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STARTUP & ACCELERATE

CFIUS AND OTHER CONSIDERATIONS WITH FOREIGN INVESTORS

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Introduction and Agenda

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- Technology startups are generally looking to raise capital, with the exception of certain well-funded companies started by serial entrepreneurs or with wealthy friends and families.
- There are many foreign investors, including some from countries or investors of concern to the US government, looking to invest in US technology companies and many companies view them as attractive sources of funding often on better terms than they can obtain from US investors.
- Often, in the case of Chinese and other strategic investment, the financial investments are coupled with strategic partnerships including licensing, collaboration/co-development agreements and joint ventures to build the Chinese market and acquire technology, products and talent abroad. This is particularly the case with Chinese government supported investment in the US life sciences industry.
- There are special issues to be considered before engaging in a transaction with a foreign investor.

Introduction and Agenda (Cont.)

- The issues to consider that we will cover in this presentation include the following:
  - Background investigation on foreign investor
  - Export control, sanctions and FCPA compliance
  - US government funding restrictions
  - National security reviews (CFIUS)

Background Investigations on Foreign Investors

- It is critically important to do a background investigation on your foreign investor to understand its source of funding, financial and commercial resources, ownership and control, investment authority, reputation and regulatory status (e.g., is it subject to any US sanctions or export restrictions or a company of concern in prior CFIUS filings).
- The current state of the US-China relationship has implications for Chinese investment in US companies (or foreign companies with material US assets), and transactions by Chinese investors have been blocked on national security grounds. Transactions have also been carefully scrutinized and/or blocked involving Russian or MENA investors and certain SWFs.
- Third party services can be used (e.g. World Check) as well as references checked. In larger transactions involving more strategic relationships, investigative firms can be engaged to do more than a public records search but this can be time consuming and expensive.
- This background investigation is particularly important if the company plans to receive funding from, or otherwise do business with, the US government. If the company has classified contracts requiring special security clearances, special rules apply to mitigate foreign ownership, control and influence, which are beyond the scope of this presentation.
- Contractual representations, warranties and covenants are no substitute for a background investigation.

Export Controls and Sanctions

- It is important for the US company to understand the export control status of any technology or equipment that might be exported as part of the transaction. Note that exports can be made in the US by giving a foreign investor or its representatives access to certain technology in the US. So-called "deemed exports" can occur with hiring non-US citizen or permanent resident alien employees. Sufficient lead time should be allowed for obtaining any required export licenses.
- As will be discussed in more detail with respect to national security reviews (CFIUS), this analysis will be important to determine if the US company has any "critical technologies" defined currently by reference to export control regulations, but subject to expansion under an ongoing regulatory review process to add certain "emerging and foundational" technologies. It may be necessary, but it is not legally required, to obtain formal classifications for export purposes of certain technology and products.
- In our experience, many startup technology companies have not invested sufficient time and resources in classifying their technology and products for export control purpose, or in assessing the risks to their business model of taking investment from foreign investors.

Export Controls and Sanctions (Cont.)

- As part of the background investigation, the US company should have confirmed that the foreign investor is not subject to US sanctions or export restrictions by reference to various US government lists (e.g., Consolidated Screening Lists).
- Note that China is prohibited jurisdiction for ITAR-controlled items and many EAR controlled items require an export license for China or for a deemed export to Chinese nationals in the US. There are also Chinese and other foreign companies/persons on the denied or blocked persons lists.
- Export control issues can arise in license and collaboration agreement, joint ventures, during due diligence and with the visit/employment in the US of non-US persons.
- These determinations are often confirmed with representations, warranties and covenants in the transactional documents.

FCPA

- Certain foreign investors are government owned and controlled and their representatives are considered foreign government officials. A good background investigation should have revealed this information, as well as the overall compliance history and reputation of the foreign investor.
- For example, the Chinese life sciences industry has generated the highest number of FCPA investigations and enforcement cases, particularly in the medical device industry because of a number of factors:
  - The counterparties are state-owned hospitals or research institutions and doctors/scientists may be considered foreign government officials for FCPA purposes
  - The low pay in China of these persons
  - The complexity of the Chinese regulatory process and the prevalence of bribery notwithstanding efforts of the Chinese government to prohibit it.

FCPA (Cont.)

- With transactions that involve strategic partnerships that go beyond a straight investment by a foreign investor in the US company, care must be taken that no funds transferred to the foreign investor or its representatives violate the FCPA anti-bribery provisions or will be used by the foreign investor or its representatives in violation of the FCPA with respect to foreign government officials, which could create liability for the US company.
- Tailored FCPA representations, warranties and covenants should be included in the transactional documents and FCPA training provided to relevant US company and foreign investor personnel.

US Government Restrictions

- If the US company has any grants, contracts or other sources of funding from the US government, the relevant agreements must be checked for compliance with any provisions applicable to a potential investment by, or a strategic partnership with a foreign investor.
- US government rights under the Bayh-Dole Act may require manufacturing in the US, although waivers may be granted in certain situations.
- The US government is focusing more on investments by foreign persons, particularly from China.
- Although the Department of Justice terminated its previous "China Initiative," it has been replaced with "A Strategy for Countering Nation-State Threats." However, the Department has not modified its focus on investigating, and prosecuting as warranted, theft and improper transfer of US funded intellectual property by foreign investors or researchers.

CFIUS and FIRRMA

- FIRRMA, the latest comprehensive amendment to national security reviews adopted in 2018, is embedded in the Defense Production Act (DPA), a statute that includes a range of broad national security authorities. The Committee on Foreign Investment in the US (CFIUS) has the discretion to review transactions but the statutory and regulatory focus revolved around ownership and control (both affirmative and negative), which is defined by CFIUS more broadly to include material influence and less-than-majority control.
- FIRRMA expanded that focus to address ownership, control, bankruptcies, and other investments that are not considered controlling. Prior to FIRRMA, these reviews were based on voluntary submissions–the parties to a transaction could decide whether to voluntarily file a joint notice, although CFIUS has had the right to require covered transactions regardless of whether a submission was made.
- Since FIRMMA's adoption, CFIUS has entered interim orders blocking transactions from being closed as well as requiring the divestment of other transactions and has more resources to increase its review of covered transactions that were not notified to CFIUS.

Impact on Foreign Direct Investment Review by International Partners

- FIRRMA also directed the President to engage in multilateral discussions to encourage other countries to establish or enhance national security reviews of cross-border investments.
- FIRRMA and the regulations created a cascading effect–as CFIUS issued its regulations, developed its policies and interpretations, restructured its offices and increased its resources, other countries changed their FDI review processes as well.
- This cascading effect has resulted in new or enhanced national security review regimes in Japan, Australia, the United Kingdom, the European Union, Germany, France, Italy, China and Russia.
- In concert with CFIUS, these regimes help protect national security interests of the United States and its allies and partners.

New Focus on US Technology, Infrastructure and Data Businesses

- Key focus of FIRRMA and the implementing regulations is on investment by foreign persons in so-called Technology, Infrastructure and Data (TID) businesses.
- It is important for companies to determine if they have "critical technology," "critical infrastructure" or "sensitive personal data" for CFIUS purposes.
- There are separate regulations covering foreign investment in "covered real estate" which includes certain investments in real property within defined geographical proximity to listed ports and military installations.
- Investments in TID business may trigger mandatory CFIUS filing requirements whereas there are currently no mandatory CFIUS filing requirements for investments in covered real estate.

Specific Concerns for Data Companies

- Sensitive Personal Data used in defining a "TID business"—a new focus of CFIUS review.
- "Identifiable data" refers to data that can be used to distinguish or trace an individual's identity
  - Aggregated or anonymized data will be treated as identifiable data if any party to the transaction will have the ability to disaggregate or deanonymize the data.
- It does not include encrypted data, unless the U.S. business has the means to de-encrypt the data.
- Broad definition of sensitive personal data, focused on personal, financial, and healthcare information of U.S. citizens, including identifiable data that is:
  - In applications for insurance;
  - Non-public email or messaging among users of a U.S. business's products or services;
  - Biometric data;
  - Geolocation data; or
  - Personnel security clearance data.
- "Identifiable data" will be treated as "sensitive personal data" if it is maintained or collected by a U.S. business that:
  - Targets or tailors products or services to U.S. security personnel including contractors; or
  - Has maintained or collected such data, or has a demonstrated business objective to do so, on more than one million individuals at any point in the preceding 12 months.

Specific Concerns for Data Companies (Cont.)

Sensitive personal data also includes genetic data.

- Genetic data is not subject to the above two limitations on security personnel or minimum size of data population.
- In an attempt to narrow the scope of genetic data covered, following concerns expressed regarding the proposed rules, CFIUS limited the definition in the final rules to "the results of an individual's genetic test, including any related genetic sequencing data."
  - Genetic tests are defined by reference to the Genetic Information Non-Discrimination Act of 2008.
  - Genetic tests covered are limited to identifiable genetic tests.
  - Excludes any data derived from U.S. Government databases and given to third-parties for research purposes.

Specific Concerns for Life Sciences Companies

- Foreign investment in life sciences and medtech products and services entities has been significantly affected by the new focus on and definition of sensitive personal data, as well as by the focus on these entities as essential under COVID-19.
- Many life sciences and medtech product developers and manufacturers will have or intend to have access to data of one million or more individuals.
- Certain life sciences companies, particularly those developing or manufacturing biotechnology-derived products or services, will have access to genetic test data.
- Foreign investment in healthcare service providers, including hospitals and healthcare insurers also may be significantly affected by this new focus, in view of the likelihood of collection and retention of data on more than one million individuals as well as of genetic test data.
- Foreign investment in the U.S. food supply chain also likely will be affected by focus on these entities as essential under COVID-19.

Specific Concerns for Infrastructure Companies

- New, detailed definitions of critical infrastructure for determinations of covered control transactions and covered investments involving TID businesses.
- Two-step test: U.S. business Must relate to certain types of infrastructure.
- Must perform certain specified functions for that infrastructure.
- A list of types of infrastructure and functions relating to them is set out in detail in Appendices to the final rules
- Critical infrastructure includes electric energy systems, financial systems, rail networks, public water systems, petroleum and natural gas facilities, telecom and information networks, securities and exchanges and financial networks, air and maritime ports.
- Must consider both tests in making determinations (e.g., U.S. interstate natural gas pipeline owner/operator is critical infrastructure; but U.S. business manufacturing pipe or servicing the pipeline is not).

Specific Concerns for Telecom Companies

- Most telecommunications network and service providers are now considered part critical infrastructure.
- Telecom transactions may be reviewed additionally by the Committee for the Assessment of Foreign Participation in the United States Telecommunications Sector, created by Executive Order on April 4, 2020 (superseding the informal Team Telecom process).
- The CFIUS process does not substitute for the Telecom Committee's review, but a CFIUS filing (even if voluntary) may be helpful to expedite approval by the Telecom Committee.
- The Executive Order is not expected to change the substance of prior Team Telecom reviews, but established new deadlines for the Telecom Committee's review (120 days after submission of responses to questions and a possible additional 90 days), which will have to be taken into account by filing parties in conjunction with CFIUS review timelines.

Emerging and Foundational Technologies

- When FIRMMA was adopted the accompanying Export Control Reform Act (ECRA) laid the groundwork for the potential expansion of critical technology to include emerging and foundational technology
- There has been heavy lobbying by various industries because of the concern of overregulation that will affect collaboration by introducing additional export control requirements.
- There have also been inter-agency conflicts on the adoption of new export controls.
- Consequently, the process of adding export controls on emerging and foundational technology is proceeding slowly and legislative reforms have been introduced in an attempt to accelerate the process.

Strategies for Addressing CFIUS Concerns

- It is important to determine if the investor is a foreign person for CFIUS purposes (US subsidiary of foreign person is a foreign person) or if it is possible to structure the investment so as not to involve foreign persons (e.g., use of private fund exemption) that do not constitute evasion.
- It is important to know if the foreign investor has a positive/negative track record with CFIUS (e.g. mitigation required for approval, or subject of non-notified reviews).
- A CFIUS self assessment should be done on whether the business is a US TID business or has covered real estate. A sophisticated foreign investor will conduct CFIUS due diligence and ask for contractual representations and warranties that the business is not a US TID.
- It may be possible to structure the transactions so it is not subject to the mandatory filing requirements or be a covered transaction. Examples include a license/collaboration agreement with no equity investment or a passive investment with no board/observer rights or access to "critical technology."
- If a mandatory filing is not required, a decision needs to be made whether closing should be conditioned on CFIUS clearance because of national security risk profile (e.g., TID business, supply chain concerns, foreign government as an investor, US government nexus through contracts/funding)?

Strategies for Addressing CFIUS Concerns(cont.)

- Consider potential voluntary self-mitigation strategies to address any national security concerns. These could include adopting special security agreements, proxy control or a voting trust structure, or spinning off certain assets/contracts/product lines that present national security issues.
- Consider appropriate contractual provisions to allocate risk and cost of CFIUS filings and affect on timeline. Address any mitigation that CFIUS might require or paying break-up fees if CFIUS rejects transaction.
- Consider appropriate (proactive or reactive) PR/lobbying strategies to counter any opposition from interest groups or competitors. Strictly comply with FARA and LDA requirements.

Mandatory Filing Requirements for Private Investors

- Critical technology is the trigger and is based on a determination that export authorization is required for the country of the foreign investor.
- Required for a covered investment where investor obtains a board/observer seat, or access to material nonpublic technical information, or substantive decision-making rights regarding critical technology of the U.S. business. Passive investors (generally less than 10%) can give up these rights to avoid the mandatory filing requirements where critical technology is present.
- There are no mandatory filing requirements under the separate CFIUS regulations governing real estate.

Special Mandatory Filings Requirements for Governments

- There are mandatory filing requirement for foreign government-controlled transactions, where a "substantial interest" is acquired in a US TID business
  - If a foreign government-affiliated investor (from a single foreign state) would hold a 49% or more voting interest (direct or indirect) in the acquirer/investor.
  - And the investment involves a 25% or more acquisition of a voting interest (direct or indirect) in a US TID business. A TID business is one with "critical technology," "critical infrastructure" or "sensitive personal data" as defined by the final regulations.
  - In the case of an investment fund, only acquisition of interest in the general partner is considered (provided any limited partner interests do not confer control by the foreign investor).

Exceptions to the Mandatory Filing Requirements

- Transactions by funds controlled by U.S. nationals discussed more below.
- Investments made by "Excepted Foreign Investors" (i.e., individuals, governments and private entities from Australia, Canada, New Zealand and United Kingdom).
- An entity is exempted if:
  - It is organized under the laws of an excepted foreign state or in the United States;
  - Such entity has its principal place of business in an excepted foreign state or in the United States; and
  - 75% or more of the members and observers in the board of directors or equivalent governing body of such entity are: (i) US nationals; or (ii) nationals of one or more excepted foreign states who are not dual nationals of any foreign state that is not an excepted foreign state (Dual Nationals).

Exceptions to the Mandatory Filing Requirements (cont.)

  - Any foreign person that individually, and each foreign person that as part of a group, holds 10% or more of the outstanding voting or equity interests of such entity is (A) a national of one or more excepted foreign states and not a Dual National; (B) a foreign government of an excepted foreign state; or (C) a foreign entity organized under the laws of an excepted foreign state and that has its principal place of business in an excepted foreign state or in the United States; and (D) the equity of such person is held by investors from that foreign state and who are not Dual Nationals. There are special rules for publicly traded corporations.
  - Investors from excepted foreign states may be disqualified for previous violations of export control or sanction laws or for having committed federal crimes.
- Investments by foreign entities operating under facilities security clearance and subject to a mitigation agreement to address FOCI executed with the DCSA.
- Investments in TID Businesses that produce, design, manufacture, test, fabricate or develop one or more critical technologies that may be exported under license exemption "ENC" under the EAR (i.e., most commercial encryption items).

Exceptions for Investment Funds Managed by US National

- Investment fund managers should determine if their existing funds qualify for the private equity exemption and design future funds, where possible, to qualify.
  - In order to qualify the general partner must not be a foreign person.
- Neither the advisory board/committee of limited partners nor any foreign person may have the ability to approve, disapprove or otherwise control investment decisions or decisions made by the general partner related to the entities in which the fund is invested.
  - The foreign limited partners may not have control over the selection, dismissal or compensation of the general partner.
- No foreign limited partner may have access to material nonpublic technical information through membership on the advisory board/committee.
- No foreign limited partner may be afforded access to any material nonpublic technical information in the possession of any US TID business in which the fund invests, or membership or observer rights on the board of any such US TID business or any involvement, other than through voting of shares, in substantive decision-making of the US TID business.

Exceptions for Investment Funds (cont.)

- The final regulations introduced the concept of a principal place of business test that allows a fund to establish that its principal place of business is in the United States, even if organized outside of the United States, if the general partner is based in the United States and directs, controls and coordinates the fund's activities from there.
- The final regulations clarify, as noted above, that the substantial interest triggering event in the case of the fund will only be examined with respect to the general partner and not with respect to any limited partners.
- There is still a lack of clarity concerning the effect of minority foreign general partners.

To File or Not to File? – That is the Question

- If the mandatory filing requirements apply, you can file a short-form declaration that will be reviewed in 30 days from acceptance by CFIUS, but CFIUS may require a full joint submission or give a regulatory "shrug" indicating that it has had insufficient time to make a determination. Some parties are willing to close on a regulatory "shrug" even though it provides no protection from a later CFIUS review. Full joint submissions can take 1-2 months to prepare and be accepted by CFIUS and 3-4 months to complete even in routine cases. Fees are now due for full joint submissions generally paid for by the buyer/investor.
- If the mandatory filing requirements do not apply, the decision to clear the transaction with CFIUS will be based upon a number of factors, including the status of the investor/buyer, timing and competitive considerations, if the target company has "critical technology," "critical infrastructure," or "sensitive personal data" or the transaction constitutes a covered real estate transaction because of proximity to certain ports and military installations or there is material business with the USG
- Because of the fast pace of most noncontrolling venture capital deals, voluntarily filing with CFIUS is rare in these transactions and, more commonly, the parties structure the transactions to avoid triggering the mandatory CFIUS filing requirements.

Filing Fees

- Effective May 1, 2020, CFIUS introduced a sliding scale of required filing fees, depending on the size of the transaction.
- The fees range from no fee for transactions less than U.S. $500,000 to a $300,000 fee for transactions of U.S. $750,000,000 or more.
- Filing fees apply only to Joint Voluntary Notices, not mandatory or voluntary Declarations.
- Who pays is a matter of parties' negotiation, but generally can be expected to be the buyer/investor, as with antitrust HSR pre-notification fees.

Penalties

- Several civil penalties provisions are incorporated in the new rules.
- $250,000 per violation for submitting false information in a filing to CFIUS.
- $250,000 or the value of the transaction, whichever is greater, for failure to make a mandatory filing.
- $250,000 or the value of the transaction, whichever is greater, for intentional or grossly negligent violation of a material provision of a mitigation agreement, per violation.
- A mitigation agreement also may include a provision for liquidated or actual damages for breaches of the agreement.
- CFIUS revealed that in 2018, it imposed a $1 million civil penalty on an unnamed entity "for repeated breaches" of a 2016 mitigation agreement; and CFIUS revealed that in 2019, it assessed a $750,000 penalty for violations of a 2018 interim order, including failure to restrict and adequately monitor access to protected data.

CFIUS Review of Non-Notified but Covered Transactions

- CFIUS has increased its resources to monitor so-called non-notified covered transactions and since 2016 the number of reviews of non-notified covered transactions has increased, particularly involving sensitive personal data as noted above or in certain industries (e.g. Chinese investment in life sciences or semiconductors).
- It is expected that CFIUS will further increase its review of non-notified covered transactions, but only time will tell as to the pattern and practice.
- CFIUS is actively reviewing non-notified, non-controlling venture capital investments by Chinese investors and investors from certain other countries of concern.
- Just because CFIUS reviews a non-notified covered transaction does not mean that it will require mitigation of national security issues or divestiture. Those remedies will likely remain only in a small percentage of cases. Based on the latest CFIUS data, mitigation is required in less than 10%-15% of all cases filed. Forced divestiture is very rare and has generally involved Chinese investors of concern.

CFIUS Contractual Language

- Pre-FIRRMA, standard CFIUS language was developed in change-of-control transactions based on HSR pre-merger notification provisions. Varations depended upon commercial leverage and often revolved around who bore the consequences of nonclearance by CFIUS in terms of breakup fees and the level of required cooperation/mitigation by the foreign person to obtain CFIUS clearance.
- Post-FIRRMA, representations and warranties were developed to address triggering events for mandatory filings. Target companies are often asked to give representations and warranties that they do not have "critical technology," "critical infrastructure" or "sensitive personal data."
- The NVCA has developed CFIUS screening language to keep foreign investors from triggering a mandatory CFIUS filing in noncontrolling venture capital investments.
- The NVCA has developed general partner–friendly CFIUS language to insert in limited partnership agreements, which can also be used in side letters with foreign limited partners if the limited partnership agreements don't address CFIUS.
- Parties need to address alternative filing strategies on CFIUS, including whether or not to file and, if so, whether on a short-form declaration or full joint submission and the risk of CFIUS delays on the long-stop date or review of non-notified covered transactions if the transaction is not conditioned upon CFIUS clearance.

Effects on Timing of Closing and Agreement Provisions

- A transaction can be closed before or during CFIUS review, but if parties choose to make a voluntary filing it is generally a good idea to give CFIUS enough time to review.
- Extensions of review period or re-filing demands within sole discretion of CFIUS.
- Need to consider provisions in deal agreements to address potential issues
  - Possible closing during CFIUS review
  - Whether to make a CFIUS filing only a condition or a condition precedent
  - Inclusion of break-up / reverse break-up fees
  - Contract rep and warranty that no mandatory filing is required (because, e.g., no "critical technology," no "critical infrastructure" / target does not maintain or collect personal data of U.S. citizens)
  - Contract rep and warranty that investor is not a "foreign person" or an "excepted investor."

CFIUS Remedies

- CFIUS can and often does impose monitoring responsibilities, by outside entities
- In addition to divestiture, CFIUS can impose mitigation conditions, including
  - Prevention of foreign entity access to data, technology, or participation in decision-making of the U.S. business
  - Prevention of acquiring a board or observer seat
  - Prevention of technology transfer

Biography

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Carl Valenstein focuses his practice on domestic and international corporate and securities matters, mergers and acquisitions, project development, and transactional finance. He counsels extensively in the life science, telecom/electronics, and maritime industries, and has worked broadly in Latin America, the Caribbean, Europe, Africa, Asia, and the Middle East. He previously served as co-chair of the International Section of the Boston Bar Association and co-chairs the firm's environmental, social, and governance (ESG) and sustainable business and Cuba initiatives. Carl is the leader of the Boston office corporate and business transactions practice.

Biography

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David Plotinsky, the former acting chief of the US Department of Justice's Foreign Investment Review Section, represents clients such as venture capital, private equity, and infrastructure firms. In particular, he steers clients through government national security review processes for foreign investment, including by the Committee on Foreign Investment in the United States (CFIUS) and Team Telecom. In addition, David focuses on trade, information communications technology and services, and critical and emerging technology. He maintains a security clearance and advises clients on their most sensitive matters.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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Almaty
Beijing*
Boston
Brussels
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Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
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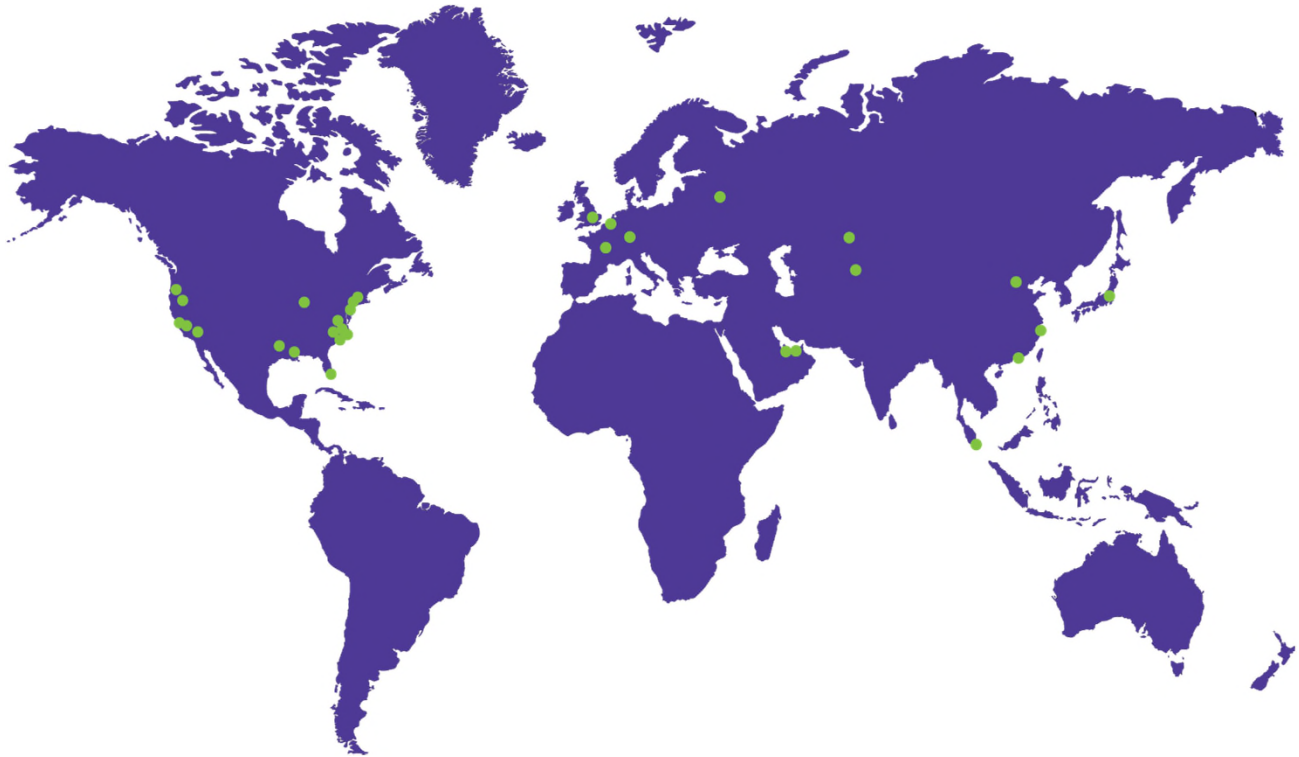

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