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Report from Washington

Treasury Issues Proposed Regulations Updating the CFIUS Pilot Program

May 21, 2020

Introduction

On May 20, 2020, the Office of Investment Security of the U.S. Department of the Treasury ("Treasury") issued proposed regulations modifying the Committee on Foreign Investment in the United States' ("CFIUS" or the "Committee") mandatory declaration provision for certain foreign investments in critical technology companies, known previously as the "Pilot Program." Specifically, the proposed rules focus on export control requirements for critical technologies in determining whether a filing is required, and remove the North American Industry Classification System ("NAICS") code criteria and the list of NAICS codes from the appendices of the CFIUS regulations. These proposed regulations also introduce new criteria indicating which persons in the foreign acquirer's ownership chain should be reviewed for export authorization purposes. The rules do not, however, modify the definition of "critical technologies," which is defined by the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA"). These proposed rules are not yet finalized and remain subject to public comment until June 22, 2020.

Background

CFIUS first enacted a Pilot Program in November 2018 to review both control transactions and certain non-controlling investments by foreign persons (whether or not government owned or controlled) in U.S. businesses involving critical technologies in 27 specified industries identified by NAICS code, including in the semiconductor, nanotechnology and biotechnology sectors. Whereas before, CFIUS filings were submitted pursuant to a voluntary regime, transactions falling within the scope of the Pilot Program were required to be notified to the Committee pursuant to a mandatory declaration or formal notice. The Pilot Program remained in effect until February 2020, when final regulations implementing certain provisions of FIRRMA took effect. These final rules largely incorporated the scope of the Pilot Program, though they exempted certain transactions involving excepted investors;

entities subject to an agreement to mitigate foreign ownership, control, or influence pursuant to the National Industrial Security Program regulations; certain encryption technologies; and certain investment funds from the critical technology mandatory declaration requirement. The current mandatory declaration requirement for critical technology companies will remain in effect for transactions that occurred from February 13, 2020, until the proposed regulations take effect upon publication of a final rule later this year.

Shifted Focus to Export Control Regimes

The proposed regulations shift the mandatory declaration requirement from one that is based on NAICS code industry classifications to one that is based on U.S. export control regimes. In particular, a mandatory declaration would be triggered for a covered transaction involving a company that "produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies for which a U.S. regulatory authorization would be required" to transfer that critical technology to certain transaction parties *and* foreign persons in the acquirer's ownership chain. Conversely, if the U.S. business at issue is authorized to export the critical technology to the foreign acquirer without a license (based on the foreign acquirer's principal place of business for entities, and nationality for individuals), then the transaction should not be subject to the mandatory declaration requirement.

The term "U.S. regulatory authorization" means a license or authorization from one of the four main U.S. export control regimes: (i) the International Traffic in Arms Regulations ("ITAR") administered by the Department of State; (ii) the Export Administration Regulations ("EAR") administered by the Department of Commerce; (iii) regulations governing assistance to foreign atomic energy activities administered by the Department of Energy; and (iv) regulations governing the export or import of nuclear equipment and material administered by the Nuclear Regulatory Commission. The proposed new rules' focus on export control requirements will often require a technical review of specific products including an "analysis of the particular item and end user, and the particular foreign country for export, re-export, transfer (in country), or retransfer." In determining whether a U.S. regulatory authorization would be required, no effect should be given to any license exemptions available under the ITAR or EAR, with the exception of certain mass market encryption software subject to EAR License Exception ENC; License Exception Technology and Software Unrestricted ("TSU"); and certain elements of License Exception Strategic Trade Authorization ("STA").

Voting Interests for Purposes of Critical Technology Mandatory Declarations

The proposed rules also introduce the term "voting interest for purposes of critical technology mandatory declarations" to specify which persons in the foreign acquirer's ownership chain should be reviewed for export authorization purposes to determine whether the transaction could trigger a mandatory declaration. In the context of an interest in a foreign person, this term is defined as "a voting interest, direct or indirect, of 25 percent or more." Additionally, for the purposes of determining an indirect interest under the proposed regulations, "any interest of a parent entity in a subsidiary will be deemed to be a 100 percent interest." For investment funds, a foreign person will be considered to have a voting interest for purposes of critical technology mandatory declarations in the acquiring entity if the foreign person holds a 25 percent or more interest in the general partner, managing member, or equivalent of that fund. Additionally, foreign persons who are affiliated, have arrangements to act in concert, or are controlled by the same foreign state will have their interests aggregated.

Key Takeaways

Determining the extent to which an investment target falls within the scope of the mandatory declaration provision pursuant to these proposed regulations will require a much more detailed and technical analysis of particular products and end users. This, coupled with the increasingly complex review of the nature of the investor and the investor's ownership structure, will often require much more attention during transaction diligence from both buyer and seller, as well as a heightened level of cooperation in coordinating this analysis. Simpson Thacher & Bartlett is experienced in navigating the complexities of the CFIUS review process and continues to monitor the relevant regulatory developments.

For further information, please contact one of the following members of the Firm's Litigation Department.

WASHINGTON, D.C.

Mick Tuesley
+1-202-636-5561
mick.tuesley@stblaw.com

Abram J. Ellis
+1-202-636-5579
aellis@stblaw.com

* * * * * * *

Mark B. Skerry
+1-202-636-5523
mark.skerry@stblaw.com

Nicholas Olumoya Ridley
+1-202-636-5824
nicholas.ridley@stblaw.com

Claire M. DiMario
+1-202-636-5536
claire.dimario@stblaw.com

Laurel E. Fresquez*
+1-202-636-5537
laurel.fresquez@stblaw.com
**Not Yet Admitted*

Jennifer Ho
+1-202-636-5525
jennifer.ho@stblaw.com

NEW YORK CITY

George S. Wang
+1-212-455-2228
gwang@stblaw.com

Daniel S. Levien
+1-212-455-7092
daniel.levien@stblaw.com

Lani E. Lear
+1-202-636-5827
lani.lear@stblaw.com

Joseph P. Betteley
+1-202-636-5865
joseph.betteley@stblaw.com

Samantha N. Sergent
+1-202-636-5861
samantha.sergent@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000