

## **THE CFIUS REVIEW PROCESS: A REGIME IN FLUX**

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Beginning about five years ago, several controversial transactions, culminating with the Dubai Ports debacle in 2006, elevated CFIUS from relative obscurity to the front pages. Responding to this increased focus, Congress passed the Foreign Investment and National Security Act (FINSA) in late 2007,<sup>1</sup> which brought some significant changes to the CFIUS regime. The President provided some further clarification through an Executive Order on January 23, 2008.<sup>2</sup> Additional clarification will come when the Treasury Department issues new regulations required under FINSA by April 2008.

The growing significance of sovereign wealth funds, large pools of investment capital controlled by governments, and their increasing investments in the United States, notably in the financial sector, have also raised new questions in Congress and the Executive Branch about the regulation of foreign investment.<sup>3</sup> As with investments by other sorts of foreign investors, investments by sovereign wealth funds emanating from countries such as China and Gulf Arab states, with which the United States has important strategic and geopolitical entanglements, have raised particular concerns. At the urging of the United States, the International Monetary Fund (IMF) is developing a set of proposed “best” practices for sovereign wealth funds, while the Organization for Economic Cooperation and Development (OECD) is working on a parallel set of best practices for countries that receive significant investments from sovereign wealth funds.

Spurred by the weak dollar and booming state revenues in China and oil-rich countries, acquisitions in the U.S. by foreign firms reached \$407 billion in 2007, up 93% from 2006.<sup>4</sup> Foreign buyers accounted for 46% of the \$230.5 billion of U.S. mergers and acquisitions in the fourth quarter of 2007,<sup>5</sup> the largest percentage of foreign buyers since 1998.<sup>6</sup>

All these developments are pointed reminders that, although the United States prides itself on openness to foreign investments, such transactions may raise special regulatory and political issues. Parties to potential foreign acquisitions of U.S. companies or assets need to consider carefully the CFIUS process in planning—and potentially in valuing—the transaction.

## **Background**

Since Congress passed the “Exon-Florio” amendment in 1988, the President has been authorized to investigate the impact on U.S. national security of “mergers, acquisitions, and

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<sup>1</sup> Pub. L. No. 110-49, 121 Stat. 246 (2007).

<sup>2</sup> Executive Order: Further Amendment of Executive Order 11858 Concerning Foreign Investment in the United States, Jan. 23, 2008.

<sup>3</sup> For helpful brief overviews, see Robert M. Kimmitt, *Public Footprints in Private Markets*, Foreign Affairs, Vol. 87, No. 1, at 119-30 (Jan./Feb. 2008); *Asset-backed Insecurity*, The Economist 78-80 (Jan. 19, 2008).

<sup>4</sup> *Weak dollar Fuels China’s Buying Speed of U.S. Firms*, Washington Post (Jan 28, 2008)

<sup>5</sup> Zachary R. Mider, *International Deals: Americans Sell Out to Foreign Firms at Record Rate*, Bloomberg News Service, Jan. 9, 2008.

<sup>6</sup> *Id.*

takeovers” by “foreign persons” that result in foreign control over a U.S. company or certain U.S. assets.<sup>7</sup> If the President finds: (1) “credible evidence” that a transaction would impair national security, and (2) that no other provision of law grants him authority to take steps to ameliorate this impact, he may act to block the transaction.<sup>8</sup>

Exon-Florio applies both to proposed mergers and acquisitions and to completed transactions. Unless a party to the transaction voluntarily seeks pre-consummation review, there is no time limit on the President’s authority to investigate a completed transaction. A voluntary notice that results in CFIUS clearance grants the transaction a safe harbor from post-closing review and challenge (except possibly if the parties materially breach a condition of CFIUS’s clearance approval).<sup>9</sup>

CFIUS is charged with implementing Exon-Florio. The Secretary of the Treasury chairs the Committee, but, under FINSA, other agencies may be appointed “lead agency” with respect to particular investigations depending on the nature of the transaction.<sup>10</sup> The Departments of Defense, Homeland Security, Commerce, and Justice often take the most active roles in the CFIUS process. Other cabinet departments and economic and national security bodies within the Executive Office of the President also serve on the Committee.<sup>11</sup> An important addition that FINSA mandated is a defined role for the Director of National Intelligence, who is now an ex-officio member and must evaluate a transaction’s national security implications.<sup>12</sup>

President Bush’s recent Executive Order establishes a variety of rules to clarify the Committee’s procedures and ensure that the different agencies can work together smoothly, under Treasury’s ultimate leadership. The Committee’s review process is confidential, and the process is intended to focus on the true national security implications of particular deals rather than political considerations.

The CFIUS notification process is voluntary, requires no filing fee, and imposes no mandatory waiting period before closing the transaction, though parties to a CFIUS review or investigation typically wait until the process is complete before closing. The CFIUS process involves four steps: (1) a voluntary filing, which must be submitted by both parties to the transaction; (2) a 30-day Committee review of the transaction; (3) a potential additional 45-day Committee investigation, and, following such an investigation and the Committee’s recommendation, (4) a 15-day period during which the President decides to permit or deny the acquisition (or seek divestiture after an ex post facto review).

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<sup>7</sup> 50 U.S.C. app § 2170.

<sup>8</sup> *Id.* at § 2170(d)(4).

<sup>9</sup> *Id.* at § 2170(b)(1)(D)(iii).

<sup>10</sup> *See id.* at § 2170(k).

<sup>11</sup> *See* Executive Order: Further Amendment of Executive Order 11858 Concerning Foreign Investment in the United States, Jan. 23, 2008.

<sup>12</sup> 50 U.S.C. app § 2170(b)(4)(D).

The Treasury Department's Office of International Investment administers the CFIUS process. Although FINSA preserved the confidentiality requirements, Congress added requirements designed to allow it to exercise increased supervision. CFIUS must now report to Congress at the end of reviews and formal investigations and also report annually about its activities.<sup>13</sup>

CFIUS had traditionally approved the vast majority of notified transactions during the initial 30-day period, but a growing number of transactions are now being subjected to a second-phase 45-day investigation. Indeed, in 2006 alone, CFIUS launched seven 45-day investigations, as many as had been initiated in the previous five years combined.<sup>14</sup> Though numbers for 2007 have not yet been made available, the trend almost certainly continued, especially in light of increased political pressure from Congress for CFIUS to scrutinize transactions and the general increase in foreign investment in the United States.

### **Scope and Focus of CFIUS Review**

In determining whether voluntarily to seek "safe harbor" protection by notifying a transaction to CFIUS, parties should assess the risk that CFIUS could investigate the transaction on its own initiative. If that investigation is undertaken post-closing, it could potentially result in the unwinding of the transaction (or the imposition of terms and conditions that could affect the economics of the deal). In assessing these risks, parties should consider three threshold questions: (1) does the transaction involve a "foreign person" acquiring a "United States person"?; (2) might the transaction implicate U.S. national security interests?; and (3) might the structure of the transaction bring it outside CFIUS's jurisdiction altogether?

The first question can be surprisingly tricky and sometimes requires close analysis of the Exon-Florio statute and the CFIUS regulations. For instance, under Exon-Florio, the same entity could be a "foreign" or "United States" person depending on whether it is the target or the acquirer.<sup>15</sup> Any entity is a U.S. person to the extent of its business activities in the United States. Accordingly, the application of the statute could be triggered if a foreign company acquires (directly or indirectly) the U.S. branch office or subsidiary of a foreign company.<sup>16</sup> On the other hand, the same foreign-controlled U.S. branch or subsidiary would be deemed a foreign person for Exon-Florio purposes if it acquires a U.S. company or U.S. assets.

The second inquiry is extraordinarily open-ended and may be susceptible to changing public policy concerns. The notion of "national security interests" can be writ quite large. The newly enacted FINSA gives some limited guidance, making clear that national security includes

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<sup>13</sup> *Id.* at § 2170(g).

<sup>14</sup> See Testimony of Treasury Assistant Secretary Clay Lowery before the House Financial Services Committee, Feb. 7, 2007 (available at <http://www.treas.gov/press/releases/hp250.htm>).

<sup>15</sup> See 31 C.F.R. § 800.213 (example 3).

<sup>16</sup> *Id.*

“homeland security”<sup>17</sup> concerns but not “economic security.” FINSA also makes clear that transactions involving “critical infrastructure,” “critical technologies,” and “major energy assets” may frequently raise national security concerns.<sup>18</sup> More clarity may be forthcoming in April 2008, when, as required by FINSA, the Department of Treasury is required to issue “guidance on the types of transactions that the Committee has reviewed and that have presented national security considerations.”<sup>19</sup>

As a practical matter, the Committee has often shown particular interest in transactions when the target U.S. company has export-controlled technologies, classified contracts with the U.S. government, or technologies critical to national defense; or when CFIUS member agencies have specific “derogatory intelligence” about the foreign purchaser. CFIUS may also examine whether the transaction will result in an absence of U.S.-controlled companies that supply technology or products deemed important to U.S. security. Treasury, however, is unlikely to tie CFIUS’s hands by defining “national security” to include only these or other narrowly defined areas.

Some recent examples illustrate the broad range of transactions that may implicate national security for CFIUS purposes:

- ***Bain Capital/3Com.*** After undergoing a 30-day review, followed by several weeks of a 45-day investigation, Bain Capital in February 2008 withdrew its proposed takeover of 3Com, a U.S.-based information technology company.<sup>20</sup> The proposed transaction received considerable attention because a division of 3Com supplies anti-hacking technology to the Defense Department, and Chinese telecommunications company Huawei, which reportedly has ties to the People’s Liberation Army, was a minority partner in the Bain Capital acquisition proposal.
- ***Citic Securities/Bear Stearns.*** In the second half of 2007, Citic Securities, a leading state-controlled investment bank in China, invested \$1 billion in Bear Stearns after clearing a voluntarily initiated CFIUS review.
- ***Alcatel/Lucent.*** In November 2006, after a 75-day review and investigation period, the committee recommended that President George W. Bush clear the merger of Lucent Technologies with French telecommunications firm Alcatel. However, the President’s approval of the deal, which included the transfer of Lucent’s Bell Labs, was conditioned on the companies entering into a national security agreement with U.S. government agencies, which included an “evergreen” clause allowing the government to reopen its review of the transaction if certain specific conditions were not met. As publicly

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<sup>17</sup> 50 U.S.C. app. § 2170(b)(1)(A)(i).

<sup>18</sup> *Id.* at § 2170(f)(6) & 2170(f)(7).

<sup>19</sup> See Regulations Pertaining to Mergers, Acquisitions, and Takeovers, 72 Fed. Reg. 57,900 (Oct. 11, 2007).

<sup>20</sup> See Bain, *3Com Deal Hits Obstacle on Chinese Stake*, Reuters (Feb 20, 2008).

disclosed, the parties also agreed that an independent U.S. subsidiary would handle sensitive government projects.<sup>21</sup> (The President recently required similar provisions in connection with a \$20 billion networking joint venture between Nokia and Siemens.<sup>22</sup>)

- **Check Point/Sourcefire.** In 2006, Check Point, an Israeli company, cited the CFIUS process as the basis for abandoning a deal to acquire a U.S. company, Sourcefire.<sup>23</sup> Sourcefire produced intrusion detection technology used by many U.S. government departments in various sensitive contexts. Check Point made its announcement while CFIUS's 45-day investigation was ongoing.
- **Smartmatic/Sequoia Voting Systems.** In 2006, CFIUS may have played a role in a decision by Smartmatic, a Florida company controlled by Venezuelan shareholders alleged to have connections with Venezuelan President Hugo Chavez, to sell its U.S. voting machine business Sequoia Voting Systems. Smartmatic had sought post-closing review of its acquisition of a U.S. electronic voting machine manufacturer, and members of Congress and pundits pressured CFIUS to conduct an extensive review based on concerns about the security of U.S. elections. Smartmatic sold the business during the course of that review.<sup>24</sup>

Finally, the limits of CFIUS's jurisdiction have become an increasingly important subject for inquiry as foreign funds have stepped up the pace of investment in the United States. The CFIUS regulations provide that only transactions that "involve a change in control" of some type are "covered transactions" over which CFIUS has jurisdiction.<sup>25</sup> Thus, acquisitions of voting securities that do not afford the acquirer de jure or de facto control do not trigger CFIUS. The acquisition of convertible options or warrants would be similarly exempt until such time as exercised (assuming they then resulted in control). Further, acquisitions that are made solely for investment purposes are exempt if the acquirer will hold 10 percent or less of the outstanding voting securities.<sup>26</sup> An "ordinary course" investment by a bank or investment company that does not typically acquire businesses may also fall outside CFIUS's purview. In all these cases, the acquirer typically should not have board seats or other indicia of day-to-day control.

Recently, significant foreign investments in U.S. financial institutions by sovereign wealth funds and other investors have been structured to avoid CFIUS review using these guidelines. Typically, the investor has taken no board seats, obtained less than a 10 percent

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<sup>21</sup> Jeff Bliss and Otis Bilodeau, *Carlyle, Dubai Aerospace Deal May Clear Congressional Hurdles*, Bloomberg News Service, March 20, 2007.

<sup>22</sup> *U.S. Imposes Restrictions on Nokia-Siemens JV: Paper*, Washington Post, Jan. 8, 2007.

<sup>23</sup> Clifford Carlsen, *Sourcefire Gets Second Wind*, May 25, 2006.

<sup>24</sup> Bill McConnell, *Smartmatic to Divest Unit*, Daily Deal, Dec. 25, 2006.

<sup>25</sup> 50 U.S.C. app. § 2170(a)(3).

<sup>26</sup> 31 C.F.R. § 800.302.

interest, and publicly disclaimed any ability to oversee or engage in the management of the company or business.

### **The CFIUS Review Process and Strategic Considerations**

For transactions that potentially raise CFIUS issues, parties generally engage in pre-filing consultations and negotiations with the Committee or member agencies. Such discussions can influence the outcome and lead parties to modify their transaction before filing to expedite clearance; they may also help parties avoid the possibility that they may have to abandon a transaction mid-review that is unlikely to be cleared at all (or only on unacceptable terms).

The formal notification itself must contain a detailed description of the transaction, including timelines and assets or businesses to be acquired, and detailed background concerning the parties.<sup>27</sup> The information submitted must be certified by both parties to the transaction according to a form publicized by the Treasury Department. The 30-day initial review period commences once the CFIUS staff gives notice it is satisfied that the filing contains all of the required information.

If CFIUS decides not to clear the transaction in the 30-day review period, then it must commence an additional 45-day investigation before the end of the initial review period.<sup>28</sup> Under FINSA, the extended investigation is mandated when the transaction threatens to “impair national security.” FINSA leaves CFIUS with broad discretion to make that determination, but it suggests two circumstances where an extended review is presumed more likely: when the transaction would result in “foreign government control,” or in foreign control of “critical infrastructure.”<sup>29</sup> Although the statute leaves the term “critical infrastructure” vague, experience suggests that telecommunications and transportation infrastructure would typically qualify, and the statute suggests that energy assets are a specific form of critical infrastructure. The range of other assets that could fall within this definition seems almost limitless, however.

At the conclusion of the 45-day investigation, CFIUS will submit a recommendation to the President. The President has 15 days from the date of referral to clear, prohibit, or suspend the transaction.<sup>30</sup>

### **The Future**

With the enactment of FINSA, the issuance of the President’s Executive Order, and the forthcoming Treasury regulations, CFIUS review of foreign investments is undergoing a period of flux. The Treasury regulations, which are due in April 2008, should provide more guidance about recurring procedural and definitional issues, mitigation agreements, and information

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<sup>27</sup> *Id.* at § 800.401(c).

<sup>28</sup> 50 U.S.C. app. § 2170(b)(2)(B)(i)(I).

<sup>29</sup> *Id.* at §§ 2170(b)(2)(B)(i)(II) and 2170(b)(2)(B)(i)(III).

<sup>30</sup> *Id.* at § 2170(d)(1).

collection and confidentiality issues.<sup>31</sup> The regulations' clarification of the definitions of "critical infrastructure," "critical technologies," and "control" will be particularly important.

The increasing prominence of sovereign wealth funds has added an additional layer of concern about the possible political or national security significance of foreign investment. Sovereign wealth funds presently control about \$2.5 trillion, and that figure is expected to grow by perhaps a \$ 1 trillion per year for the next decade at least.<sup>32</sup> Sovereign wealth funds' present holdings represent only about 3% of global assets, but they already top the capital held by private equity firms and hedge funds.<sup>33</sup> The Treasury Department has initiated a review of policies related to sovereign wealth funds, has engaged in bilateral talks with governments controlling significant funds, and has encouraged dialogue between investor and recipient countries. The U.S. has also pushed for the IMF, with the held of the World Bank, to develop a set of best practices to encourage transparency and strictly market-based, rather than politically motivated, investment by sovereign wealth funds. At the same time, the U.S. has supported the OECD's efforts to encourage a parallel set of best practices for recipient countries, emphasizing openness to investment, evenhandedness in the treatment of foreign investors.<sup>34</sup>

These steps suggest that, for the moment, the Executive Branch does not see the need for any legislative modifications of the CFIUS process to deal with sovereign wealth funds. But some voices in Congress are already questioning that approach and suggesting that further revision of the CFIUS statute may be necessary.<sup>35</sup>

Important insights about the substance of CFIUS reviews may come from the reports CFIUS now must make to Congress, providing publicly available precedents that should be useful for investors seeking to chart the likely course of CFIUS reviews for particular types of transactions.

One thing is clear: The heightened scrutiny that CFIUS is applying to foreign acquisitions will affect tactics for merger and acquisition activity that might raise national security issues. Foreign acquiring companies may need to be more active in making commitments to address the risk of national security reviews, so as not to be at a disadvantage relative to domestic bidders. And in some cases, parties may wish to structure their transactions to try to avoid CFIUS review altogether.

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<sup>31</sup> See Regulations Pertaining to Mergers, Acquisitions, and Takeovers, 72 Fed. Reg. 57,900 (Oct. 11, 2007).

<sup>32</sup> Kimmitt, *Public Footprints in Private Markets*, at 119.

<sup>33</sup> *Asset-backed Insecurity*, at 79.

<sup>34</sup> On all these efforts, see Kimmitt, *Public Footprints in Private Markets*.

<sup>35</sup> See, e.g., *Sovereign Funds Need Best Practices, Not New Legislation, Treasury Official Says*, BNA Daily Report for Executives A-28 (Feb. 14, 2008).