Date: April 30, 2008

To: Interested Persons

Re: FINSA Proposed Regulations

On April 21, the United States Department of the Treasury issued proposed regulations (the "Proposed Regulations") to implement the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA amended the 1988 "Exon-Florio" statute, which regulates foreign acquisitions of U.S. businesses that could raise national security risks, including businesses with state-of-the-art technology or products or services of military importance. FINSA formally recognized the inter-agency Committee on Foreign Investment in the United States ("the Committee" or "CFIUS") as the entity responsible for reviewing relevant transactions and named the Treasury Department as its Chairperson.

Comments are due on June 9, 2008 and may be submitted electronically via the federal government E-Rulemaking Portal: www.regulations.gov. Any comments received will be made public and posted on the Internet. The Treasury Department has scheduled a public meeting for May 2, 2008 to discuss the proposal.

While the Proposed Regulations retain many of the basic features of the existing regulations, they also reflect changes mandated by FINSA and incorporate some of the current practices of the Committee. Proposed changes include, among other things, expansion of the concept of a "covered transaction," new and/or expanded definitions and examples of key terms, including "critical infrastructure," "critical technology" and "control," a significant increase in the amount of information required in a voluntary notice and new rules and procedures governing the notice and the review and clearance process.

I. FINSA

FINSA maintained the basic structure and purpose of the pre-existing Exon-Florio process, including voluntary notice (or self-initiation by the Committee), a 30-day "**review**" and a follow-on 45-day "**investigation**" if necessary, and the authority of the President to prohibit or suspend a transaction that threatens to impair national security. It also made a number of significant changes to the process and procedures by which foreign investments are reviewed for national security risks, including:

- expanding the range of transactions subject to review;

- broadening the authority of the Committee to negotiate, enter into, impose, modify, monitor and enforce agreements and conditions to mitigate national security threats;
- authorizing the Committee to reopen reviews and investigations where there has been an intentional material breach of mitigation agreements or conditions;
- introducing the concept of one or more lead agencies ("Lead Agency") for each covered transaction and for negotiating, entering into, imposing, monitoring and enforcing mitigation agreements or other conditions;
- mandating an investigation for any transaction that threatens to impair U.S. national security unless the threat has been mitigated;
- unless an exception is granted, mandating investigations for (1) transactions by purchasers controlled by foreign governments; and (2) transactions that would result in foreign control of critical infrastructure (if the national security risk has not been mitigated during the review);
- authorizing civil penalties for violations of FINSA or a mitigation agreement or condition; and
- increasing Congressional oversight.[1]

II. The Proposed Regulations

Set forth below is a description of several important provisions of the Proposed Regulations.

A. Covered Transactions

The Proposed Regulations define a "covered transaction" as a transaction that could result in control of a U.S. business by a foreign person. As discussed below, the term is further clarified by defining the key elements of the definition. Only covered transactions are subject to review.

Transaction

Under the Proposed Regulations, the term "transaction" means a proposed or consummated merger, acquisition or takeover and encompasses the same transactions covered by the current regulations, including (1) the acquisition of an ownership interest in an entity;[2] (2) the acquisition or conversion of

[1] A more detailed explanation of the changes mandated by FINSA is contained in the Davis Polk & Wardwell memorandum of July 26, 2007.

[2] The Proposed Regulations expand the definition of "entity" to mean: any branch, partnership, group or sub-group, association, estate, trust, corporation, division of a corporation, or organization (whether or not formally organized); assets operated by any one of the foregoing as a business undertaking in a particular location or for particular products or services, even though those assets may not be organized as a separate legal entity, and any government (including a foreign national or subnational government, the U.S. Government, a subnational government

convertible voting instruments; (3) the acquisition of proxies from holders of a voting interest; and (4) a merger or consolidation. In addition, the Proposed Regulations explicitly add certain long-term leases and the formation of joint ventures[3] to the list of transactions.

Control

"Control" is a keystone concept under the Exon-Florio statute and an important focal point in an Exon-Florio analysis. The concept of control is relevant in a number of contexts, including when determining whether an entity is a foreign person and assessing whether a transaction could result in foreign control of a U.S. business.

The term would continue to be defined generally as "the power, direct or indirect, whether or not exercised . . . to determine, direct, or decide important matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach or cause decisions" on specified matters or any other similarly important matters. The Proposed Regulations, however, expand the list of "important matters" affecting an entity.[4]

Under the Proposed Regulations, the right to determine, direct or decide important matters of an entity, even if unexercised or not exercisable for a specific, known period, would constitute control. In examining questions of control, the Committee would consider whether foreign persons with separate ownership interests are either related or have an arrangement to act in concert, and whether the foreign persons are controlled by the same entity. For example, according to the Proposed Regulations, control would exist if several

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within the United States, and any agency, corporation, financial institution, or other entity or instrumentality thereof, including a government-sponsored agency).

[3] Elsewhere the Proposed Regulations make clear that joint ventures are only covered transactions where they result in control by a foreign purchaser of a U.S. business.

[4] The following are included on the list in the Proposed Regulations: (1) the sale, lease, mortgage, pledge, or other transfer of any of the tangible or intangible principal assets of the entity, whether or not in the ordinary course of business; (2) the reorganization, merger, or dissolution of the entity; (3) the closing, relocation, or substantial alteration of the production, operational, or research and development facilities of the entity; (4) major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of the entity; (5) the selection of new business lines or ventures that the entity will pursue; (6) the entry into, termination, or non-fulfillment by the entity of significant contracts; (7) the policies or procedures of the entity governing the treatment of non-public technical, financial, or other proprietary information of the entity; (8) the appointment or dismissal of officers or senior managers; (9) the appointment or dismissal of employees with access to sensitive technology or classified U.S. Government information; or (10) the amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of the entity with respect to the foregoing matters.

unrelated foreign persons who separately held a combined 50% voting interest had an arrangement to act in concert.

The concept of control does not include negative rights that are intended only to protect investment-backed expectations of minority shareholders,[5] but it does include negative rights that give the foreign person a veto over important matters affecting the U.S. business.

U.S. Business

The Proposed Regulations continue to define a "U.S. business" as any entity engaged in U.S. interstate commerce, but only to the extent of its activities in interstate commerce. Thus, a U.S. branch or subsidiary of a foreign entity would be considered a U.S. business. Each would also be a foreign person for purposes of acquiring a U.S. business.

Foreign Person

The term "foreign person" is defined as any foreign national, foreign government or foreign entity, or any other entity controlled by any of the foregoing. The term "foreign entity," in turn, is defined to mean any public company or other entity organized in a foreign country whose equity securities are primarily traded on foreign exchanges or in which foreign nationals hold, directly or indirectly, 50% or more of the outstanding ownership interests, even if those ownership interests are unaffiliated and widely dispersed.

Transactions that are not Covered Transactions

Certain transactions continue to be exempt from the Exon-Florio process since they could not result in foreign control over a U.S. business and are therefore not covered transactions. "Greenfield" or start-up investments are an example. Where a foreign person will acquire or hold 10% or less of the voting interest and that interest is held solely for purposes of investment, the transaction would also be exempt. An interest is held solely for purposes of investment if the investor has no intention of exercising control and does not take any action inconsistent with that intention, such as obtaining rights to make decisions about important matters affecting the entity, whether or not it intends to exercise them.[6] For

[5] The Proposed Regulations also indicate that the Committee would consider on a case-by-case basis whether other minority shareholder protections confer control over an entity.

[6] Similarly, an acquisition of convertible voting instruments that does not involve control would not be a covered transaction. In making such a determination, CFIUS would focus on factors such as whether the date of conversion is either fixed or up to the purchaser and whether the amount of voting interests in the target entity upon conversion is known when the instruments

example, a foreign person's acquisition of a less than 10% interest in a U.S. business would be a covered transaction where the purchaser had the right to appoint 1 of 11 board members, since, according to the Proposed Regulations, the right to appoint a board member is inconsistent with an intent to hold an interest solely for investment purposes.[7]

B. Processes and Procedures

The Proposed Regulations make significant modifications to the processes and procedures by which Exon-Florio notices are filed and transactions are reviewed. A number of these modifications are a codification of the Committee's existing, informal practices and procedures.

Pre-submission Communication

The Proposed Regulations contain a provision encouraging parties to consult with CFIUS and, in appropriate cases, submit a draft notice or other appropriate documents at least five days before filing a formal notice. The Preamble notes that these consultations and submissions will help ensure that a notice, once filed, provides the Committee with the information needed to do its work.

Commencement of 30-Day Review

Under current practice, the review period generally begins the day after a notice is filed. Under the Proposed Regulations, the 30-day review begins on the next business day after the Chairperson of CFIUS determines that the notice is complete and disseminates it to all members of the Committee. The Proposed Regulations may therefore extend the process somewhat, although they require the Chairperson to disseminate the notice "promptly."

Certifications

Consistent with FINSA, the Proposed Regulations require signed certifications of the accuracy of all information submitted to CFIUS. They also require each party to file a final certification at the conclusion of the review or investigation if it has submitted any information beyond that in the voluntary notice. Failure to file a final certification would be grounds for rejection of the notice.

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are acquired. Even if the acquisition of convertible voting securities is not a covered transaction, the conversion itself might be, depending on the facts.

[7] The Preamble notes that the rule applies to all types of investments and does not assume that certain types of institutions are passive investors.

Rejection or Deferral of Notice

The Proposed Regulations continue to provide for rejection (or deferral of acceptance) of a notice if the parties fail to submit required information in the filing, and for rejection after a filing if there is a material change in the transaction or the Committee finds that the transaction is not a covered transaction. They further allow CFIUS to reject a previously accepted notice if: (1) information surfaces contradicting material information provided by the parties; (2) the required certifications are not filed; or (3) a party fails to provide requested follow-up information within two business days of the request, unless a longer period has been granted in writing by the Chairperson in response to a written request.

Investigations

The Proposed Regulations list the triggers for commencing an investigation. CFIUS must undertake an investigation if: (a) any member of the Committee believes that the transaction threatens to impair the national security and the threat has not yet been mitigated; or (b) the Lead Agency recommends, and the Committee concurs, that an investigation be undertaken. It must also ordinarily undertake an investigation if: (a) the proposed purchaser is controlled by a foreign government or (b) the transaction would result in control by a foreign person of critical infrastructure[8] and CFIUS has determined that the transaction could impair the national security unless the potential impairment has already been mitigated. In these latter two cases, however, a mandatory investigation would not be required if officials of the Treasury and the Lead Agency determined at the conclusion of the review that the transaction would not impair the national security. Upon completion of an investigation, the Committee may decide to close the investigation or send a report to the President recommending the suspension or prohibition of the transaction or requesting that he make a determination with respect to the transaction.

Withdrawal of a Notice

Under the Proposed Regulations, parties wishing to withdraw their notices would be required to file a written request and explanation and obtain written

[8] FINSA incorporated the concept of critical infrastructure, including major energy assets, as a factor in CFIUS' analysis of national security risks. A transaction involves critical infrastructure when the incapacity or destruction of the assets at issue would have a debilitating impact on national security. While the Proposed Regulations do not clarify the term's meaning, the Committee is expected to issue guidance shortly on the types of transactions that have presented national security considerations, including those involving the proposed acquisition of critical infrastructure by foreign government-controlled purchasers that raise U.S. national security concerns.

approval. The Proposed Regulations require the Staff Chairperson, in consultation with the Committee, to establish, as appropriate, (1) a process for tracking actions taken by a party to a withdrawn transaction before notice is refiled and (2) interim protections to address specific concerns that have been raised. The Staff Chairperson is also required to specify a time frame, as appropriate, for the parties to resubmit a notice.

C. Notice

The Proposed Regulations call for a significant expansion of the required contents of the voluntary notice, adding to what was already a long list of information required from the parties.[9] Much of the added material is information that CFIUS has requested in the past to supplement the voluntary notice. Noteworthy additions from the Proposed Regulations include the following:

- A full statement by the proposed purchaser as to whether it is (1) a foreign person; or (2) controlled by a foreign government; and a full statement by both parties as to whether the transaction will result in foreign control of a U.S. business, including, in each case, the reasons for these views.
- The names of all financial institutions involved in the transaction, including as advisors, underwriters, or a source of financing for the transaction.
- For the U.S. business and its subsidiaries:
    - Their products and services and an estimate of the U.S. market share for the primary product or service lines together with a list of direct competitors for those lines;
    - Any products or services it supplies to third parties that it knows are rebranded or incorporated into the products of another entity, together with related information;
    - For the prior three years, the number and level of priority-rated contracts and orders received or placed with others under the Defense Priorities and Allocation Systems regulation;

[9] Under the current regulations, the notice must describe, among other things, (1) the transaction; (2) the business activities of the U.S. entity, including recent and existing contracts with any U.S. government agency with national defense responsibilities; (3) any products or services it supplies directly or as a subcontractor to the Department of Defense; (4) the locations of the U.S. facilities that provide products or services to the military; (5) any technology with military applications; (6) any products or technical data for which validated export licenses are required; (7) the ultimate parent or parents of the foreign acquirer; (8) any ownership interests, convertible voting interests, contingent interests or other specified rights of a foreign government or entity controlled by a foreign government with respect to the acquirer; and (9) the plans of the foreign person for eliminating or reducing research and development, changing product quality, shutting facilities down or moving them offshore, or modifying or terminating contracts for goods and services affecting national security.

  - A description and copy of any plan to protect against cyber attacks on the U.S. business's services, networks, systems, data storage, and facilities;
  - Descriptions of, and other information about, the critical and emergent technologies that the U.S. business produces or trades in;[10] and
  - Any other licenses, permits, or other authorizations granted to the U.S. business by the U.S. government.
- For the foreign person and its parents
  - A description of any affirmative or negative rights or powers of a foreign government or government-controlled person in the purchaser that could be relevant to the Committee's determination of foreign government control;
  - A description of any arrangement among foreign ownership interest holders of the foreign person or between the foreign person and other persons to act in concert on particular matters affecting the U.S. business, together with the relevant documents;
  - An organization chart illustrating all the entities or individuals above the foreign person up to and including the persons having ultimate control, including the percentage of shares held by each;
  - Biographical information of board members, senior management, and the ultimate beneficial owners of 5% or more of the acquirer and its intermediate and ultimate parents; and
  - Personal identifying information for the board members and senior executives of the immediate acquirer, and its intermediate and ultimate parents and for any natural person with 5% or more ownership interest in the ultimate parent, including
    - full name(s), business address and country and city of residence;
    - date and place of birth;
    - U.S. social security number and/or national identity number;
    - U.S. and foreign passport numbers and U.S. visa type and number, if any; and
    - dates and nature of foreign government and foreign military service.

[10] Information is sought with respect not only to "critical technology" but to defense articles, services, and technical data that have not been, but may be, designated or determined to be covered by the United States Munitions List (USML). "Critical technology" is defined to include: (1) defense articles or defense services covered by the (USML); (2) those items on the Commerce Control List that are controlled pursuant to multilateral regimes or are controlled for reasons for regional stability or surreptitious listening; (c) nuclear equipment, parts and components, materials software and technology subject to named regulations; and (d) select agents and toxins.

- Certified English translations of any supplementary materials, such as annual reports, that are in a foreign language.

D. Mitigation Agreements and Liquidated Damages

As noted above, the Lead Agency is authorized to negotiate, enter into, impose and monitor agreements or other conditions designed to mitigate risk. CFIUS is authorized under the Proposed Regulations to include a liquidated damages provision in a mitigation agreement based on a "reasonable assessment of the harm to the national security that could result from a breach of the agreement." If a liquidated damages provision is included it would, by regulation, need to indicate that CFIUS would consider the severity of the breach in deciding whether to seek a lesser amount than stipulated in the agreement.

E. Monetary penalties

Implementing FINSA's requirement to provide for civil penalties, the Proposed Regulations would authorize CFIUS to impose a civil penalty of no more than $250,000 on any person who intentionally or through gross negligence submits a material misstatement or omission in a notice or makes a false certification. Any person who intentionally or through gross negligence violates a material agreement or condition would be subject to a penalty of no more than $250,000 per violation *or the value of the transaction*. Such penalties would be separate from any liquidated damages sought for breach of the mitigation agreement. The Proposed Regulations also provide for appeal of the monetary penalties to the Committee and for recovery of the penalties in civil actions brought by the United States in federal district court. If one or more parties has submitted false or misleading material information to CFIUS, or omitted material information, the Committee could also reopen its review, even after the transaction has closed.

For more information, please call your Davis Polk contact.