COVINGTON

COVINGTON & BURLING LLP

E-ALERT | Cross-Border Investment

December 20, 2013

CFIUS 2012 ANNUAL REPORT TO CONGRESS

The Committee on Foreign Investment in the United States ("CFIUS") yesterday released its Annual Report to Congress on transactions filed in 2012. The report provides data on all notices filed with CFIUS during the 2012 calendar year and all reviews or investigations completed during that year. As expected, the report reveals a surge in the number of notices involving Chinese investors. It also reveals an unprecedented increase in the number of transactions withdrawn by the parties, suggesting that more deals faced heightened scrutiny in 2012 and, potentially, adverse presidential action. At the same time, the report also reaffirms that the United States remains open to foreign investment, with most transactions being cleared within the initial 30-day review period.

ANALYSIS OF ADDITIONAL CHINESE INVESTMENT AND WITHDRAWN AND ABANDONED CASES

We think it is important that our clients and contacts who are interested in cross-border investment in the United States understand the trends reflected in the Annual Report, especially as they relate to China.

Calendar year 2012 saw an unprecedented increase in the number of transactions notified to CFIUS that involved Chinese investors. Of the 114 notices filed with CFIUS, 23 — or about 20 percent — involved a Chinese acquirer. This is up from ten in 2011 and six in 2010. China also overtook the United Kingdom as the home country for the most notices filed in 2012, a position that the United Kingdom historically has held. In monetary terms, Chinese investment also increased significantly, with $11.5 billion worth of mergers or acquisitions involving Chinese firms in 2012, which was the most since 2007.

Not coincidentally, the data for 2012 also reflect heightened scrutiny applied by CFIUS to a greater number of cases. To this end, CFIUS reports that 22 notices were withdrawn from consideration in 2012 — the largest number in CFIUS history. This also represents a substantial increase from 2011, when only six cases were withdrawn. Indeed, over the prior three reporting periods (2009-2011), only 25 cases in total were withdrawn. Perhaps even more significant, of the 22 transactions that were withdrawn in 2012, only 12 were re-filed and ten were abandoned. By comparison, only eight withdrawn transactions were abandoned from 2009—2011. Moreover, as we have discussed previously, 2012 resulted in only the second Presidential order ever directing the divestiture of an acquisition — namely, the President's order prohibiting Ralls Corporation from owning four wind farm project companies in Oregon.

Parties withdraw notices to CFIUS for a range of reasons. In some cases, parties withdraw a notice because they are abandoning a transaction for commercial reasons. In other cases, a material change in the nature of the transaction may necessitate a new filing. However, parties may also withdraw and re-file to provide more time to answer CFIUS's questions or negotiate mitigation measures to address outstanding national security concerns. Finally, parties may withdraw a notice where it becomes clear that CFIUS is likely to recommend that the President suspend or prohibit the transaction.

Although CFIUS does not disclose the reason that parties withdraw specific notices, the considerably larger number of notices that were withdrawn and re-filed in 2012 reflects several trends and aspects of the CFIUS process.

First, while the U.S. remains open to investment and the majority of Chinese cases succeed, the data in the CFIUS Annual Report verifies that investments from China and certain other countries attract closer scrutiny. In particular, transactions that touch on certain types of extant risk, such as potential espionage or cyber-based risks, can present challenges for CFIUS. For example, 2012 presented several China-related transactions, including the Ralls case noted above, that touched on concerns about proximity — or what the government has called "persistent co-location" — to U.S. military bases and other sensitive facilities. Proximity issues are among the most challenging to mitigate because they combine a persistent threat (the threat of espionage or other clandestine action) with a fixed vulnerability (the physical location of the assets). Similarly, transactions that implicate concerns within the U.S. government about cyber attacks can be challenging to resolve because of the persistent nature of the threat and vulnerability; these cyber-related concerns can be particularly acute in Chinese transactions that may involve access to important information systems or networks, but they are not exclusive to China.

Second, 2012 saw several "non-notified" transactions. Many of the most challenging CFIUS cases— including many cases involving investors from countries other than China — have arisen from transactions that were consummated before filing with CFIUS. Such cases are especially challenging because closing a transaction locks in a certain set of facts before CFIUS has reviewed the terms.

Third, there is an important element of the statute governing CFIUS that results in a deliberate and cautious process. Specifically, for transactions that proceed to a second-stage investigation, the statute requires that for transactions CFIUS approves, senior political appointments — the Deputy Secretary of the Treasury Department and the Deputy Secretary of any other "lead" agency in a CFIUS review — must certify to the U.S. Congress that the transaction presents "no unresolved national security concerns." (The same certification applies for transactions completed in the initial 30-day review period, but it can be made at the Assistant Secretary level.) This is not an insignificant administrative and political threshold to cross, and it contributes to CFIUS officials exercising great care and caution before approving any transaction. This, in turn, can lead to (i) longer timeframes for the process; and (ii) in certain cases where there are national security concerns, CFIUS erring on the side of requiring extremely strict mitigation conditions to address the national security concerns, which restrictions may frustrate the parties' expectations and cause them to abandon the transaction.

Fourth, an often overlooked aspect of the CFIUS regime is the Executive Order that governs the CFIUS process. In particular, Section 7(b) of the Executive Order requires CFIUS to agree to and approve any risk mitigation measure before it is proposed and negotiated with transaction parties. As it is being applied, this requirement, while disciplined and intended to ensure that CFIUS focuses strictly on addressing only true national security issues, also creates an additional layer to the CFIUS regulatory approval process. And, often the Committee's proposed mitigation, because it is developed without input from the parties, may have unintended commercial implications that become challenging to resolve in the statutorily allotted timeframe.

While these factors collectively help explain the higher number of investigations by CFIUS and withdrawn and abandoned transactions in 2012, they do not mean that CFIUS has altered its course; CFIUS remains a narrowly tailored process focused strictly on national security concerns and open to foreign investment. However, these factors do underscore the importance of careful preparation and

planning in cross-border mergers and acquisitions, especially involving China. In particular, transaction parties are well advised to vet potential national security issues during the transaction planning stage and engage with CFIUS prior to closing a transaction that involves an acquisition of control by a foreign person over a U.S. business.

CHANGE IN INTELLIGENCE COMMUNITY'S ASSESSMENT CONCERNING COORDINATED STRATEGY AMONG FOREIGN ACQUIRERS TARGETING U.S. CRITICAL INDUSTRIES

In last year's report, the Intelligence Community ("IC") assessed for the first time that there was likely a coordinated strategy among foreign governments or companies to acquire U.S. "critical technology" companies—a circumstance that was found unlikely in prior reports. In the most recent report, the IC appears to have backed off that assessment and returned to its previous judgment that such a strategy is unlikely. The report states that the IC "judges it unlikely that there is a coordinated strategy among one or more foreign governments or companies to acquire United States companies involved in research, development, or production of critical technologies for which the United States is a leading producer."

However, the IC also notes that "indications of a coordinated strategy may go unobserved due to limitations on intelligence collection, or may be hidden or misconstrued because of foreign denial and deception activities." Thus, the change in the IC's assessment may simply reflect a lack of relevant reporting during calendar year 2012 to support a judgment similar to last year's finding, rather than a fundamental change in its overall assessment. In our experience, concerns about the targeting of critical technologies by foreign companies and governments continued to animate CFIUS action in 2012 and almost certainly will continue to be a factor in the future.

OTHER HIGHLIGHTS FROM THE MOST RECENT REPORT

- The total number of notices filed increased slightly to 114, up from 111 in 2011. This is lower than the record of 155 in 2008 — the first year after the reform of CFIUS through the Foreign Investment and National Security Act of 2007 — but up substantially from 2009 and 2010, which saw 65 and 93 notices, respectively.
- As with last year, the number of cases that proceeded to the investigation stage remained relatively high and increased slightly over recent years. The percentage of notices proceeding to a 45-day investigation increased to 39 percent, up from 36 percent in 2011 and 38 percent in 2010.
- The notices filed in 2012 continued to represent a broad range of industries. Manufacturing continued to be the largest sector represented, accounting for 39 percent of notices filed. Of those, about half involved the computer and electronics subsector.
- The number of cases resulting in legally binding mitigation measures remained essentially the same. Eight cases in 2012 resulted in mitigation, the same as in 2011 and 2010, although this represented a slightly smaller percentage of the total number of notices filed.
- The number of acquisitions by investors from close U.S. allies remained high. Together, the United Kingdom, Canada, Japan, and Australia accounted for approximately 37 percent of total notices, down slightly from 2011.
- Acquisitions involving investors from other major emerging economies increased over past years. Brazil had two notices in 2012, compared to one in 2011 and none in 2010; India had four notices, an increase from one each in 2011 and 2010; and Russia had two notices in 2012, after having none in 2011.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our cross-border investment practice group:

Mark Plotkin	+1.202.662.5656	mplotkin@cov.com
David Fagan	+1.202.662.5291	dfagan@cov.com
Alan Larson	+1.202.662.5756	alarson@cov.com
Stuart Eizenstat	+1.202.662.5519	seizenstat@cov.com
Roger Zakheim	+1.202.662.5959	rzakheim@cov.com
Damara Chambers	+1.202.662.5279	dchambers@cov.com
Jonathan Wakely	+1.202.662.5387	jwakely@cov.com