

## Treasury Department Issues Proposed Regulations on National Security Scrutiny of Foreign Direct Investment in the United States

April 25, 2008

On April 23, 2008, the U.S. Department of the Treasury published proposed regulations<sup>1</sup> to implement changes mandated by the "Foreign Investment and National Security Act of 2007" ("FINSA"), which was a comprehensive revision of the Exon-Florio law.<sup>2</sup>

Exon-Florio authorizes the President to block foreign acquisitions of and mergers with US businesses and to order divestment of completed transactions for national security reasons. The President has delegated responsibility under Exon-Florio to the Committee on Foreign Investment in the United States ("CFIUS"), a 13-member inter-agency committee chaired by the Secretary of the Treasury. The CFIUS administers screening of foreign investment transactions under Exon-Florio. The proposed regulations would take the place of the Treasury Department's existing Exon-Florio regulations at 31 C.F.R. Part 800.<sup>3</sup>

The Treasury Department has asked for written comments regarding the proposed regulations, which are due on June 9, 2008. In addition, the Treasury Department will hold a public meeting to discuss issues associated with the proposal on May 2, 2008.

### Proposal Highlights

The proposed regulations would largely codify existing regulatory practice and reinforce the ongoing movement of the CFIUS towards broadened and more intensive examination of foreign direct investment. Still, the proposed regulations entail several positive developments from the perspective of foreign investment transaction parties:

- The proposal would retain the current "safe harbor" provision for passive foreign investment of 10 percent or less in a US business. Specifically, the proposed regulations would continue to consider foreign acquisition of 10 percent or less of a US business to be other than a "covered transaction" if the transaction is "solely for the purpose of investment." Only "covered transactions" are susceptible to adverse

<sup>1</sup> Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, U.S. Department of the Treasury, 73 Fed. Reg. 21,861 (Apr. 23, 2008).

<sup>2</sup> Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (effective October 24, 2007) amending Defense Production Act of 1950, 50 U.S.C. App. § 2170 (so-called Exon-Florio law).

<sup>3</sup> Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. Part 800 et seq. (2007).

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action under Exon-Florio. The proposed regulations stress that the CFIUS will closely scrutinize whether a transaction is "solely for the purpose of investment."

- The proposal's definition of "critical infrastructure" signals no intention to go beyond the limited meaning ascribed to the term by the FINSA.<sup>4</sup> Under the FINSA, if a transaction implicates US "critical infrastructure" the CFIUS is generally to pursue an official 45-day "investigation" beyond the normal 30-day "review." In addition, the CFIUS is to consider the significance of "critical infrastructure" in assessing whether a transaction threatens US security. The proposed regulations seem to imply that whether any given assets comprise "critical infrastructure" should be evaluated on a case-by-case basis in the context of the particular transaction at issue.
- The proposed definition of "critical technologies" is congruent with treatment under existing US export controls. Apart from "critical infrastructure," the FINSA extended the list of statutory factors to be considered by the CFIUS in evaluating the national security implications of transactions to include the impact on "critical technologies" (and "major energy assets").
- Confirmation is provided that "covered transactions" under Exon-Florio do not include foreign acquisitions of mere assets or start-up investments. Covered transactions encompass only foreign acquisitions that would result in foreign control of an existing US business.

But proposed regulatory modifications would also introduce challenges for transaction parties:

- Elements of information that transaction parties must provide to the CFIUS would be substantially expanded, including extensive additional information regarding the foreign acquirer and all levels of parent companies. (The CFIUS has, in practice, already been requiring many of these new elements.)
- The time and effort required for an initial CFIUS "review" of a transaction will likely grow. The statutory limit for CFIUS "reviews" is 30 days. But the proposed regulations would reinforce the need for informal communications with CFIUS staff prior to submission of an official notification. Resolution of CFIUS examinations through negotiation of "mitigation agreements" with the government is also likely to become more common and involved, as an increasing number of CFIUS agencies

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<sup>4</sup> Following the FINSA, the proposed regulations define "critical infrastructure" to mean "in the context of a particular covered transaction, systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular systems or assets of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security."

- seek more and more commitments from transaction parties as a condition to Exon-Florio clearance.
- In several other respects, the proposed regulations would codify movement in CFIUS practice towards increasingly detailed and complex transaction screening.

#### Current Exon-Florio Transaction Screening Process

Originally enacted in 1988, the Exon-Florio law was intended to provide residual authority to block investment transactions in what were expected to be unusual circumstances when there is no other legal basis to protect the national security (apart from special emergency authority). Sparked largely by concerns regarding efforts by a Dubai company to acquire US port operations in 2006 and a Chinese company to acquire Unocal in 2005, the FINSAs impose a variety of new requirements on and modifications of the Exon-Florio screening structure and processes. Many transactions previously not considered to have national security implications are now subjected to Exon-Florio screening.

Exon-Florio screening of proposed foreign investment transactions can entail as many as four steps and is designed to take no more than 90 days. In practice, and as the screening process becomes more complex, it can take longer. Parties often pursue informal consultations with government officials in advance of initiating a formal screening, and the proposed regulations would formalize this practice.

The first formal step in the Exon-Florio screening process is normally for transaction parties, at their discretion, to file a voluntary notification with the CFIUS.<sup>5</sup> Although the CFIUS may only make recommendations to the President, parties who successfully complete CFIUS screening can generally obtain assurance that their proposed transaction will not be considered to threaten to impair US national security and will not be altered pursuant to the Exon-Florio law.

Second, following receipt of the parties' notification the CFIUS conducts a "review" for up to 30 days to evaluate whether the transaction raises national security concerns, including a mandatory assessment by the Director of National Intelligence.

Third, if at least one member of the CFIUS determines that there are national security issues that warrant further examination the CFIUS prosecutes a supplemental 45-day "investigation" of the transaction. An "investigation" is ordinarily required if the US transaction party holds US "critical infrastructure" or the foreign acquiring entity is owned or controlled by a foreign government.

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<sup>5</sup> Alternatively, the CFIUS may issue a notice of review and thereby self-initiate screening if it has reason to believe that a transaction may raise national security concerns.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Fourth, if the CFIUS does not clear a transaction at the end of an investigation, the decision on whether to take action against the transaction is in the hands of the President, who must act within 15 days. Transactions have rarely been presented formally to the President, and the President has formally disapproved of only one transaction.

At the same time, the government sometimes induces parties to alter transactions in substantial ways to address perceived national security concerns. The FINSA provided the first express statutory basis for government-private party "mitigation agreements" and for addressing noncompliance with such agreements, including imposition of civil penalties for violations of such agreements. The government is also authorized to reopen Exon-Florio screening after clearance of a transaction and even to order divestiture if a transaction party is found purposefully to have violated a mitigation agreement or submitted false or misleading material information or omitted material information.

Given these pressures, parties have sometimes felt compelled to withdraw and re-file notifications -- thus "restarting the clock" -- because they believe that CFIUS agencies will not issue a clearance unless given more time to examine the transaction. The FINSA subjects parties wishing to withdraw and resubmit transaction notifications to a system for tracking the transaction. Parties may be required to enter into interim agreements, which can restrict their ability to conclude the transaction. Furthermore, parties have sometimes voluntarily terminated or withdrawn from transactions based on an expectation that Exon-Florio clearance would not be forthcoming (as was the case with CNOOC's 2005 effort to acquire Unocal).

Finally, congressional oversight of Exon-Florio screening has been expanded, clarified, and codified through a "system of Congressional notification."<sup>6</sup> The FINSA requires the CFIUS to submit a certified report to the Congress regarding every examined transaction. The report must contain a description of the actions taken by the CFIUS with respect to the transaction, as well as identification of the determinative factors considered by the committee. The CFIUS is required to certify that there are no unresolved national security concerns with the examined transaction. In addition, the CFIUS is required to submit an annual report to the Congress.

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<sup>6</sup> S. Report 110-80, 110th Cong., 1st Session (June 13, 2007).