

# Court Alert – New CFIUS Regulations Implement Mandatory Filings Prior to Foreign Ownership – NAICS Codes Implications

By Camille Stewart

## OVERVIEW

Foreign nation states are exploiting the U.S. legal system for their advantage. Left unchecked, this exploitation enables nation states with malicious intent to amass technical capability and insight into military and critical technology and infrastructure systems to support potentially highly-damaging cyber attacks. The U.S. government’s Committee on Foreign Investment in the United States (CFIUS) is charged with protecting national security by reviewing investments (such as mergers and acquisitions or takeovers) by foreign entities. However, U.S. adversaries are circumventing this process by purchasing interests in companies during bankruptcy and observing bankruptcy proceedings, both of which give them access to sensitive technology and intellectual property (IP). This type of unregulated access can pose a major threat to U.S national security.

Earlier this year, Congress passed legislation aimed at addressing a range of vulnerabilities within the CFIUS process. The U.S. Treasury Department issued new “pilot program” regulations on October 10, 2018 to implement components of this legislation.<sup>1</sup> The pilot program, among other things, presents an opportunity for bankruptcy court judges to mitigate the leak of sensitive technology and IP by flagging potential national security concerns for CFIUS. Treasury’s pilot program mandates filings for all transactions within its scope and identifies 27 critical industries, defined by NAICS (North American Industry Classification System) codes.<sup>2</sup> According to Treasury, **these are “industries for which certain strategically motivated foreign investment could pose a threat to U.S. technological superiority and national security.”**<sup>3</sup> **The regulations go into effect on November 10, 2018.**

As NAICS codes are often provided in filings, **bankruptcy court judges have a unique opportunity to identify technologies that may have national security implications and flag them for review by CFIUS if the parties have not made the mandatory filing.** Failure to file with CFIUS opens parties to potential civil penalties up to the value of the transaction and could lead to Presidential action to block the transaction.

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<sup>1</sup> For additional background on the changes to CFIUS, see “New Regulations Implement Significant Expansion of CFIUS Jurisdiction – Mandatory Filings and Civil Penalties,” *Wiley Rein LLP*, October 10, 2018. (<https://www.wileyrein.com/newsroom-articles-Alert-New-Regulations-Significantly-Expand-CFIUS-Jurisdiction-by-Requiring-Mandatory-Declarations-for-Critical-Technology-Deals.html>); Giovanna M. Cinelli, Kenneth J. Nunnenkamp, Stephen Paul Mahinka, Carl A. Valenstein, “CFIUS Scratches the FIRRMA Itch – Pilot Programs Begin Early Implementation,” *Morgan, Lewis & Bockius LLP*, October 11, 2018. (<https://www.morganlewis.com/pubs/cfius-scratches-the-firma-itch-pilot-programs-begin-early-implementation>)

<sup>2</sup> “The North American Industry Classification System (NAICS) is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy.” “North American Industry Classification System.” *United States Census Bureau*, accessed October 19, 2018. (<https://www.census.gov/eos/www/naics/>)

<sup>3</sup> U.S. Department of the Treasury, “Fact Sheet: Interim Regulations for FIRRMA Pilot Program,” October 10, 2018. (<https://home.treasury.gov/system/files/206/Fact-Sheet-FIRRMA-Pilot-Program.pdf>)

A forthcoming Foundation for Defense of Democracies report by Camille Stewart will explain the national security implications of foreign investment in sensitive technology and IP outside of the CFIUS and export control regimes. It will provide recommendations about role the judiciary can play in mitigating this national security threat and ensuring that parties comply with federal law.

## **FIRRMA**

On August 13, 2018, the President signed the Foreign Investment Risk Review Modernization Act (FIRRMA)<sup>4</sup> into law as part of the National Defense Authorization Act for Fiscal Year 2019. The legislation expanded the scope of jurisdiction for CFIUS, a multi-agency committee that reviews foreign investment in U.S. companies for national security considerations. CFIUS rulings have a significant impact on U.S. investment policy and foreign investment flows into the country, especially those from high-risk countries, such as China. Among other changes, **FIRRMA clarified that CFIUS has jurisdiction over transactions that occur “pursuant to a bankruptcy proceeding or other form of default on debt.”**<sup>5</sup>

## **NEW “PILOT PROGRAM” REGULATIONS**

On October 10, 2018, the U.S. Department of the Treasury took the first step toward implementing FIRRMA by publishing new regulations<sup>6</sup> that empower CFIUS to review transactions that were not previously subject to the committee’s scrutiny.

Treasury’s pilot program immediately implements two important parts of FIRRMA:

1. The pilot program expands the scope of transactions subject to review by CFIUS to include certain investments, as outlined below, involving foreign persons and critical technologies.
2. The pilot program implements FIRRMA’s mandatory declarations provision for all critical technology transactions that fall within the scope of the pilot program.

Foreign investments covered under the pilot program regulations are those in which the foreign investor acquires any of the following powers:

1. Access to any material, nonpublic, technical information in a U.S. business’ possession;

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<sup>4</sup> John S. McCain National Defense Authorization Act for Fiscal Year 2019, Pub. L. 115-232, §§ 1701-1793. ([https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA\\_0.pdf](https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA_0.pdf))

<sup>5</sup> John S. McCain National Defense Authorization Act for Fiscal Year 2019, Pub. L. 115-232, § 1703, page 546. ([https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA\\_0.pdf](https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA_0.pdf))

<sup>6</sup> Determination and Temporary Provisions Pertaining to a Pilot Program To Review Certain Transactions Involving Foreign Persons and Critical Technologies, Office of Investment Security, U.S. Department of the Treasury, 83 Federal Register 51322, October 11, 2018. ([https://home.treasury.gov/system/files/206/FR-2018-22182\\_1786904.pdf](https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf))

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.

This is a significant expansion of CFIUS's authority. Prior to FIRRMA, CFIUS regulations did not adequately cover transaction types such as, but not limited to, joint ventures, minority investments, transition agreements, framework agreements, and purchased assets from bankruptcies. In particular, bankruptcy proceedings that transfer technology to purchasers but do not result in foreign control of a U.S. entity would not trigger CFIUS or one of the other relevant regulations.<sup>7</sup> These and other gaps in the previous processes have been exploited by savvy foreign entities to circumvent CFIUS and other national security review.

**The pilot program regulations go into effect on November 10, 2018.**

## **ESTABLISHMENT OF MANDATORY DECLARATIONS FOR PILOT PROGRAM INDUSTRY TRANSACTIONS**

Whereas CFIUS filings were voluntary prior to the issuance of these regulations with authority to review only transactions that could result in foreign control of a U.S. business, the pilot program adds a mandatory declaration requirement for certain non-controlling critical technology investments from any country. This includes *any* acquisition of an equity interest in a U.S. business that produces, designs, tests, manufactures, fabricates, or develops critical technology (as defined under FIRRMA) that affords a foreign person with access to specified information or governance rights. The parties will have to file either a full notice or a declaration.

## **NAICS CODES**

The pilot program identifies 27 critical industries, defined by NAICS codes, as "Pilot Program Industries." This list is included below. According to Treasury's fact sheet, this list was "carefully developed" based on the government's determination that these are "industries for which certain strategically motivated foreign investment could pose a threat to U.S. technological superiority and national security."<sup>8</sup>

**To promote compliance and in the interest of national security, judges are encouraged to review the NAICS codes provided in court filings and flag relevant cases that have not demonstrated completion of a CFIUS review for follow up and potential submission to the CFIUS committee. Additionally, judges are encouraged to consider requiring NAICS codes in filings to facilitate identifying potential noncompliance.**

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<sup>7</sup> Other relevant regulations include, but are not limited to, export control regulations such as Export Administration Regulations and International Traffic in Arms Regulations, and Anti-Assignment Act.

<sup>8</sup> U.S. Department of the Treasury, "Fact Sheet: Interim Regulations for FIRRMA Pilot Program," October 10, 2018. (<https://home.treasury.gov/system/files/206/Fact-Sheet-FIRRMA-Pilot-Program.pdf>)

<b>Industry</b>	<b>NAICS Code</b>
Aircraft Manufacturing	336411
Aircraft Engine and Engine Parts Manufacturing	336412
Alumina Refining and Primary Aluminum Manufacturing	331313
Ball and Roller Bearing Manufacturing	332991
Computer Storage Device Manufacturing	334112
Electronic Computer Manufacturing	334111
Guided Missile and Space Vehicle Manufacturing	336414
Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing	336415
Military Armored Vehicle, Tank, and Tank Component Manufacturing	336992
Nuclear Electric Power Generation	221113
Optical Instrument and Lens Manufacturing	33314
Other Basic Inorganic Chemical Manufacturing	325110
Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing	336419
Petrochemical Manufacturing	325110
Powder Metallurgy Part Manufacturing	332117
Power, Distribution and Specialty Transformer Manufacturing	335311
Primary Battery Manufacturing	335912
Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing	334220
Research and Development in Nanotechnology	541713
Research and Development in Biotechnology (except Nanobiotechnology)	541714
Secondary Smelting and Alloying of Aluminum	331314
Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing	334511
Semiconductor and Related Device Manufacturing	334413
Semiconductor Machinery Manufacturing	333242
Storage Battery Manufacturing	335911
Telephone Apparatus Manufacturing	334210
Turbine and Turbine Generator Set Units Manufacturing	333611

## **ABOUT FDD:**

The Foundation for Defense of Democracies (FDD) is a Washington, DC-based nonpartisan 501(c)(3) research institute focusing on national security and foreign policy.

FDD launched the Transformative Cyber Innovation Lab (TCIL) to drive revolutionary, society-wide improvement in cyber resilience through the innovative synthesis of technology, policy, and governance. TCIL helps policymakers and operators recognize and mitigate cyber vulnerabilities that affect American core societal strengths. Our work assists those government agencies and private sector companies on the frontlines of cyber space.

TCIL is led by Chairman **Dr. Samantha Ravich** and Executive Director **Dr. Michael Hsieh**. Earlier this year, Dr. Ravich was appointed vice chair of the President's Intelligence Advisory Board and a member of the congressionally-mandated Cyberspace Solarium Commission. Dr. Hsieh brings extensive expertise in fundamental research in secure computation, having served as program manager in the Information Innovation Office at the Defense Advanced Research Projects Agency.

TCIL experts identified that the intellectual property and technology leakage through bankruptcy courts is a problem for U.S. national security. TCIL recruited **Camille Stewart**, a cyber and technology professional with substantial business, legal, and policy experience to study the scope of the problem. Her research will also develop training modules for the legal community and identify regulatory changes and technical solutions that will address this problem.

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