

New CFIUS Law: Key Issues Affecting the Energy Sector

Expanded Review of Foreign Investments Involving Critical Infrastructure, New Covered Transactions

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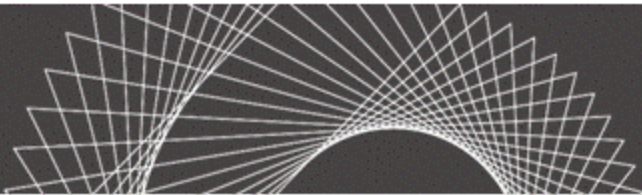
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CFIUS Developments: Key Issues Affecting the Energy Sector



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What is CFIUS?

- The Committee on Foreign Investment in the United States (“CFIUS”) is an inter-agency panel authorized to conduct national security reviews of transactions that could result in foreign control of a U.S. business (“**covered transactions**”).
 - CFIUS has the authority to require mitigation measures, suspend transactions and recommend that the President block a pending deal or order divestiture in a completed transaction.
- Parties submit a voluntary notice to obtain clearance (“safe harbor”) for the transaction to proceed.
- The Committee consists of:
 - 9 Executive Branch departments/offices
 - 5 observing members
 - Others can be added for specific reviews (e.g., USDA)

Permanent Members			Observers/Ad hoc	
Dep't of Treasury (chair)	Dep't of Defense	Dep't of Homeland Security	Office of Management & Budget	National Economic Council
Dep't of Justice	Dep't of State	Dep't of Energy	Council of Economic Advisors	Homeland Security Council
Dep't of Commerce	Office of the U.S. Trade Representative	Office of Science & Technology Policy	National Security Council	

Current CFIUS Jurisdiction: “Covered Transaction”

“any transaction ... by or with any foreign person, which could result in control of a U.S. business by a foreign person”

- “Foreign Person”
 - Includes any entity controlled by a foreign national.
- “Control” – “the power, direct or indirect, whether or not exercised ... to determine, direct, or decide important matters affecting an entity”
 - No bright-line test.
 - Excludes passive investments of 10% or less voting interest.
- “U.S. Business”
 - “Any entity, regardless of the nationality of the persons that control it, engaged in interstate commerce in the United States.”
 - Includes non-U.S. companies with U.S. operation.

Overview of National Security Analysis

- The buyer – is there a potential threat?
 - Foreign government-owned?
 - Country of concern or ties to a country of concern?
 - Characteristics of specific buyer (e.g., criminal history, sanctions, etc.)?
 - Unclear business motivations?
- The U.S. business – is there a potential vulnerability?
 - Government contractor / classified programs?
 - Sensitive sector / Critical infrastructure?
 - Advanced / export-controlled technology?
 - Real estate proximity to military or national security facilities?
 - Access to sensitive or pooled data?
- Consequences of the interaction of threat and vulnerability.
- Currently, this national security analysis is the basis for the decision to file voluntarily with CFIUS with respect to a covered transaction.

CFIUS Trends in Recent Years

- **Steadily increasing caseload**
 - 2018: 200+ reviews thus far
 - 2017: 238 reviews
 - 2016: 172 reviews
- **Longer review periods**
 - CFIUS is taking longer to start the formal review following the pre-filing stage, asking more questions at all stages of review
- **More transactions subject to 45-day investigation period**
 - In 2017, 70% of reviews went into a 45-day investigation
- **Increase in withdrawals and re-filings of notices**
 - CFIUS can restart the new filing period in the investigation phase
- **Many high-profile deals related to China (Ralls, Ant-Moneygram, Qualcomm-Broadcom)**
- **Cleared energy sector transactions typically have involved investors from U.S. allied nations.**
 - Capital Dynamics Inc. (Switzerland) merged with 8point3 Energy Partners LP, a U.S. partnership that operates and acquires solar energy producers (June 2018)
 - Hydro One Limited (Canada) is acquiring Avista Corp., a U.S.-based electricity and natural gas provider. CFIUS cleared the deal (May 2018).
 - AltaGas Limited (Canada) acquired WGL Holdings, Inc., the U.S.-based sole shareholder of a D.C. natural gas utility (Aug. 2017)

Policy Motivations for CFIUS Reform

- Changes in Chinese investment strategy and targets (*e.g.*, Made in China 2025)
- Concerns regarding uncontrolled investments in emerging technology and early-stage companies (“DIUx Report”)
- General concerns among those in national security and intelligence communities that CFIUS did not have broad enough authorities in light of a combination of issues
- Perceived gaps in export controls
- Evolving relationship between the commercial and military space
- Concerns about third parties
- Increase in digitization of the U.S. economy
- Increase in transactions designed to evade CFIUS jurisdiction
- Increasingly complex transaction structures
- Lack of resources to address aforementioned threats and continue to promote foreign investment

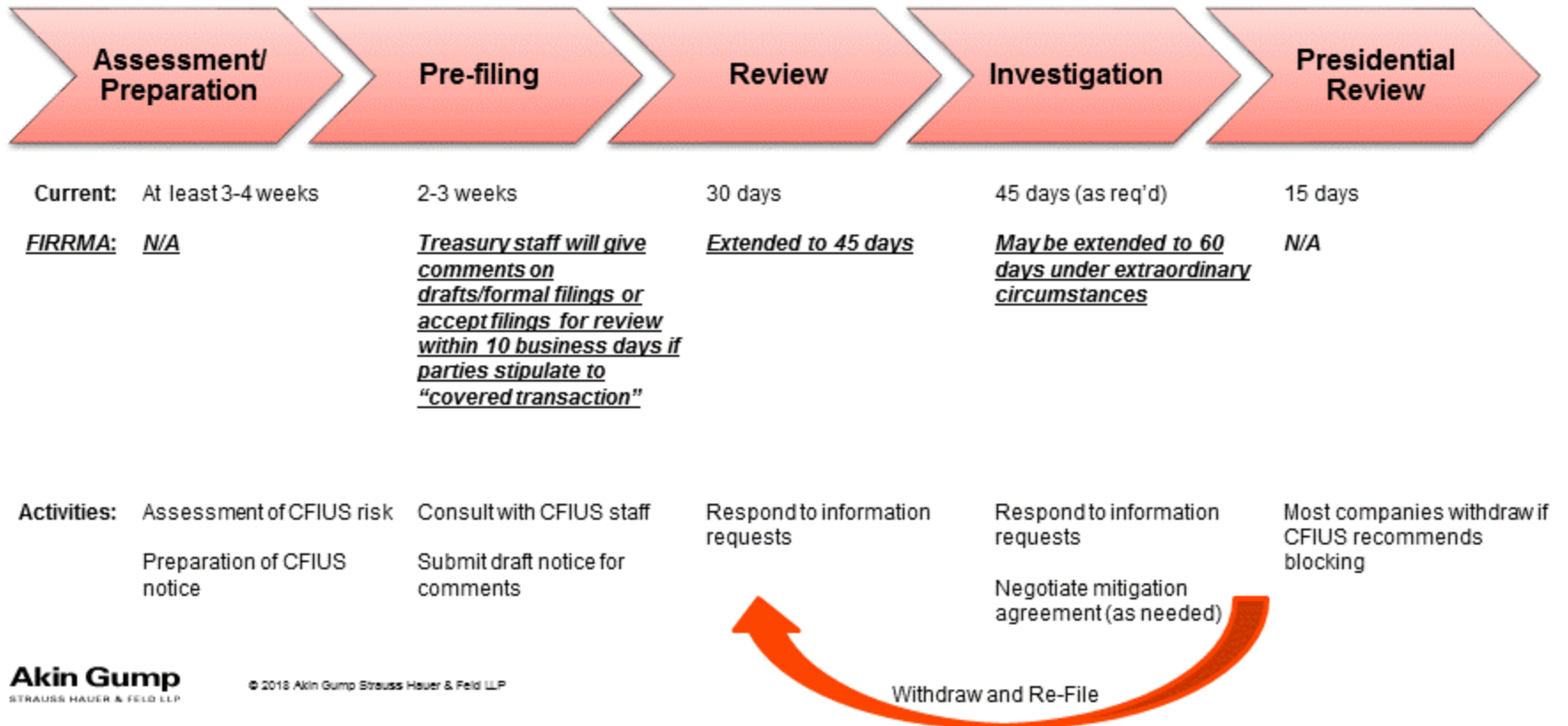
Overview of FIRRMA

- The President signed the John S. McCain National Defense Authorization Act for Fiscal Year 2019 (NDAA) on August 13, 2018, which includes the **Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA)** that reforms the CFIUS process.
- FIRRMA will result in a variety of changes to the CFIUS regime including:
 - **Expanded jurisdiction** over four additional types of covered transactions:
 1. Purchase, lease, or concession by or to a foreign person of **U.S. real estate** near sensitive U.S. government locations and in U.S. ports,
 2. “**Other investments**,” which are noncontrolling investments in an “unaffiliated” U.S. business involving critical infrastructure, critical technology, or sensitive personal data of U.S. citizens under certain circumstances.
 3. Any **change in foreign investor’s rights** that result in foreign control of a U.S. business or an “other investment” (discussed above),
 4. Any investment or transaction designed to **evade CFIUS review**, and
 - **Mandatory reporting requirements** for certain investments in critical technology companies or transactions where foreign gov’t has “substantial interest”
 - **Extended timeline**
 - **Short-form filings** called “declarations”
 - **Filing fees** of up to \$300,000
 - **Additional resources**
 - **Establish formal mechanism to monitor non-notified transactions**

FIRRMA Changes in Effect Currently

- CFIUS review period has been extended from 30 to 45 days, and the 45-day investigation period may be extended for one 15-day period in extraordinary circumstances
- Clarified jurisdiction exists to cover (i) change in rights leading to control, and (ii) transactions designed to evade.
- Express authority to suspend transactions pending review or enter into interim mitigation while review is ongoing
- Monitoring mechanism to identify non-notified transactions
- Authority to share national security analyses with allied governments
- Authority to conduct pilot programs to implement FIRRMA authorities (until March 5, 2020)
- Creation of funding mechanism and \$20 million in appropriations
- Civil monetary penalties for breach of mitigation agreement, condition, or order (prior to Oct. 11, 2018)

FIRRMA Extends Timeline for CFIUS Review



2018 FIRREA Pilot Program

- Announced: October 10, 2018.
- Effective date: November 10, 2018.
- Purpose: Test-run of new FIRREA authority and address perceived national security risks that were the policy drivers of the legislation.
- Take-away 1: **Expands CFIUS jurisdiction** to certain noncontrolling investments in U.S. businesses that are involved in “critical technologies.”
- Take-away 2: **Introduces mandatory disclosures**. Parties must file a declaration to CFIUS if the relevant transaction could result in control of a “Pilot Program U.S. Business” by a foreign person or if the transactions involves a covered noncontrolling investment in a Pilot Program U.S. Business.

Pilot Program: Which U.S. business are captured?

- **Pilot Program U.S. Business:** any U.S. business that **produces, designs, tests, manufactures, fabricates or develops** a “**critical technology**”
 - A “critical technology” is essentially any technology that is controlled on a U.S. export control list, including items captured on:
 - The Commerce Control List (15 CFR Part 774) of the Export Administration Regulations
 - Nuclear controls imposed by the Department of Energy (10 CFR Part 810) and the Nuclear Regulatory Commission (10 CFR Part 110)
 - This definition will expand to cover “emerging” and “foundational” technologies that are being identified by the U.S. government through an ongoing interagency process.
- This critical technology must be:
 - (i) **utilized in** connection with the U.S. business’s activity in one or more of **targeted industries**,
 - (ii) **designed by** the U.S. business **specifically for** use in one or more of the **targeted industries**.

Pilot Program: Targeted Industries

Aircraft Manufacturing	Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing	Powder Metallurgy Part Manufacturing	Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing
Aircraft Engine and Engine Parts Manufacturing	Military Armored Vehicle, Tank, and Tank Component Manufacturing	Power, Distribution, and Specialty Transformer Manufacturing	Semiconductor and Related Device Manufacturing
Alumina Refining and Primary Aluminum Production	Nuclear Electric Power Generation	Primary Battery Manufacturing	Semiconductor Machinery Manufacturing
Ball and Roller Bearing Manufacturing	Optical Instrument and Lens Manufacturing	Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing	Storage Battery Manufacturing
Computer Storage Device Manufacturing	Other Basic Inorganic Chemical Manufacturing	Research and Development in Nanotechnology	Telephone Apparatus Manufacturing
Electronic Computer Manufacturing	Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing	Research and Development in Biotechnology (except Nanobiotechnology)	Turbine and Turbine Generator Set Units Manufacturing
Guided Missile and Space Vehicle Manufacturing	Petrochemical Manufacturing	Secondary Smelting and Alloying of Aluminum	

Pilot Program: Noncontrolling Investments

The pilot program applies to noncontrolling investments in a Pilot Program U.S. Business that afford a foreign person:

1. access to any “**material nonpublic technical information**” in the possession of the U.S. business;
 - “information that is not available in the public domain, and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods.” Material nonpublic technical information does not include financial information related to the performance of an entity.
2. **membership or observer rights** on the board of directors or equivalent governing body of the U.S. business, or the right to nominate an individual to a position on the board of directors or equivalent governing body of the U.S. business; or
3. any involvement, other than through voting of shares, in **substantive decision-making** of the U.S. business regarding the use, development, acquisition or release of critical technology.

Pilot Program: Mandatory Reporting

The pilot program establishes a **mandatory declaration requirement** for transactions that (i) could result in control of a Pilot Program U.S. Business by a foreign person or (ii) involve a noncontrolling investment in a Pilot Program U.S. Business.

The parties to such transactions may either submit a written notice that triggers a full CFIUS review or a “declaration” (i.e., abbreviated notices that generally should not exceed five pages in length). If parties file a declaration, CFIUS will have 30 days to either:

1. Clear the transaction,
2. Request a written notice,
3. Initiate a CFIUS review, or
4. Inform the parties that CFIUS did not have enough time to complete its review and that the parties may submit a written notice to obtain clearance.

Pilot Program: Timing and Penalties

- The pilot program is **effective as of November 10, 2018** and is set to end no later than March 2020 or more likely when the final rules are implemented in February 2020.
- The pilot program **does not apply** to:
 - Transactions completed prior to November 10.
 - Transactions in which, prior to October 11, 2018: (i) parties have executed a binding written agreement or other document establishing material terms of the transaction, (ii) a party has made a public offer to shareholders to buy shares or (iii) a shareholder has solicited proxies in connection with a board election or has requested the conversion of convertible voting securities.
- For transactions that are subject to the reporting requirement, and that are set to close prior to December 25, 2018, the parties must file by November 10 or “promptly thereafter.”
- In all other transactions subject to the requirement, the parties must file **45 days before the completion** of the transaction.
- Parties can be assessed a **civil monetary penalty** up to the value of the transaction for failing to meet this filing requirement.

Implementation of Other FIRRMA Provisions

- FIRRMA states that the remainder of the law will take effect at the earlier of February 2020 or thirty days following the publication of the determination by the Treasury secretary the regulations, organizational structure, personnel and other resources are in place to administer the law.
 - Expected to occur by August 2019.
 - The next step will be proposed rules.
- The most significant changes will relate to:
 - Expanded jurisdiction for additional transactions (discussed further)
 - Mandatory reporting for transactions in which a foreign government obtains a “substantial interest”
 - Declarations available for all transactions

Key FIRRMA Provisions: Real Estate Transactions

- Under the current rules, foreign investments in real estate near sensitive U.S. government locations or ports are within CFIUS jurisdiction only if they could result in a foreign person's control over a U.S. business.
- FIRRMA expands CFIUS jurisdiction over the purchase, lease, or concession of U.S. real estate to a foreign person that:
 - is in close proximity to a U.S. military or other sensitive U.S. government location if such property could reasonably allow for the collection of intelligence or otherwise expose national security activities at a U.S. government site; or
 - is located within, or will function as part of, an air or maritime port.
- To address the potential breadth and ambiguity of this provision, FIRRMA requires the implementing regulations to
 - exclude investments in single-housing units or in urbanized areas
 - provide a limited definition of "close proximity"
- **Energy sector impact:** This provision is likely to capture energy deals that may not be currently subject to CFIUS jurisdiction.
 - Ex: If a non-U.S. company acquires or leases a parcel of land to develop wind or solar assets or to extract oil and gas, that transaction may be subject to CFIUS jurisdiction if the parcel is located in proximity to U.S. military facilities or an air or sea port. Pre-FIRRMA, such a transaction would likely fall within the "greenfield" exemption to CFIUS since it does not involve the acquisition of a U.S. business.

Key FIRRMA Provisions: Noncontrolling Investments

Two-step test for FIRRMA's expanded jurisdiction over noncontrolling investments or "other investments":

- **Step 1:** Is there an investment by a **foreign person** in an unaffiliated U.S. business that:
 - owns, operates, manufactures, supplies, or services "**critical infrastructure**"; *or*
 - produces, designs, tests, manufactures, fabricates, or develops one or more "**critical technologies**" [**note: largely implemented through the pilot program**]; *or*
 - maintains or collects "**sensitive personal data**" of U.S. citizens that could be exploited in a manner that threatens U.S. national security.

- **Step 2:** Does the **investment afford** the foreign person:
 - access to "**material nonpublic technical information**" possessed by the U.S. business; *or*
 - membership, observer or nomination **rights for the board** (or equivalent body) of the U.S. business; *or*
 - any involvement, other than through voting of shares, in **substantive decision making** related to sensitive personal data, critical technologies or critical infrastructure.

Key FIRRMA Provisions: Noncontrolling Investments and Critical Infrastructure

- **Critical infrastructure**: FIRRMA generally adopts the existing definition, which is any “systems or assets, whether physical or virtual, so vital to the United States that incapacity or destruction ... would have a debilitating impact on national security.”
 - In response to concerns that the term is too broad, FIRRMA requires that the final regulations limit this definition with respect to this provision to what is likely important to national security and to give specific types and examples of such infrastructure.
- **Energy sector impact**: investments that affect domestic energy infrastructure, such as the U.S. power transmission grid or strategic petroleum reserves, may be subject to this provision.
 - Example: A non-U.S. company makes a five percent equity investment in a U.S. energy company. This investment affords the non-U.S. company observer rights on the target's board. Assuming the target fits within the definition of critical infrastructure, that transaction would be subject to CFIUS review.

Key FIRREA Provisions: Investment Funds Clarification

- FIRREA provides that investments by foreign limited partners in funds that are accompanied by advisory board or similar rights *will not be* subject to CFIUS jurisdiction as “other investments” in certain identified circumstances, which may be further clarified in regulations:
 - The fund is managed exclusively by a general partner, managing member, or equivalent that is not a foreign person;
 - Neither the board or committee, nor the foreign person, has the ability to approve, disapprove, or otherwise control investment decisions or decisions regarding the entities in which the fund is invested;
 - The foreign person does not otherwise have the ability to control the fund, including (but not limited to) the right to unilaterally dismiss, retain, select or determine the compensation of the general partner; and
 - The foreign person does not have access to “material nonpublic technical information.”
- Note: Certain waivers are permitted (e.g., conflict of interest).

Key FIRRMA Provisions: Change in Rights

- FIRRMA expands CFIUS jurisdiction to cover any change in the rights that a foreign person has with respect to a U.S. business in which the foreign person has an investment that could lead to (i) foreign control, or (ii) an “other investment.” The control portion is already in effect but the “other investment” trigger will become effective with the final regulations.
- **Energy sector impact:** This provision could add regulatory burdens to energy JVs and other investments in energy assets by foreign persons.
 - Ex: If a foreign company establishes a joint venture in the United States to develop energy resources and thereafter negotiates an adjustment to its rights (e.g., changing the board representation or decision making process), those changes could result in a CFIUS review.

Key FIRRMA Provisions: Mandatory Reporting

- FIRRMA imposes mandatory reporting requirements on transactions that result in a foreign government, directly or indirectly, obtaining a “substantial interest” in a U.S. business that (i) owns, operates, manufactures, supplies, or services critical infrastructure; (ii) produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies; or (iii) maintains or collects sensitive personal data of United States citizens that may be exploited in a manner that threatens national security.
 - As with the pilot program, the parties will have the decision whether to file a short-form declaration or a full CFIUS notice.
- In defining “substantial interest,” CFIUS must consider the level of influence that the foreign government could have and must set the level at least above 10% voting interest.
- CFIUS may grant waivers for certain foreign persons based on the independence of the buyer from the foreign person and the history of cooperation with CFIUS.
- **Energy sector impact:** This provision could impose regulatory burdens on foreign government investments in the U.S. energy sector.
 - Example: A sovereign wealth fund makes serial investments in U.S. energy assets. Assuming that they are covered transactions and qualify as a “substantial interest,” they would all require CFIUS reporting unless a waiver was granted for the entity.

Summary of Key Issues for FIRRMA Proposed Rule

- Notice and comment period will help determine key issues, including:
 - Definition of “close proximity” in real estate provision
 - Definition of “critical infrastructure” and “sensitive personal data”
 - Exemptions for “certain categories of foreign persons” in real estate and “other” investments provisions
 - What it means for a foreign government to have a “substantial interest” in a transaction

Takeaways

1. CFIUS will now play a bigger role in the M&A process: more deals captured and mandatory reporting.
2. New requirements can impact deal timing and expose companies to penalties for failure to comply. Liability applies to the buyer and the seller.
3. Analyze early in the deal whether the pilot program will apply. Build into diligence process.
4. The analysis requires diligence of the U.S. business that focuses on export control issues. Requires an assessment of the technology that relates to the target.
5. Still need to consider the “old” CFIUS rules and risks.
6. Evaluate whether deal terms can be adjusted to avoid falling into a covered noncontrolling investment.
7. Act quickly on pending deals.
8. Stay tuned for the proposed and final rules that will fully implement FIRRMA.
9. Plan ahead for full implementation of FIRRMA.