIUS real estate regulations.

b. What is Covered Real Estate?

Specific types of property are considered “covered real estate” within CFIUS jurisdiction, as follows:

- Any property located within, or that will function as part of, certain airports and marine ports as defined under Department of Transportation regulations.
- Property located near a U.S. military installation or another facility or property of the U.S. government that is sensitive for reasons relating to national security. This includes property located within:
  - "Close proximity” of a designated military installation or another facility or property of the U.S. government listed in Part 1 and Part 2 of Appendix A to Part 802. “Close proximity” is defined as one mile from the outer boundary of the designated military installations or government facilities.
  - "Extended range” of a designated military installation listed in Part 2 of Appendix A to Part 802. “Extended range” typically means 100 miles outward from the outer boundary of the military installation but, where applicable, not exceeding the outer limit of the territorial sea of the United States.
  - Any county or other geographic area identified in connection with a designated military installation in Part 3 of Appendix A to Part 802.
  - Any part of certain, specified military installations identified in Part 4 of Appendix A to Part 802, to the extent located within the limits of the territorial sea of the United States.

c. Exceptions for Certain Real Estate

The Final Rule includes several notable exceptions to the Committee's jurisdiction over covered real estate transactions:

- Real estate within an “urbanized area” or “urban cluster” as defined by the Census Bureau (unless the property is in or will function as part of an airport or maritime port or is in close proximity to certain specifically identified military installations);
- Transactions for single housing units, including fixtures and adjacent land, provided the land is incidental to the use of the real estate as a single housing unit;
- Certain leases by and concessions to qualifying foreign air carriers;
- Land owned by certain Alaska Native entities or held in trust by the United States for American Indians, Indian tribes, Alaska Natives, and Alaska Native entities;
- Real estate that is to be used only for the purpose of engaging in the retail sale of consumer goods or services to the public; and
- Commercial space within a multi-unit building provided the foreign person does not hold more than 10% of the building's total square footage or represent more than 10% of the building's tenants.

d. Excepted Real Estate Investors

The Final Rule provides a carve-out for certain real estate transactions by an “excepted real estate investor.” Similar to the definition of excepted investor discussed previously, excepted real estate investors will be defined by reference to a list of excepted foreign states periodically updated by CFIUS. CFIUS has initially designated Australia, Canada, and the United Kingdom as excepted foreign states. The qualifications for excepted real estate investors are the same as those discussed with respect to covered investments discussed in Section II.c above.

e. Other Exceptions

CFIUS's jurisdiction does not extend to mortgages, loans, or similar financing arrangements by foreign persons to other persons for the purpose of the purchase, lease, or concession of covered real estate. In addition, transactions that involve real estate that also constitute investments in “U.S. businesses” are not “covered real estate transactions” but rather should be treated as noncovered transactions subject to the CFIUS rules discussed in Section II above.

IV. ADDITIONAL UPDATES

a. Proposed Definition of "Principal Place of Business"

In response to various public comments, CFIUS also simultaneously issued an interim rule defining "principal place of business," which had been previously undefined in the definition of an excepted investor in the Proposed Rules. CFIUS has proposed to use an analysis akin to the "nerve center" test used by U.S. courts to evaluate federal diversity jurisdiction and has defined principal place of business as "'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" subject to certain qualifications. The definition is designed to provide further clarity concerning investment funds managed and controlled by U.S. persons.

CFIUS is seeking public comments on its proposed definition, which are due February 18, 2020.

b. Short-Form Declarations Allowed for All Notifications

In a welcome development that may ease the burden of companies going through the CFIUS process, the Final Rules will allow parties to covered transactions and covered real estate transactions to notify CFIUS via a short-form declaration (similar to the one permitted for the CFIUS Critical Technology Pilot Program) rather than submitting a lengthy JVN. Such declarations, once accepted as complete by CFIUS, will be subject to a maximum 30-day review period rather than the longer period to review a JVN.

We understand that CFIUS has been unable to complete its review of many of the declarations submitted under the Critical Technology Pilot Program, which has resulted in either a request to file a full JVN or a notice that the parties can proceed with a transaction but without benefit of the safe harbor of CFIUS clearance. Parties requiring safe harbor clearance for their transactions therefore may still opt to file the full JVN.

V. FUTURE RULEMAKING

Consistent with the CFIUS Critical Technology Pilot Program, the mandatory requirement to file a declaration is based in part on whether the U.S. business produces, designs, tests, manufactures, fabricates, or develops a critical technology that is used in connection with or specifically designed for use in one of 27 industries defined by North American Industry Classification System ("**NAICS**") codes. CFIUS plans to issue a notice of proposed rulemaking switching its reliance on NAICS codes to a reliance on export control licensing requirements.

Finally, FIRRMA authorizes CFIUS to assess filing fees. Treasury has stated that it will defer this issue to a future rulemaking. For now, parties may continue to submit notifications to CFIUS without having to pay any filing fees.

VI. CONCLUSION

Follow K&L Gates as we continue to track CFIUS-related developments and changes. Our global trade team works closely with our colleagues across all of our 45 offices to help our clients understand and manage risks in

the pursuit of their business objectives. Contact any of the authors for additional information on CFIUS, the Final Rules, or other related topics.

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[1] The Final Rule gives the terms “purchase” and “lease” their ordinary meaning, but the term “concession” is defined specifically as “an arrangement, other than a purchase or lease, whereby a U.S. public entity grants a right to use real estate for the purpose of developing or operating infrastructure for a covered port” (including the assignment of a concession, in whole or in part, by the party who is not the U.S. public entity).

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