Client Advisory: Recent FDI Developments Affecting U.S. M&A Practice
January 2024

The second half of 2023 saw the emergence of key developments that may be of interest to companies engaging in M&A in the United States in 2024: (1) the Federal Trade Commission (FTC) and the Department of Justice (DOJ) released new merger guidelines signaling a policy shift towards greater scrutiny of mergers; (2) the FTC, along with the DOJ, proposed rule changes that would broaden the type and volume of information to be filed in connection with pre-merger notifications (HSR filings) and thus significantly increasing the cost and time required to prepare these notifications; (3) CFIUS released its 2022 annual report, which provides insight into recent trends in CFIUS filings and review; (4) CFIUS made an important definitional clarification that will have a significant impact on the way foreign investments in certain U.S. technology companies are structured; and (5) President Biden signed an Executive Order designed to restrict U.S. investments into certain sensitive technologies in China (sometimes referred to as "reverse CFIUS"). In this Client Advisory, we provide a brief overview of these developments.

1. FTC and DOJ Issue Final Revised Merger Policy Guidelines

On December 18, 2023, the U.S. Federal Trade Commission and Department of Justice released their final revised Merger Guidelines, reflecting modest adjustments to the draft merger guidelines that had been released on July 19, 2023 for public comment. These new Merger Guidelines are intended to replace the 2010 Horizontal Merger Guidelines and 2020 Vertical Merger Guidelines (which had already been rescinded by the FTC in 2021). Along with the proposed overhaul of the pre-merger notification form and instructions described below, these Merger Guidelines reflect the current administration's policy of greater regulatory oversight and are consistent with the agencies' recent aggressive merger enforcement practices (indeed, the Merger Guidelines focus on theories used by the agencies in recent failed merger challenges).

The Merger Guidelines set forth 11 core guidelines that will guide the agencies in their review of merger transactions. Some key changes from the prior guidelines include lowering the threshold for which a transaction would be presumptively anticompetitive, creating a presumption against mergers involving a firm with a "dominant position" (meaning 30% or greater market share, or the power to direct price or quality or dictate favorable terms), lowering the threshold for determining undue concentration of the markets, and giving agencies wide latitude in defining the relevant market. The new Merger Guidelines also emphasize the agencies' intent to scrutinize acquisitions that will have the effect of eliminating "potential entrants," even if their market share is small at the time of the acquisition. The new Merger Guidelines also target vertical mergers, mergers involving platforms, especially when a platform operator is also a platform participant, and the practice of "roll-up" acquisitions (acquiring multiple companies in the same or adjoining similar markets) by PE firms and other serial acquirors. Finally, the Merger Guidelines also announce a more skeptical view of efficiencies resulting from mergers. It is safe to assume that under the new guidelines, the agencies are more likely to investigate or challenge transactions that would have gone unchallenged under the prior guidelines.

2. FTC and DOJ Propose Major Overhaul of HSR Filing

On June 28, 2023, the FTC, with the concurrence of the DOJ, announced proposed changes to the pre-merger notification form and instructions under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act). Public comments on the proposed changes may be submitted until September 27, 2023, after which the FTC will issue a final rule, taking into consideration comments received. There is no specific timeline for the adoption of the final rule.

The HSR Act, which was signed into law in 1976, governs the requirements and rules relating to pre-merger notification filings in the United States. The FTC explained in a recent statement that the HSR Act has not been substantively updated since the late 1970s despite drastic changes in the deal landscape in the past 45 years in terms of deal volume, complexity of deals, and overall market realities. The proposed changes are intended to address current deficiencies in the amount and type of information required in pre-merger filings, which deficiencies make it difficult for the enforcement agencies to properly review contemplated transactions within the regulatory 30-day waiting period.

The proposed rules do not alter the statutory threshold or other requirements used to determine whether a filing is required; instead, the proposed changes expand the type and volume of information to be submitted in connection with the pre-merger notification. In addition, the proposed rules will implement the Merger Filing Fee Modernization Act of 2022 (MFFMA). Many of the proposed changes would bring the U.S. pre-merger filing requirements closer in line with those of the European Commission and the United Kingdom.

Under the proposed rules, a substantial volume of information under areas not covered by the current rules would need to be submitted, including information regarding the transaction, the parties and their employees, competitive overlap and relationship analysis, and foreign filings. The proposed rules also require filers to provide information about any subsidies received from foreign entities of concern, such as certain foreign governments, foreign terrorist organizations, sanctioned nationals or blocked persons. In addition to the increased volume of information required, the proposed rules also contemplate expanding the types of documents required to be submitted, such as documents prepared by or for officers or directors of the merging company for the purpose of evaluating the transaction and verbatim English translations of all foreign language documents.

Market participants and legal practitioners anticipate that the proposed rules, if adopted, would significantly increase the cost and time required to prepare a pre-merger filing. The FTC estimates that the proposed changes would increase the average preparation time needed from 37 hours to 144 hours, an increase of 107 hours, or nearly four times. In practice, the time required to prepare a pre-merger notification varies widely depending on the complexity of the transaction, and many practitioners are of the opinion that a filing for a complex matter would likely take multiple times the FTC's estimated 144 hours.

While it is unclear how much of the proposed rules will be adopted in the final rule, these proposed changes, like the new merger guidelines discussed above, reflect the current administration's view that past pre-merger review and enforcement had been too lax and highlight the administration's concern over increasing market concentration. In light of the changes on the horizon, companies contemplating transactions that will require a pre-merger notification filing should engage legal counsel early in the process and begin collecting information and documents to ensure that they are able to meet their anticipated transaction timelines.

3. CFIUS Annual Report for 2022

On July 31, 2023, the Committee on Foreign Investment in the United States (CFIUS) released its 2022 annual report to the U.S. Congress. Some of the key trends from this report are as follows:

- **Number of notices and declarations filed mostly constant.**[1] The number of covered transactions reviewed by CFIUS in 2022 (440) was approximately the same as those reviewed in 2021 (436). After several years of steady increases in the number of filings in connection with the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018, it appears that the number of filings has reached a plateau.

- **Shift in home countries of investors.** Singaporean investors filed the most notices (as well as the most filings overall), followed by Chinese investors. The rise in filings by Singaporean investors was particularly notable, nearly doubling from 24 (13 notices and 11 declarations) to 46 (37 notices and 9 declarations). This may have been due to the inflow of Chinese wealth into Singapore in recent years. In the case of declarations, Canada was the top filer for the second year in a row (22 in both 2021 and 2022), followed by Japan (also for the second year in a row; 11 in 2021 and 18 in 2022). Japan topped the list of foreign acquirers of U.S. critical technology companies reviewed by CFIUS in 2022 with 16 filings.

- **Increase in mitigation measures and withdrawals.** The data in the annual report suggests that even investors from countries that are closely allied with the U.S., such as Japan,[2] are increasingly being required to enter into mitigation agreements as a condition of approval. One implication of this trend is that Japanese investors may need to create internal controls to ensure ongoing compliance with such mitigation agreements. Furthermore, the number of instances where a notice was withdrawn and subsequently refiled increased, likely due to the larger number of cases in which approval was conditioned on mitigation.

- **Rise in number of reviews proceeding to the investigation phase.** A fewer number of cases were cleared during the initial 45-day review phase in 2022 as compared to 2021, and a majority of cases proceeded onto the second-stage 45-day investigation phase in 2022 (approximately 57% compared to 48% in 2021). Companies should keep this trend in mind for deal timing purposes, particularly in cases where it is critical for a transaction to close by a certain date.

- **Higher number of declarations resulting in a CFIUS request for a full notice.** There was a marked increase in the number of declarations for which CFIUS issued a request to file a full notice (50 cases in 2022 compared to 20 cases in 2021). Companies considering filing a declaration should therefore be aware that, in all but the lowest-risk transactions, there is now a much higher chance that they will be asked by CFIUS to file a full notice despite filing a declaration.

4. Renewed CFIUS Emphasis on Enforcement

[1] "Notices" are the traditional method of filing with CFIUS, and "declarations" are short-form filings that are designed to expedite review and approval of foreign investments that present little to no risk to U.S. national security interests.

[2] Note that four countries are exempted from the CFIUS rules with respect to non-controlling "covered investments" in "TID U.S. businesses" and with respect to "covered real estate transaction": Australia, Canada, New Zealand, and the United Kingdom.

On September 14, 2023, CFIUS held its second annual conference. Government representatives at the conference announced an intensifying emphasis on compliance, enforcement, and monitoring. As an example of enforcement actions, government officials noted that CFIUS had already imposed two civil monetary penalties in 2023 and several more are pending (CFIUS had announced only two such penalties ever before 2023). CFIUS appears to be imposing mitigation measures in an increasing number of cases and at the conference announced greater resources to monitor compliance under mitigation agreements (particularly through site visits). Panelists described a ramp up of efforts to identify non-notified transactions, explaining that CFIUS requested filings in 19 non-notified transactions in 2022, many of which ended up in mitigation or voluntary divestment. Government officials at the conference also expressed a heightened focus on the U.S. energy and biotechnology sectors. The conference confirmed the trend toward enhanced CFIUS enforcement apparent in the 2022 Annual Report.

5. Clarification by CFIUS Prohibiting "Springing Rights" Arrangements

With little fanfare and tucked in an FAQ (https://home.treasury.gov/policy-issues/international/the-committee-on-foreign-investment-in-the-united-states-cfius/cfius-frequently-asked-questions) released in late-May 2023, CFIUS announced what appears to be a technical clarification of its interpretation of the definition of "completion date" that will have a significant impact on the way foreign persons (non-U.S. persons) invest in U.S. technology companies. This clarification essentially prohibits the "springing rights" arrangements commonly used in investments subject to mandatory CFIUS filings.

Since CFIUS promulgated FIRRMA, any acquisition of equity interests, no matter how small, by a foreign person in a "TID U.S. business" (a business involved in certain critical technology or critical infrastructure or in the collection or maintenance of sensitive personal data) that is accompanied by "covered investment rights" (such as the right to appoint directors or board observers, the right to veto important decisions with respect to the target's "critical technology," or the right to access information about "critical technology") for the foreign acquirer can trigger a mandatory filing with CFIUS.

Preparing and making CFIUS filings is time-consuming and expensive. When mandatory filings for foreign investments in TID U.S. businesses coupled with covered investment rights were first implemented under FIRRMA regulations, investors in a financing transaction often considered two options: (1) the target makes a CFIUS filing at or around the first closing, when only U.S. investors invest, and foreign investors invest later, either after expiration of the mandatory 30-day waiting period following a filing with CFIUS or upon CFIUS clearance, and (2) all investors invest at the same time and the target and foreign investors make CFIUS filings, but foreign investors do not receive their covered investment rights until CFIUS clearance. The second approach, the "springing rights" arrangement, where foreign investors' covered investment rights are dormant at closing and "spring" upon CFIUS clearance (and in the absence of CFIUS clearance, these rights never spring into action), quickly became the industry standard for investments by foreign persons coupled with covered investment rights. Indeed, the NVCA model financing documents contemplate the springing rights arrangement and CFIUS routinely approved transactions adopting this approach.

In its FAQ, CFIUS explained that the "completion date" for purposes of determining when a mandatory filing should be submitted is the date on which the foreign person first acquires an

equity interest, even if covered investment rights do not arise until after CFIUS clearance. CFIUS further clarified that if a filing is mandatory, it must be submitted 30 days before the "completion date." For example, if a foreign investor acquires a 1% stake on July 1 with covered investment rights deferred until CFIUS clearance, the "completion date" is July 1 and the latest date by which the parties must notify CFIUS is June 1.

This clarification thereby eliminates option 2 (the springing rights arrangement) and leaves the parties with option 1. The clarification does not require the parties to wait until CFIUS clearance to close a transaction (which can take several months, and in extreme cases, more than a year); the parties may close the transaction 31 days after making the filing and have covered investment rights spring into effect the same day, even if CFIUS has not yet approved the transaction.

Option 2 (springing rights arrangement) is generally considered to be more favorable to the target than option 1 because it allows the target to receive funds at the first closing. On the other hand, option 2 is generally considered to be less favorable to the foreign investor than option 1 because option 2 locks in the foreign investor without certainty of receiving covered investment rights. This clarification may or may not benefit foreign investors (this depends in part on whether foreign investors are able to negotiate CFIUS clearance as a condition to closing), but it most certainly does not benefit TID U.S. businesses, as they will have to wait longer before receiving funds from foreign investors subject to a mandatory filing.

Because the FAQ does not amend the CFIUS regulations but rather clarifies them (although many practitioners are treating this clarification as a new position and a break with past practice and comments), the clarification applies not only prospectively, but also retrospectively. As a result, CFIUS could determine that past financings that employed the springing rights arrangement did not comply with CFIUS. It is expected that CFIUS will recognize that many mandatory notification transactions since the enactment of the FIRRMA regulations around five years ago adopted the springing rights arrangement without objection by CFIUS (including many handled by this firm), and as a result, it is unlikely that CFIUS will revisit past transactions, but CFIUS has the right to do so if it so wishes.

It is worth noting that the clarification is limited to mandatory filings and does not apply to voluntary filings (voluntary filings are far less common than mandatory filings in connection with foreign investments in TID U.S. businesses).

Finally, it is also worth noting that "contingent equity interests" (such as convertible notes or Safes) are generally not considered to be equity interests and the purchase of convertible note or Safe should not trigger a mandatory CFIUS filing until conversion. The FAQ notes, however, that CFIUS has the authority to determine that a "contingent equity interest" may be treated as an equity interest under certain circumstances (for example, one that grants the holder too much power to initiate conversion into equity).

6. Executive Order for Outbound U.S. Investments ("Reverse CFIUS")

On August 9, 2023, President Biden issued an Executive Order for the establishment of a program for the review of outbound U.S. investments into entities based in countries of concern (currently defined as the People's Republic of China, Hong Kong, and Macau) and that are engaged in activities involving certain national security technologies and products, namely: (1) semiconductors and microelectronics, (2) quantum information technologies, and (3) certain artificial intelligence systems.

The Executive Order directs the Secretary of the Treasury to promulgate regulations to (a) require U.S. persons to provide notification of information regarding certain transactions involving persons of a country of concern, and (b) prohibit U.S. persons from directly or indirectly engaging in such transactions in cases where a transaction is determined to "pose a particularly acute national security threat because of [its] potential to significantly advance the military, intelligence, surveillance, or cyber-enabled capabilities of countries of concern."

On the same day as the Executive Order, the Department of the Treasury issued an Advanced Notice of Proposed Rulemaking (ANPRM) to seek public comments regarding the implementation of this program. The following passage in the ANPRM may be particularly noteworthy for Japanese companies: *The Treasury Department is considering including "indirect" transactions as "covered transactions" in order to close loopholes that would otherwise result, and to clarify that attempts to evade prohibitions on certain transactions cannot find safe harbor in the use of intermediary entities that are not "U.S. persons" or "covered foreign persons," as defined. Examples of such conduct could include, but would not be limited to, a U.S. person knowingly investing in a third-country entity that will use the investment to undertake a transaction with a covered foreign person that would be subject to the program if engaged in by a U.S. person directly.*

If this approach is adopted in the regulations that are ultimately implemented, Japanese companies with significant U.S. operations may possibly be subject to this Executive Order if the Japanese entity engages in activities that would be restricted if they were conducted directly by the U.S. subsidiary or affiliate.

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