

CFIUS at a Crossroads:

Congress considers significant CFIUS reform on heels of CFIUS Annual Report and blocked Chinese semiconductor investment

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Introduction

After a summer of discussion surrounding the U.S. government’s ability to control Chinese investment in U.S. companies, members of the House and Senate have introduced new legislation that seeks to improve the government’s national security review process. On November 8, 2017, a bipartisan group led by Sen. John Cornyn (R-TX) introduced the Foreign Investment Risk Review Modernization Act (“FIRRMA”), which would make significant changes to the Committee on Foreign Investment in the United States (“CFIUS” or “Committee”), an interagency committee responsible for assessing threats to U.S. national security posed by acquisitions of control in U.S. businesses by non-U.S. investors.

Among other changes, the bill would expand the scope of transactions subject to CFIUS review to include joint ventures and other transactions involving contributions of U.S. intellectual property, U.S. real estate transactions and other investments in U.S. technology or infrastructure companies. The new legislation seeks to shore up CFIUS jurisdiction by closing what some lawmakers view as a gap in existing authority. Under the current rules, investors have increasingly crafted transactions specifically to avoid the Committee’s reach.

By granting CFIUS the authority to review a wider variety of deals resulting in the transfer of industrial and technological capabilities to foreign investors, FIRRMA would allow the Committee to capture a greater share of the transactions that affect U.S. national security.

Sen. Cornyn and other supporters of the bill have described it as a response to the problem of “potential adversaries, such as China . . . degrading our country’s military technology edge by acquiring, and otherwise investing in, U.S. companies.”

The Senate is considering FIRRMA just weeks after CFIUS released its annual report to Congress detailing the Committee’s activities through 2015, the most recent year for which complete data on foreign investment in the United States is available. CFIUS also released high-level information regarding transactions reviewed in 2016. This information demonstrates a

continuation of recent trends, such as the growing number of reviews, the expanding timeframes of many reviews and the significant number of reviewed transactions involving Chinese investors.

The proposed legislation focuses new attention on CFIUS, which advised President Donald Trump to block a major Chinese investment in a U.S. semiconductor manufacturer in mid-September. After CFIUS conducted an extended review, President Trump blocked the proposed US\$1.3 billion acquisition of Lattice Semiconductor, a U.S. chip manufacturer, by Canyon Bridge Capital Partners LLC, a Chinese-backed private equity fund. The action represents only the fourth time that a U.S. President has formally blocked a transaction on CFIUS' recommendation (though it also represents the second time during the last year that a transaction was blocked due to concerns raised by CFIUS).

This report examines highlights from the CFIUS Annual Report, describes the Lattice Semiconductor transaction in detail and outlines the key changes that will result if and when FIRRMA becomes law.

Background on CFIUS

CFIUS is an interagency committee principally comprising nine members, chaired by the Secretary of Treasury and tasked with reviewing transactions that could result in control of U.S. businesses by non-U.S. persons to determine the effect of such transactions on U.S. national security. CFIUS operates pursuant to the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 ("FINSA"), which defines a "covered transaction" as "any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States."

After receiving notice of a covered transaction, CFIUS commences a 30-day review and is authorized to conduct an additional 45-day investigation if warranted. CFIUS may also negotiate an agreement with any party to a covered transaction to mitigate perceived threats to national security. Once CFIUS completes its review — and at any time during a subsequent investigation — it may conclude that national security concerns raised by a transaction have been addressed adequately. If such concerns remain unaddressed at the conclusion of an investigation, however, CFIUS refers the transaction to the president for a decision. The president enjoys broad discretion in taking actions deemed appropriate to suspend, prohibit or unwind a covered transaction when acting based on credible evidence. The president must announce a decision within 15 days of referral by CFIUS.

Highlights from CFIUS Annual Report

The most recent CFIUS Annual Report covers transactions through 2015 and therefore does not reflect the blocking of proposed Chinese acquisitions of U.S. semiconductor businesses in 2016 and last month. CFIUS also released a table, however, that provides some high-level information regarding transactions reviewed by the Committee during 2016. Highlights from the most recent report and accompanying table include:

More covered transactions

While the number of covered transactions reviewed by CFIUS remained steady from 2014 (147) to 2015 (143), there was a noticeable increase for 2016 (172). Information for 2017 will not be available for at least another year, but CFIUS is on pace to review more than 200 covered transactions during the current year, which would set a new record.

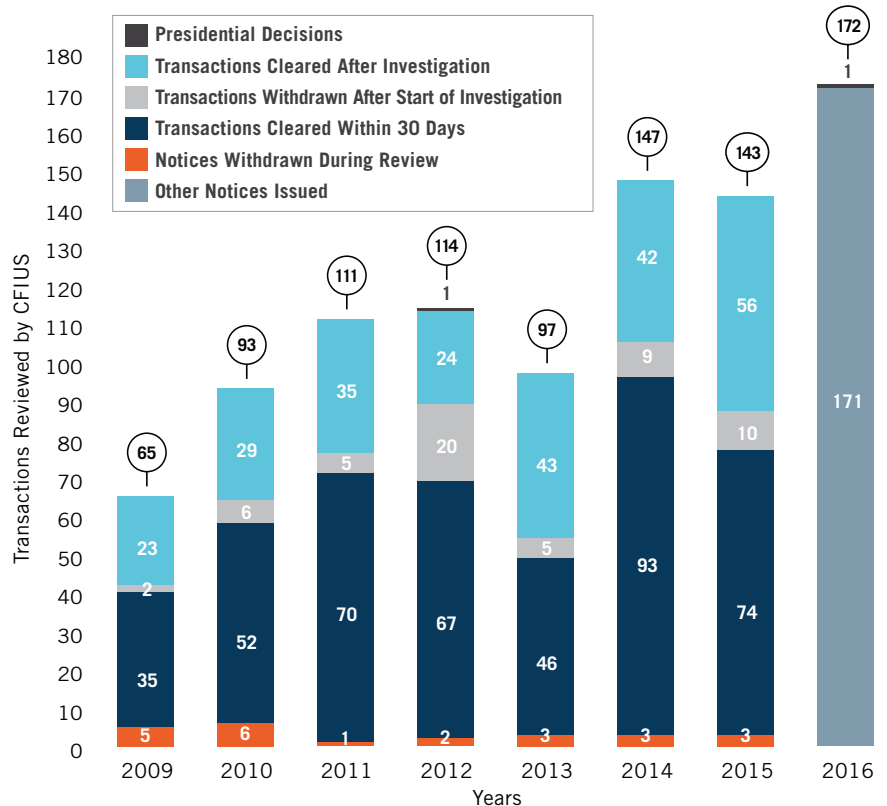
More investigations

CFIUS conducted “investigations” of covered transactions — resulting in an additional review period of up to 45 days — at a higher rate in 2015 and 2016 than in prior years. CFIUS conducted investigations of approximately 45% of the 315 transactions it reviewed in 2015 and 2016 combined, representing an increase of nearly 10% from 2014. This trend, combined with recent resource shortages at CFIUS and an increase in transactions being reviewed by the Committee this year, suggests that parties filing notices of covered transactions have less reason to expect CFIUS to conclude its review at the end of the initial 30-day review period and should instead expect that CFIUS will make use of some or all of the subsequent 45-day investigation period.

More deals withdrawn and abandoned due to CFIUS concerns

The number of notifications that have been withdrawn, as well as withdrawn and refiled, has steadily increased in recent years. Seven notices were withdrawn and refiled in 2014, a number that rose to nine in 2015 and 15 in 2016. There has also been a steady increase in the number of deals abandoned due to national security concerns raised by CFIUS — from two in 2014 to three in 2015 to five in 2016.

CFIUS Transaction Notices By Year



Data on withdrawal and approval timing for 2016 transactions was unavailable at time of publication. Total notices issued in 2016 were 172, with 79 total investigations commenced and 1 presidential decision reached. For 2016 data, visit https://www.treasury.gov/resource-center/international/foreign-investment/Documents/CFIUS_Stats_2014-2016.pdf

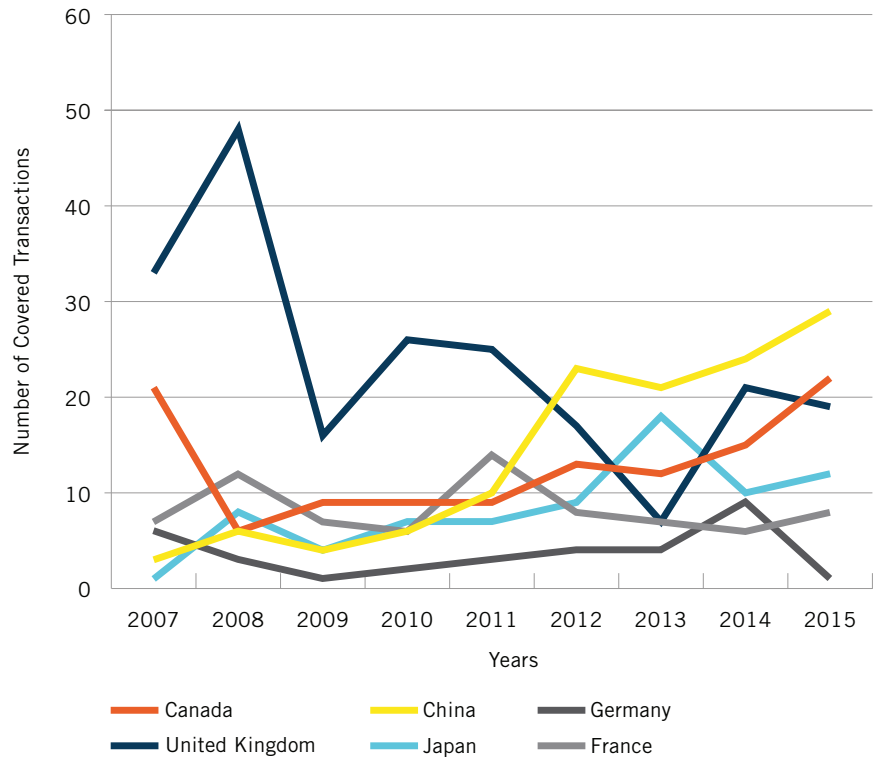
Many reviews pertaining to China, Canada and the United Kingdom

Chinese investors have submitted more notifications to CFIUS each year since 2012, and CFIUS continues to review more transactions involving China than any other country each year. In 2015, Chinese investors submitted 29 transactions for review, up from 24 in 2014. As in 2014, Canada and the United Kingdom submitted the second and third most transactions of any country in 2015, with Canadian acquirers submitting 22 transactions (up from 15) and UK acquirers submitting 19 (down from 21).

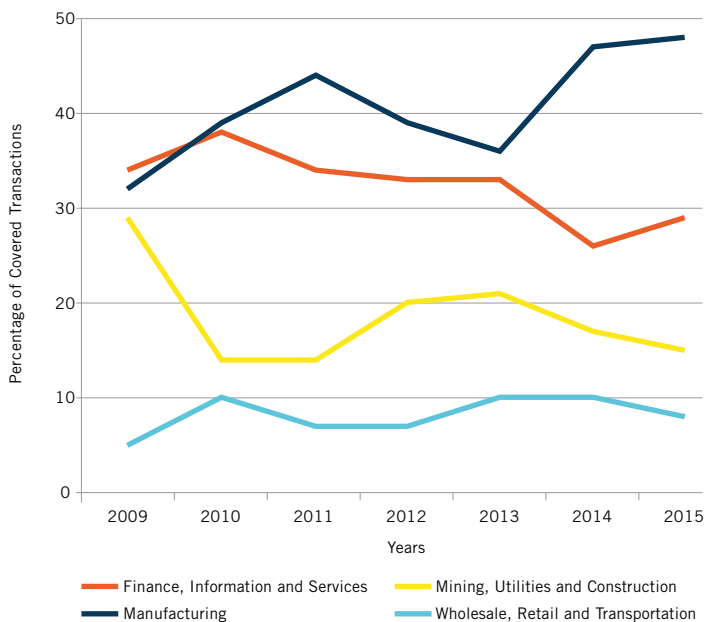
Continuing focus on transactions in the manufacturing sector

The annual report's data on covered transactions by sector indicates the attention that CFIUS continues to pay to manufacturing. In 2009, manufacturing; finance, information and services; and mining, utilities and construction each accounted for around a third of CFIUS's review total. Since then, the share of manufacturing transactions has grown, with 68 (48% of the total) submitted in 2015. Within the manufacturing sector, computer and electronic products have accounted for by far the most CFIUS filings since 2011, with 33 covered transactions in 2015.

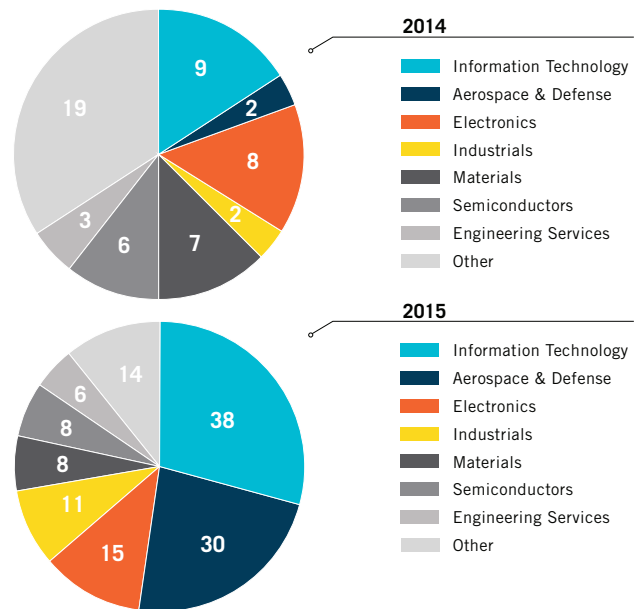
Covered Transactions By Country



Covered Transactions by Sector (2009-2015)



Completed Critical Technology Transactions by Company Sector



The number of transactions appearing in these charts is less than the total number of transactions reviewed because some transactions did not include a sector description.

Blocking of the Acquisition of Lattice Semiconductor

Lattice Semiconductor Corporation (“Lattice”) is an Oregon-based semiconductor company that manufactures programmable logic devices. In November 2016, Canyon Bridge Capital Partners, a newly launched private equity firm focusing on technology investment, announced a US\$1.3 billion acquisition of Lattice. Though Canyon Bridge is based in Palo Alto, the acquisition attracted the attention of government regulators after news reports indicated that the firm was funded partly by the Chinese government. CFIUS’s review produced a negative recommendation, and President Donald Trump issued an order on September 13, 2017 blocking the transaction from proceeding.

It has been publicly reported that CFIUS focused its review on Lattice’s production of chips called field-programmable gate arrays, which the company formerly sold to the U.S. military. The proposed transaction reportedly underwent three 75-day cycles of review and investigation by CFIUS, during which the parties argued that the acquisition did not pose national security threats and also proposed mitigation measures to address concerns raised by CFIUS. For example, Lattice reportedly offered to transfer certain intellectual property to the U.S. government in order to safeguard it from misuse, and it also argued that its outsourcing of chip manufacturing meant that the transaction would not implicate national security concerns.

Still, CFIUS ultimately determined that it was not possible to mitigate the national security concerns posed by the transaction. According to a White House statement, the president blocked the transaction because of “the potential transfer of intellectual property to the foreign acquirer, the Chinese government’s role in supporting this transaction, the importance of semiconductor supply chain integrity to the United States Government, and the use of Lattice products by the United States Government.”

While many transactions involving Chinese acquirers are approved by CFIUS, only four transactions have been blocked by the president in the 40 years of CFIUS’s existence, and all have involved Chinese acquirers. The blocked acquisition of Lattice marks the second time in 10 months that the U.S. government has prevented the acquisition of a U.S. semiconductor business by a Chinese buyer (see our update of the December 2016 blocking of the AIXTRON SE transaction). In 2012, President Barack Obama blocked Ralls Corp., a Chinese company, from developing wind farm sites near a military base in Oregon (see our article detailing the blocked transaction), and in 1990, President George H.W. Bush stopped a Chinese company from purchasing MAMCO Manufacturing, Inc., an aerospace manufacturer. Furthermore, it is likely that several more transactions involving Chinese acquirers were abandoned due to the parties’ inability to address concerns raised by CFIUS during the review process.

Foreign Investment Reform Efforts

In October and November 2017, the Senate introduced two bills to strengthen the U.S. government’s approach to reviewing the acquisition of U.S. companies by foreign entities. One bill regulates foreign investment based on the economic impact in the U.S., and the other focuses on national security safeguards through CFIUS reform. Reform discussions gathered momentum last summer amid mounting concerns about increased investment by Chinese companies. In 2016, Chinese investment in the United States grew to US\$46 billion, with acquisitions ranging from movie theaters to technology start-ups. A March 2017 Pentagon report indicated U.S. government concerns regarding China’s increased interest in technology investment. In a June speech at the Council on Foreign Relations, Sen. Cornyn referred to growing investment by Chinese firms in robotics and artificial intelligence as he described the need for CFIUS reform.

Foreign Investment Review Act

On October 18, 2017, Senators Sherrod Brown (D-OH) and Chuck Grassley (R-IA) introduced the Foreign Investment Review Act (“FIRA”). Under FIRA, the Department of Commerce (“Commerce”) would review certain investments that could result in foreign control of a U.S. entity. Unlike FIRRMA, this bill introduces a review process that is distinct from CFIUS,

focusing on the impact of each proposed transaction on the economic interests of the United States, rather than its national security.

FIRA's proposed review process would apply to all transactions valued at or above US\$1 billion that would result in foreign control of a domestic entity. For transactions involving foreign state-owned enterprises, the threshold for notification would be only US\$50 million. Unlike existing CFIUS rules, where notification is ostensibly voluntary, FIRA would introduce mandatory notification obligations. In reviewing each transaction, Commerce would consider the long-term economic interests of the United States, the history of distortive trade practices in each country where a foreign party is domiciled and the impact of the transaction on domestic industry, among other factors.

FIRA also relates tangentially to the CFIUS review process, as the bill would allow coordination between Commerce and CFIUS when transactions require both economic and national security review. The most significant collaboration required under FIRA would be between Commerce and the U.S. Trade Representative, who would provide a report regarding the relationship between the United States and the relevant country.

Foreign Investment Risk Review Modernization Act

FIRRMA, a proposal to reform CFIUS itself, followed in November. Senators Cornyn, Dianne Feinstein (D-CA) and Richard Burr (R-NC), among others, sponsored FIRRMA in the Senate, and Rep. Robert Pittenger (R-NC) introduced a companion bill in the House of Representatives, also with bipartisan support. Supporters of the bill say that it is intended to prevent China and other potential adversaries from exploiting gaps in the current CFIUS process to siphon off critical U.S. technologies and undermine U.S. military capabilities through transactions that fall outside of CFIUS' current authority.

Congress is expected to hold hearings on the bill within the next few months — based on strong bipartisan support of the bill, it is expected to become law in early 2018. No changes to the CFIUS process will occur, however, until the Treasury Department issues implementing regulations and the Secretary of Treasury affirmatively certifies that CFIUS has adequate resources to enforce its expanded mandate.

The additional resources requirement is expected to be a significant factor — while CFIUS is expected to review more than 200 transactions during 2017 (far surpassing the previous high), it is estimated that the number of annual filings reviewed by CFIUS under the bill's expanded mandate could easily surpass 1,000 per year.

Key provisions of the bill include:

Expanded jurisdiction for CFIUS

While current law limits CFIUS' jurisdiction to transactions that would result in the acquisition of foreign control of a U.S. company, the new bill would expand the definition of "covered transactions" to include:

- Purchases and leases of real estate in close proximity to military bases and national security facilities.
- "Non-passive" investments in critical technology and infrastructure companies.
- Changes in investor rights that would result in foreign control of a U.S. business or a non-passive investment in critical infrastructure or technology.
- Joint ventures involving the transfer of "intellectual property and associated support" to a foreign entity.
- Transactions and arrangements otherwise "designed or intended to evade or circumvent" CFIUS review.



New consideration of “countries of special concern”

FIRRMA introduces the concept of “countries of special concern,” defined as those that “pose[] a significant threat to the national security interests of the United States.” CFIUS must make certain assessments with special attention to these countries, as described below.

More factors for CFIUS to consider

Under current law, CFIUS considers a list of 10 factors in assessing transactions. FIRRMA amends some of these factors and expands the list to include nine additional factors. The new considerations include:

- The potential for resulting increases to the U.S. government’s cost of maintaining equipment and systems necessary for defense, intelligence and national security.
- “The national security-related effects of the cumulative market share of any one type of infrastructure, energy asset, critical material, or critical technology by foreign persons.”
- The acquirer’s history of compliance with U.S. laws and regulations and adherence to contracts with U.S. government entities.
- The likelihood that the transaction would expose sensitive data of U.S. citizens to foreign governments or persons that may exploit such information.
- The possibility of new or greater cybersecurity vulnerabilities.
- Whether the transaction will result in a foreign government “gaining significant new capability to engage in malicious cyber-enabled activities against the United States,” with specific reference to effects on U.S. elections.
- The involvement of a country of special concern with a “strategic goal of acquiring a type of critical technology” that a U.S. party possesses.
- The likelihood of facilitating “criminal or fraudulent activity affecting national security.”
- The likelihood that the transaction would expose sensitive national security information, procedures, or operations to foreign entities.

Streamlined filing procedures

FIRRMA would enable parties to file “declarations” in place of complete notices to CFIUS. These submissions generally would be voluntary and would not necessarily trigger CFIUS review; rather, the Committee would have the option of requesting more information, launching a review, or notifying the parties of no further action. FIRRMA further specifies that voluntary declarations will generally be no longer than five pages. Notably, such declarations would be mandatory for covered transactions involving the acquisition of a 25 percent or greater voting interest in a U.S. business by any foreign person in which a foreign government holds a voting interest of 25 percent or more.

Discretionary measures

Both CFIUS and the president would receive new discretionary authority under FIRRMA. The law would enable the Committee to promulgate new regulations partially exempting investors from certain countries. To establish such exemptions, CFIUS would need to consider factors such as the country’s involvement in treaties or other national security arrangements with the United States and the country’s own foreign investment review process. In addition to the president’s existing authority to take steps to suspend or prohibit a transaction, FIRRMA would also enable the president to “take any additional action the President considers appropriate to address the risk to the national security of the United States” caused by a proposed transaction.

New risk mitigation and compliance enforcement tools

The bill would give CFIUS new authority to implement risk mitigation measures, including imposing interim mitigation agreements while review is pending and imposing conditions even when parties abandon a transaction. The Committee would also be tasked with establishing new plans for monitoring compliance with such agreements.

Transparency and information sharing

Under FIRRMA, CFIUS would be required to add greater detail to its unclassified annual reports, including descriptions of the outcomes of each review, basic information on transacting parties, the existence of mitigation agreements and data on monitoring and enforcement actions. In addition, new rules would clarify the information that CFIUS can share with other agencies or foreign governments.

Resources

With growing transaction notices each year, FIRRMA would establish a new CFIUS Fund. The Fund would partially draw from new CFIUS filing fees, to be set by regulation at a later date but not to exceed the lesser of (i) one percent of the value of the transaction or (ii) \$300,000 (adjusted annually for inflation). CFIUS would use this funding to hire new staff outside the established civil service hiring process.

How Dechert can assist

Parties to transactions involving foreign acquisitions of stakes in U.S. manufacturing, technology, or other industries of concern to CFIUS should strongly consider availing themselves of the voluntary CFIUS notification process. Dechert has represented many clients through CFIUS reviews, including major players in the energy, telecommunications, high technology, defense and infrastructure industries. Dechert regularly advises foreign and domestic entities (“buyers” and “sellers,” as well as other interested third parties) through the CFIUS review process, helping them to: determine whether or not to bring a transaction before the Committee, assemble the required information and materials for a voluntary filing and then (as necessary) negotiate national security agreements with CFIUS in a manner that minimizes both delay and the imposition of conditions that might threaten the transaction. The firm also gives counsel on strategies for identifying and addressing political and policy considerations that may arise.

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