Treasury Department Issues Final Rule for Mandatory CFIUS Filing Requirements Based on 'Critical Technology'

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On September 15, 2020, the Treasury Department issued final regulations that define when it is mandatory to file with the Committee on Foreign Investment in the United States (CFIUS).[1] This final rule builds on regulations that were originally proposed in May 2020 (described in a previous Skadden client alert). The final rule, which goes into effect on October 15, 2020, retains the overall structure and essential features of the earlier proposal — in particular, it incorporates an export control-based analysis into the mandatory filing rule — while offering a few significant changes and clarifications. This appears to be the last tranche of regulations implementing the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) and brings to a close a significant, two-year interagency effort to develop the statute's implementing regulations.

The final rule focuses on defining when parties are required to file in connection with transactions that have a nexus to critical technology. Under this rule, a filing is required for a "covered transaction" involving a U.S. business that produces, designs, tests, manufactures, fabricates or develops a "critical technology" that is subject to export controls[2] if certain conditions are met. Specifically, a filing is mandatory if it would require a license to export, reexport, transfer (in-country) or retransfer the critical technology to the foreign investor, and the foreign investor:

- could directly control the U.S. business as a result of the transaction;
- is directly acquiring an interest that qualifies as a "covered investment" in the U.S. business;
- already has a direct investment in the U.S. business, but the rights held by the foreign investor are changing in ways that could result in either foreign control or a covered investment;
- is a party to a transaction that is an attempt to circumvent CFIUS' jurisdiction; or
- either individually or as part of a group of foreign investors holds — directly or indirectly — at least a 25% interest in another foreign entity that falls into any of the categories listed above.

The key innovation here is the rule's requirement that parties analyze whether a license would be required under a **hypothetical** export, reexport, transfer (in-country) or retransfer of controlled technology to the foreign investor. The parties need not actually attempt an export for the rule to apply.

This export control-based approach replaces the test that currently applies under the regulations that went into effect in February 2020. The current test centers on whether the target business falls within certain industry categories under the North American Industry Classification System (NAICS). Under this test, filings are mandatory for covered transactions involving U.S. businesses that produce, design, test, manufacture,

[1] Department of the Treasury, *Provisions Pertaining to Certain Investments in the United States by Foreign Persons*, 85 Fed. Reg. 57124 (Sept. 15, 2020) (the Final Rule).

[2] The CFIUS regulations define "critical technologies" as (a) defense articles or defense services included on the U.S. Munitions List (USML); (b) items included on the Commerce Control List (CCL) that are controlled either pursuant to multilateral regimes for reasons relating to national security, nuclear and chemical/biological weapons or missile technology or for reasons relating to regional stability or surreptitious listening; (c) certain nuclear equipment, software and technology relating to assistance to foreign atomic energy activities; (d) nuclear facilities, equipment and material relating to export and import of nuclear equipment and material; (e) select agents and toxins; and (f) "emerging and foundational technologies." 31 C.F.R. § 800.215.

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fabricate or develop critical technology that is designed for or utilized in a set of 27 sensitive business sectors. The NAICS test proved difficult to administer and gave rise to a concern that it did not adequately capture the universe of transactions that could present national security concerns. Notably, the rules call for a transition period during which the NAICS test will continue to apply to transactions for which certain steps were taken between February 15, 2020, and October 15, 2020.[3] Thereafter, the new approach set forth in the final rule will apply.

The final rule makes a few notable changes and clarifications to the mandatory declaration rule that was originally proposed in May 2020.

First, the final rule clarifies the circumstances under which a key exception to the mandatory declaration rule would apply[4] — specifically, where the transaction would be eligible for export license exceptions related to encryption (ENC),[5] technology and software (unrestricted) (TSU),[6] and strategic trade authorization (STA).[7] This exception to the mandatory declaration rule is one of several codified in the regulations, which include an exception for certain transactions in which the foreign buyer comes from an "excepted" country, and for indirect investments made through entities that are subject to various foreign ownership, control or influence-mitigation measures or operate under a valid security clearance.[8]

During the public comment process in connection with the May 2020 proposed rule, several commenters asked whether "eligibility" for the mandatory declaration exception based on the three export license exceptions requires that the U.S. business adhere to the various procedural requirements associated with the license exceptions. The final rule says yes — but only where the license exception requires fulfilling these procedural steps **before** export.

[3] The NAICS test will continue to apply to transactions for which the following occurs on or after February 15, 2020, and before October 15, 2020: (1) the closing of the transaction; (2) the parties enter into a binding written agreement establishing the material terms of the deal; (3) a party makes a public offer to shareholders to buy shares of a U.S. business; or (4) a shareholder solicits proxies in connection with an election of the board of directors of a U.S. business or an owner or holder of a contingent equity interest has requested the conversion of its contingent equity interest. 31 C.F.R. § 800.104.

[4] *See* 31 C.F.R. § 800.401(e)(6).

[5] 15 C.F.R. § 740.17(b).

[6] 15 C.F.R. § 740.13.

[7] 15 C.F.R. § 740.20(c)(1).

[8] 31 C.F.R. § 800.401(e).

As the preamble to the final rule explains, certain license exceptions impose procedural requirements that must be met before export. For instance, the ENC license exception available under Section 740.17(b)(2) and (b)(3) of the Export Administration Regulations (EAR) require a party to submit a classification request 30 days before export. As a result, the exception to the CFIUS mandatory declaration requirement based on the ENC license exception under Section 740.17(b)(2) and (b)(3) is available only if a party actually submitted a classification request and 30 days have passed.[9]

By contrast, other license exceptions either do not impose procedural requirements or do not require that they occur before export. The preamble to the final rule explains that the ENC license exception under Section 740.17(b)(1) allows parties to self-classify and imposes no procedural requirements before export. In that case, the corresponding exception to the CFIUS mandatory declaration requirement would be available without fulfilling any procedural requirements. Other license exceptions that do impose procedural requirements — for instance, the recordkeeping requirements for the TSU exception and the requirement to provide commodity classifications to third parties under the STA exception — do not require that they occur before export.[10]

The approach taken in the final rule on this point is somewhat counterintuitive. It is unclear why actual, concrete procedural steps — such as the submission of a classification request — would ever need to be taken in support of a purely **hypothetical** export to qualify for a CFIUS filing exception. Nevertheless, instead of dispensing entirely with procedural requirements from the EAR, the final rule opted to apply a bright line test grounded in **when** the procedural steps must be taken (*i.e.*, before or after export).

Second, the final rule clarifies that, for purposes of determining whether a declaration is mandatory, what constitutes a "critical technology" need not be assessed as of the closing date of the transaction. Instead, the analysis should be undertaken at the *earliest* of any of the following: the date of completion, the date the parties have executed a binding written agreement, the date a party has made a public offer to shareholders to buy shares of a U.S. business, or the date of certain activities involving the solicitation of proxies or conversion of a contingent equity interest.[11] This clarification reflects concerns over the fact that the

[9] Final Rule, 85 Fed. Reg. at 57126.

[10] Final Rule, 85 Fed. Reg. at 57126.

[11] 31 C.F.R. §§ 800.401(b)(2), (c)(3).

list of "critical technologies" could evolve over time, with new technologies announced while a transaction is pending — such as the list of "emerging and foundational technologies" currently under development. This is a welcome change that will provide certainty to transaction negotiations moving forward.

Considering the final rule as a whole, we anticipate that removing the existing NAICS test and replacing it with an export control-based rule will capture more transactions and lead to more mandatory filings overall. At the same time, the new approach will provide industry with greater investment certainty by adopting more administrable, objective criteria. We also expect that the number of CFIUS filings will grow as the universe of "critical technologies" expands, due in large part to the ongoing effort to identify and control "emerging and foundational" technologies under the Export Control Reform Act of 2018.

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