ALERT MEMORANDUM

CFIUS Shifts Focus of "Critical Technology" Mandatory Notifications to Export Controls

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On September 15, 2020, the U.S. Department of the Treasury published a final rule (the "Final Rule") significantly changing the scope of the Committee on Foreign Investment in the United States ("CFIUS") mandatory notification requirements for foreign investments in U.S. critical technology businesses and expanding it to investments in all industries.[1] The Final Rule, which is basically the same as (but does resolve some ambiguities in) the May 2020 proposed rule,[2] eliminates the current limitation of mandatory critical technology notifications to targets active in specified industries and instead focuses on whether the target develops, tests, or manufactures technologies that would require a license for export—whether or not the technologies are in fact exported or sold to third parties (e.g., proprietary manufacturing technologies)—to the jurisdiction of the investor and any entity in its chain of ownership, effectively creating different mandatory notification requirements for different countries. The Final Rule also clarifies the ownership rules used to determine when an investor linked to a foreign government is required to file with CFIUS for an investment in a sensitive U.S. technology, infrastructure, or data business. The Final Rule applies to all transactions entered into (i.e., binding agreement signed, public offer launched, proxies solicited, or options exercised) after October 15, 2020.

I. Key Takeaways

Effective October 15, 2020, the Final Rule:

- expands the CFIUS mandatory notification requirement to cover foreign investments in any industry, if the target U.S. business involves technology that would require a license or other authorization under any of the four main U.S. export control regimes to export, re-export, or transfer to any foreign person in the ownership chain of the investor(s) in the transaction;
- complicates the CFIUS mandatory notification analysis by requiring parties to determine the export control status of all products, software, and technology that are produced, designed, tested, manufactured, fabricated, or developed by the U.S. business (whether or not they are in fact exported, or even sold to any third party), the jurisdiction of every entity in the investment chain, and the corresponding licensing

[1] 85 Fed. Reg. 57124 (Sept. 15, 2020). The Final Rule is available at: https://www.govinfo.gov/content/pkg/FR-2020-09-15/pdf/2020-18454.pdf.
[2] 85 Fed. Reg. 30893 (May 21, 2020). The proposed rule is available at: https://www.govinfo.gov/content/pkg/FR-2020-05-21/pdf/2020-10034.pdf.

requirements, potentially introducing significant delays with respect to any target business that has not previously undergone a thorough export control review; and

- exempts from the mandatory notification requirement a wide range of dual-use products, software, and technology eligible for export to the buyer and its parent entities under the Export Administration Regulations ("EAR"), so long as the U.S. business has satisfied all pre-export requirements (even if no export is to occur).

II. Critical Technology Mandatory Notification Requirement

a. Shift from Industry Analysis to Investor Country Analysis

Since November 2018, foreign investments in U.S. businesses that produce, design, test, manufacture, fabricate, or develop one or more "critical technologies" have potentially triggered a mandatory CFIUS notification, if the foreign investor obtained "control" of the U.S. business or any significant governance or business information rights.[3] "Critical technologies" are defined as a wide range of technologies subject to U.S. export controls (other than the broadest and least restrictive group of technologies controlled solely for anti-terrorism reasons).[4] However, under the existing rule, the mandatory notification requirement is only triggered if the U.S. business uses the critical technology in, or the critical technology is designed for use in, one of 27 specified industries.[5] While this system created significant ambiguities, as there is no official source for determining what "industry" a business operates in and the classification system has broad and overlapping definitions, many industries were outside the scope of the rule.

The Final Rule eliminates consideration of the target industry altogether. Instead, mandatory notification is required if an export control license or other authorization would be required to export the target company's critical technologies to the country of the investor or any parent entity in the investor chain. This analysis is hypothetical—it does not matter whether the technologies ever have been or would be sold or exported to third parties—and looks to the principal place of business[6] (for entities) or country of nationality (for individuals) of any foreign entity directly or indirectly holding 25% or more of the foreign-controlled entity investing in the U.S. critical technology company.

[3] "Control" is nominally defined as "the power…to determine, direct, or decide important matters affecting an entity. 31 C.F.R. § 800.208. However, CFIUS has long interpreted the term very broadly to mean something more like "substantial influence," finding "control" in cases where the investor acquired as little as 15% of the target's shares and a single board seat. In the case of critical technology companies, any of (i) access to any material nonpublic technical information in the possession of the U.S. business; (ii) membership or observer rights on, or the right to nominate an individual to a position on, the board of directors or equivalent governing body of the U.S. business; or (iii) any involvement, other than through voting of shares, in substantive decision-making of the U.S. business regarding the use, development, acquisition, or release of critical technologies also triggers a mandatory filing. *See* 31 C.F.R. § 800.211.

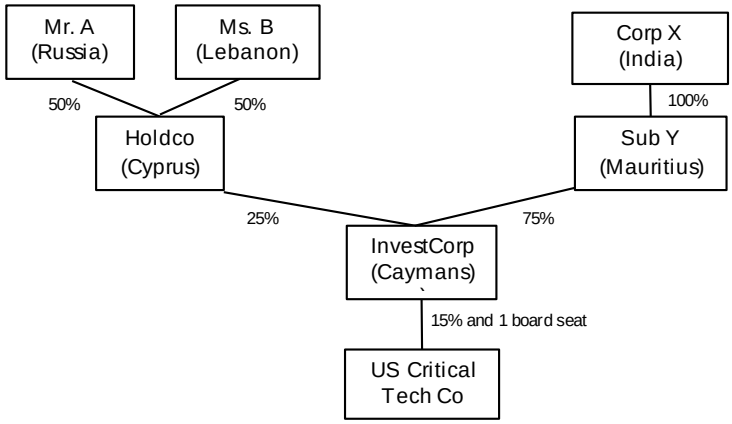
[4] *See* 31 C.F.R. § 800.215.

[5] The specified industries were identified by North American Industry Classification System (NAICS) code. 31 C.F.R. Part 800, Appendix B.

[6] "Principal place of business" means 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.

b. Covered Investors

In analyzing which entities may hold an interest of 25% or more in the foreign-controlled person making the investment in a U.S. critical technology company, any entity that is a "parent" of a shareholder (essentially, has a majority of either the economic or voting rights in that entity)[7] is attributed 100% of its interest. These rules substantially expand the number of jurisdictions to be assessed in consortium transactions or when acquirers have complex ownership structures. In the following example, if the critical technology of the target requires a license for export (and does not qualify for a license exception covered by the Final Rule) to any of Russia, Lebanon, India, Cyprus, Mauritius or the Cayman Islands, a mandatory filing is triggered:



The Final Rule clarifies that for limited partnerships, LLCs, and similar investment vehicles with passive investors, such as are commonly found in private equity funds, the applicable threshold is a 25% interest in the general partner, managing member, or equivalent. The Final Rule also states that the ownership interests of foreign persons acting in concert or controlled by a single foreign state are aggregated.[8]

c. Covered Licensing Requirements

The Final Rule did not change the definition of "critical technologies."[9] A mandatory licensing requirement is triggered if (a) the U.S. business produces, designs, tests, manufactures, fabricates, or develops one or more

[7] The definition is more fully elaborated at 31 C.F.R. § 800.235.

[8] Note that the "excepted investor" framework of the existing FIRRMA rules is maintained, but every entity in the ownership chain between the U.S. critical technology business and the excepted investor must also be a U.S. or excepted entity for the exception to apply. *See* our prior memorandum, "CFIUS Releases Final FIRRMA Regulations" (Jan. 22, 2020), *available at* https://www.clearygottlieb.com/news-and-insights/publication-listing/cfius-releases-final-firrma-regulations.

[9] Critical technologies include:

- Defense articles or defense services included on the United States Munitions List (USML) set forth in the International Traffic in Arms Regulations (ITAR) (22 CFR parts 120-130);
- Items included on the Commerce Control List (CCL) set forth in Supplement No. 1 to part 774 of the Export Administration Regulations (EAR) (15 CFR parts 730-774), and controlled pursuant to multilateral regimes, including for reasons relating to national security, chemical and biological weapons proliferation, nuclear nonproliferation, or missile technology; or for reasons relating to regional stability or surreptitious listening;
- Specially designed and prepared nuclear equipment, parts and components, materials, software, and technology covered by 10 CFR part 810 (relating to assistance to foreign atomic energy activities);

"critical technologies" and (b) one or more of those technologies requires a license for export to the jurisdiction of the investor or any of its parent entities.

In determining whether a license is required, only a limited number of license exceptions under the Export Administration Regulations may be considered. The Final Rule permits use of only the license exceptions ENC (encryption), TSU (technology and software – unrestricted), and portions of STA (strategic trade authorization), so long as the U.S. business has satisfied any pre-export requirements imposed by the EAR to use the relevant license exception.[10] The relevant section of License Exception STA is particularly useful, exempting a broad range of exports subject to controls under the EAR (but not those subject to military controls under ITAR or other specialized regimes) to a wide range of trusted countries.[11] License Exception TSU is less significant, covering a limited range of low-sensitivity items, primarily mass-market software as well as items used for sales, maintenance, or repair.[12] Finally, License Exception ENC is useful given the large number of items incorporating encryption functionality, but the Final Rule clarifies that any procedural requirements to submit notifications to the Department of Commerce prior to export must have been satisfied before parties may rely on License Exception ENC to conclude that no mandatory notification is required (even if the parties do not in fact plan to export the relevant items). On the other hand, the Final Rule also makes clear, for example, that compliance with post-export requirements, such as the recordkeeping requirements applicable to license exception TSU or the requirement to provide commodity classifications to third parties under license exception STA, are not required to qualify for the mandatory notification exception when relying on those license exceptions.

Under the Final Rule, whether a technology constitutes "critical technology" and the applicable licensing requirement is assessed as of the time of the transaction – the earliest date that the parties execute a binding agreement containing the material terms of the transaction, a party launches a tender offer for shares of the target, a shareholder solicits proxies in connection with an election of the board of directors of the target, or a holder requests the conversion of a contingent equity interest in the target.[13]

- Nuclear facilities, equipment, and material covered by 10 CFR part 110 (relating to export and import of nuclear equipment and material);
- Select agents and toxins covered by 7 CFR part 331, 9 CFR part 121, or 42 CFR part 73; and
- Emerging and foundational technologies controlled under section 1758 of the Export Control Reform Act of 2018 (50 U.S.C. 4817).

[10] The eligible exceptions and portions of exceptions are 15 C.F.R. § 740.13 (TSU), 15 C.F.R. § 740.17(b) (ENC), and 15 C.F.R. § 740.20(c)(1).

[11] The eligible countries under the relevant portion of License Exception STA are Argentina, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Ireland, Italy, Japan, South Korea, Latvia, Lithuania, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, and the United Kingdom. The authorization broadly covers many items controlled only under the EAR, but not all; it is limited to specified reasons for control and is subject to a number of exceptions. 15 C.F.R. § 740.20 (b), (c)(1).

[12] License Exception TSU includes (i) the minimum technology necessary for the installation, operation, maintenance, or repair of previously exported items; (ii) sales technology and software (i.e., data supporting a prospective or actual quotation, bid, or offer to sell, lease, or otherwise supply any item) customarily transmitted with a prospective or actual quotation, bid, or offer; (iii) software updates (bug fixes) for previously exported software; and (iv) certain mass market software. 15 C.F.R. § 740.13.

[13] This assessment remains valid even if the treatment of the underlying technology under any U.S. export control regime changes prior to closing (although any such change may still provide CFIUS with jurisdiction over a transaction). The Final Rule includes a helpful example: Corporation A, a foreign person, and Corporation B, a U.S. business, execute a binding written agreement pursuant to which Corporation A will acquire a 10 percent equity interest in Corporation B and will be afforded the right to appoint two members of Corporation B's board of directors. As of the date of the agreement, none of

d. Impact

The shift in focus from specified industries identified by NAICS codes to the export control status of the underlying critical technology significantly expands the scope and complexity of analysis of the critical technology mandatory notification requirement and makes it potentially applicable to all industries. Parties to all transactions that could be covered transactions or covered investments, regardless of industry, must now evaluate the export control status of all products, software, and technology developed, produced, designed, tested, manufactured, or fabricated by the U.S. business, even if the business has never exported them or does not even sell them (e.g., manufacturing technologies developed solely for internal use). Export control analyses, which can be burdensome and time-consuming, often require someone familiar with the U.S. export control laws working closely with personnel familiar with the technical aspects of a company's products, software, and technologies to wade through the potentially applicable export control regimes.[14] At the same time, the analysis is more objective than that required in applying the vague and overlapping industry classifications, and it is more precisely targeted to particular technology transfers of concern.

If any of a target U.S. businesses' products, software, or technology would require a license for export to the foreign investor or any of its covered upstream entities, filing (either a short-form notification or a full filing) is mandatory and comes with a 30-day waiting period between filing and closing, and the potential consequences of getting it wrong (including a fine of up to the total transaction value) are severe. This may lead parties to make at least a short-form notification to CFIUS in cases of doubt, though even then the parties are expected to provide information on potential critical technologies.

III. Clarifications to the Definition of "Substantial Interest"

Since February 2020, acquisitions of a "substantial interest" in certain U.S. businesses involved in critical technology, critical infrastructure, or sensitive personal data by a foreign person in which a single foreign government holds a "substantial interest" trigger a mandatory CFIUS notification. "Substantial interest" is defined as: (i) 25% or more of the direct or indirect voting equity of the U.S. business and (ii) 49% or more of the direct or indirect voting equity of a foreign person.[15] For entities with a general partner, managing member, or equivalent, a "substantial interest" under the current regulations is 49% or more of the general partner (or equivalent), essentially discounting limited partner ownership interests.

The Final Rule includes two clarifications regarding which interests are relevant for the "substantial interest" calculation. First, the Final Rule clarifies that the exception for limited partner interests only applies to entities whose activities are "primarily directed, controlled, or coordinated" by a general partner (or equivalent).[16] Second, the Final Rule clarifies that for calculating indirect ownership percentages, any interest by a parent entity is deemed a 100% interest in any entity of which it is a parent (rather than only voting interests).

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the items that Corporation B manufactures constitutes a critical technology. After the agreement is executed, but prior to the completion of the transaction, a product manufactured by Corporation B becomes a critical technology. Assuming no other relevant facts, the transaction would not be subject to a mandatory notification requirement.

[14] It is possible to request export control classifications from the U.S. authorities if the answer is unclear at the end of the review, but that could take even longer.

[15] 31 C.F.R. § 800.244.

[16] The Final Rule clarifies that if a third party controls and coordinates the activities of an entity on behalf of the general partner, the general partner does not cease to primarily direct, control, or coordinate the activities of the entity simply by contracting a third party to perform such services.

An example illustrates the impact of these clarifications. As a result of the Final Rule, if an entity controlled by a foreign government owns 50% of an LLC of which it is not the managing member but has significant rights to direct, control, or coordinate the activities of the investment fund, 100% of the LLC's shareholdings would be included in the calculation of whether the foreign government was acquiring a "substantial interest" in a target.

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