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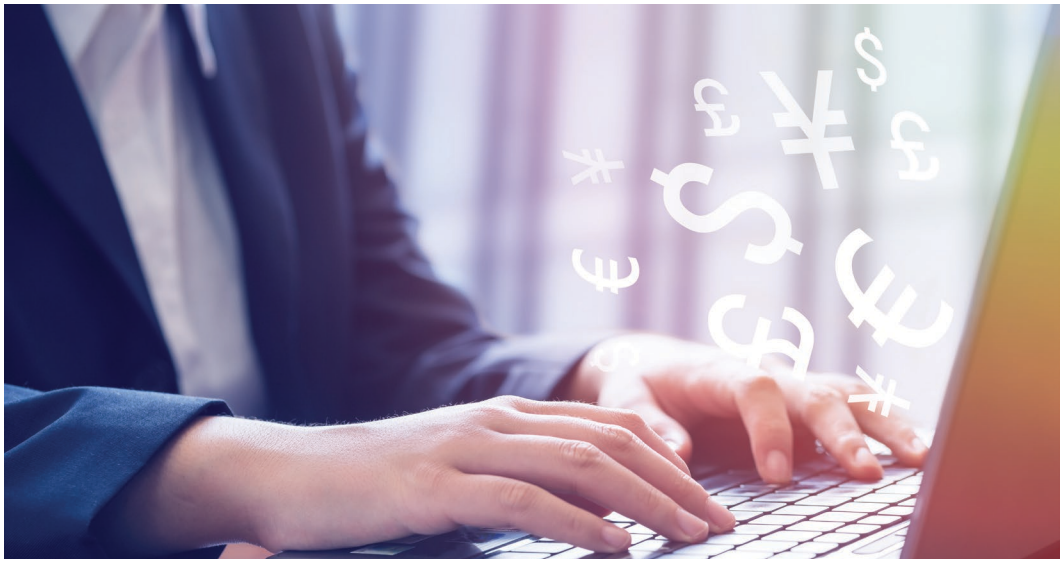
# Structuring Cross-Border Venture Investments Under the CFIUS Pilot Program



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U.S. technology companies raising funds from foreign investors should carefully consider whether the proposed financing transaction can be structured to avoid falling within the purview of the Committee on Foreign Investment in the United States (CFIUS), which now has jurisdiction to review certain financing transactions pursuant to interim rules under the Foreign Investment Risk Review Modernization Act (FIRRMA). In particular, FIRRMA expanded the jurisdiction of CFIUS through 31 C.F.R. part 801, an interim rule that establishes a "pilot program." Several significant features of the pilot program are still undefined, but it is clear that it imposes new compliance requirements on many categories of U.S. businesses and on non-U.S. investors.

## Overview

FIRRMA expands CFIUS's jurisdiction to cover certain cross-border venture investments. Before the implementation of the pilot program, CFIUS review was not a typical issue encountered by startup companies in connection with financing transactions because CFIUS's jurisdiction was limited to proposed cross-border transactions that could result in a U.S. business being controlled by a foreign person. That is no longer the case under the pilot program. The scope of CFIUS's jurisdiction now includes noncontrolling foreign investments in U.S. businesses if the U.S. business designs, develops, tests or produces certain "critical technologies" and if the foreign person receives certain management or information rights in the U.S. business.

Of particular significance to the technology startup community, the definition of "critical technologies" includes "emerging and foundational technologies" identified and controlled under the Export Control Reform Act of 2018 (ECRA), which was enacted concurrent with FIRRMA. The U.S. government has indicated the general technology categories that the U.S. Commerce Department's Bureau of Industry and Security will consider when identifying the emerging technologies subject to the ECRA, but has not yet indicated which emerging or foundational technologies will be subject to the ECRA. The general categories will be familiar to the technology startup community and include, among others, such broad technology fields as artificial intelligence, advanced computing technology, biotechnology, data analytics and microprocessor technology. The takeaway is that, even if a business is not in a "traditional" national security-related field, it may not be exempt from compliance.

The pilot program establishes a new mandatory declaration process. If the transaction in question is a covered transaction *(i.e.,* because it is a foreign control transaction or a noncontrolling foreign investment in a pilot program U.S. business in which the foreign investor is entitled to certain rights), the parties must make a CFIUS filing, either in short or long form. The pilot program empowers CFIUS to impose civil penalties, up to the value of the transaction, for failing to file a mandatory declaration in advance of closing. The pilot program will remain in effect until final FIRRMA regulations are implemented, likely in February 2020.

## When Is a Filing Required Under the Pilot Program?

Under the pilot program, the parties to the transaction must determine if the U.S. business is a "pilot program U.S. business" and, if so, whether the investment will afford a foreign person certain rights such that the transaction falls within CFIUS's national

security review jurisdiction. A "[p]ilot program U.S. business" is defined to mean "any U.S. business that produces, designs, tests, manufactures, fabricates, or develops a critical technology" that is utilized in connection with its own activity in one or more pilot program industries, or is designed by the business for use in one or more pilot program industries. 31 C.F.R. § 801.213. Therefore, a threshold question is whether the U.S. business produces, designs, tests, manufactures, fabricates or develops anything that it utilizes in connection with its own activity in one or more pilot program industries, or whether it designs anything for use in one or more of the 27 pilot program industries. If not, then the transaction will not be a pilot program-covered transaction.

If the U.S. business is found to be in one of the pilot program industries, the next question is whether it produces, designs, tests, manufactures, fabricates or develops "critical technologies" utilized in connection with its own activity in one or more pilot program industries, or whether it designs anything for use in one or more pilot program industries. A critical technology is specifically defined in the pilot program regulations. See 31 C.F.R. § 801.204. In some cases, it may be easy to determine that the U.S. business does or does not produce, design, test, manufacture, fabricate or develop any of the listed "critical technologies." In other cases, the determination may be murky, in part because of uncertainties under the ECRA.

In those cases where the U.S. business is clearly a pilot program U.S. business, and in those cases where the analysis does not result in a definitive answer, the question becomes whether the investment affords a foreign person access to any material nonpublic technical information in the possession of the U.S. business, specifically:

- 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

- 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.

If the noncontrolling investment does not provide any of these rights, it is not a covered transaction subject to CFIUS review. If, on the other hand, the investment does provide a foreign person with management or information rights in a pilot program-covered U.S. business, then the investment is subject to CFIUS review, regardless of the foreign

investor's percentage of voting interest following the investment. Investors cannot avoid CFIUS review by simply investing through a convertible note or other convertible security because the pilot program also covers "contingent equity interests" that are convertible into an equity interest with voting rights.

The pilot program makes filings mandatory — a marked difference from pre-FIRRMA rules, under which filing a CFIUS notice was optional. The pilot program permits parties to a covered transaction to submit an abbreviated "declaration" in place of a full written notice seeking CFIUS clearance. Declarations must be submitted at least 45 days before the completion date of the transaction and should be no more than five pages in length. Failure to submit a mandatory filing under the pilot program can result in civil penalties up to the transaction value. CFIUS will have 30 days to review the declaration and respond.

## The Path Forward

The path to success for a technology startup is already fraught with roadblocks. From the perspective of a U.S. business, the expansion of CFIUS jurisdiction will likely be yet another obstacle. Many of the foundational and emerging technologies are in capital-intensive fields, and foreign investors can be a crucial source of capital. The mandatory CFIUS review required by the pilot program will, in many cases, be enough to stall or prohibit cross-border deals. Still, U.S. businesses would be ill-advised to simply take their chances by not filing in a borderline case because of the significant civil penalties.

In addition, the uncertainty around the definition of "critical technologies" subject to review further complicates the analysis of this issue. Consequently, we recommend that U.S. businesses and foreign investors structure their transactions to avoid providing the investors with any of the rights that make the deal a covered transaction subject to review.

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