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CFIUS Extends Reach on Non-Notified Deals, as Biden Administration Seeks to Deepen National Security Scrutiny in 2022

The Committee on Foreign Investment in the United States (CFIUS) plans to open more investigations this year into transactions that haven't been filed to the panel, posing a new regulatory roadblock for companies that may underestimate the national security implications of their deals.

CFIUS has been ramping up its scrutiny of non-notified deals ever since Congress gave the committee the power to do so in 2018. The drive will likely accelerate in 2022, as the panel reinforces a team of case officers whose sole job is to hunt down investments that once flew under the radar, national security experts said.

"We should anticipate more deals to be caught up through the non-notified process," said Giovanna Cinelli, who leads the international trade and national security practice at the law firm Morgan Lewis.

An increasingly active CFIUS is just one way the administration of President Joe Biden will try to prevent China and other adversaries from gaining an upper hand militarily and economically this year, the experts said.

The administration is also expected to step up its use of export controls, sanctions and bans on U.S. companies doing business with some foreign companies. The government will also likely increase its monitoring of foreign participation in the telecom service industry through an interagency panel known as Team Telecom, the experts said.

In this way, U.S. economic and national security interests will increasingly converge this year, the experts said.

"The industrial policy of the United States has evolved to directly map economic security as national security," said John Lash, a chief strategist at Darkhorse Global, a firm that advises clients on U.S. national security reviews and geoeconomics.

The administration's approach will throw a spotlight on deals and foreign partnerships that previously would have escaped investigation, the experts said.

Non-notified deals. This push will likely be most apparent in CFIUS's heightened scrutiny of non-notified mergers. The Treasury Department, which chairs the interagency committee, has asked for enough resources to handle 1,000 cases a year, "including significantly expanded activity with respect to non-notified transactions," according to its budget request for fiscal 2022.

That "anticipated workload" is more than triple the 325 formal investigations conducted in 2019, before the expanded powers took effect.

The CFIUS review process remains largely voluntary. Dealmakers file in hopes of obtaining a "safe harbor" letter, which usually prevents the panel from initiating a subsequent review. In the past, merger partners could often evade scrutiny by simply not filing, but that strategy has become less viable, experts said.

With Treasury case officers now scouring financial news services, securities filings, intelligence reports and bankruptcy papers for non-notified investments, companies may no longer be able to sidestep a probe by refusing to notify, they said.

An early example came from TuSimple (TSP), a San Diego-based specialist in self-driving freight trucks that drew the attention of CFIUS last March after proposing to sell shares in an initial public offering. The IPO registration statement said the committee had asked TuSimple to supply a written notice regarding a 2017 purchase of its shares by Sun Dream, an affiliate of Chinese internet company Sina. TuSimple didn't respond to multiple requests for comment, but its security filings show that the matter was still under review last August.

The danger of not filing is twofold. The first risk is that investigations of non-notified deals tend to last at least 90 working days, whereas a transaction filed voluntarily often gains approval after an initial review of 45 days.

The second risk is that CFIUS faces no statute of limitations on its authority to investigate deals, meaning the committee can request a notification years later—as happened to TuSimple—and impose mitigations or lean on a foreign acquirer to divest its ownership or advise the U.S. president to block the transaction altogether.

Faced with those consequences, "we may see a trend where more companies choose to submit voluntary filings with CFIUS, avoiding a chance of being caught up in the non-notified process," said Cinelli at Morgan Lewis.

Team Telecom. Experts also anticipate more activity from a lesser-known interagency panel, the Committee for the Assessment of Foreign Participation in the United States Telecommunications Services Sector, more commonly known as Team Telecom.

Chaired by the U.S. attorney general, this committee exists to help the Federal Communications Commission (FCC) assess national security risks posed by foreign involvement in telecom infrastructure ranging from landlines to submarine cables.

Like CFIUS, Team Telecom screens investments, mergers and acquisitions. But the scope of its reviews is limited to the issuance of licenses, which only the FCC can grant or revoke.

That said, more than 100 FCC licensees have signed mitigation agreements with Team Telecom in recent years, according to a report by law firm Skadden, Arps, Slate, Meagher & Flom. The panel has made headlines by advising the FCC to reject a license application from China Mobile and to revoke authorizations that had allowed China Telecom to provide services to and from the U.S.

Team Telecom is expected to become more proactive this year, experts said, following an executive order in 2020 that clarified its role and introduced deadlines for reviews that once faced no time limits. The order also authorized the panel to probe not only new license applications but also "existing licenses," to determine whether they present "new risks to national security" that previously went unidentified.

"Team Telecom is expected to play a greater role in the coming years," said Harry Broadman, a former CFIUS official. "The recent reforms have formalized review processes and made the panel more efficient."

One sign of the more proactive stance came in August, when the committee weighed in on a plan by Zoom Video Communications (ZM) to acquire customer-service software provider Five9 (FIVN) in an all-stock deal valued at $14.7 billion. In a letter filed with the FCC, Team Telecom said it needed to review a license application arising from the deal to see if it posed "a risk to the national security or law enforcement interests."

The deal fell apart a month later after failing to gain enough support from Five9 shareholders, prompting Team Telecom to abandon its review. But the investigation underscored national security concerns about Zoom, whose engineers have historically been based in China and whose chief executive, Eric Yuan, was born there and later became a U.S. citizen.

Bipartisan support. CFIUS and the Telecom Team are expected to meet with little or no political resistance as they expand their reach to more deals involving Chinese investors. Though America's red-blue rift remains deep, Congress has repeatedly given bipartisan backing to laws and sanctions aimed at curbing China's military ambitions, human-rights abuses and pursuit of Western technology.

The political resolve to hold China's authoritarian government in check was on display in a round of official decisions as 2021 drew to a close last month. The Treasury sanctioned eight Chinese high tech companies involved in the biometric surveillance and tracking of the Muslim Uyghur minority in Xinjiang. Commerce, for its part, targeted a score of Chinese electronics and tech companies involved in "activities contrary to the national security or foreign policy interests" of the U.S.

An American accounting board meanwhile filed a report that could lead to the delisting of many Chinese companies now traded on U.S. stock exchanges. And Biden signed a $768 billion defense spending bill that would require any company holding a U.S. defense contract exceeding $5 million to report if any work on the contract is being performed from China.

"The Biden administration is keen on staying the course with China," said Broadman, the former committee official who now chairs the CFIUS practice at Berkeley Research Group. "Biden is as hawkish on China [as Donald Trump was], but much more deliberative."

Minefield for investors. Like the strengthening of CFIUS and Team Telecom, the year-end moves carry far-reaching consequences for U.S. companies and investors. They serve as a warning about the political and legal risks associated with China, experts said.

The eight Chinese companies sanctioned for their involvement in Xinjiang surveillance, for example, have landed on a list of entities linked to the Chinese Military-Industrial Complex, according to the Treasury's Office of Foreign Asset Control (OFAC). The listing means U.S. citizens are now forbidden to buy or sell publicly traded securities or derivatives of the sanctioned entities. Violating the ban can result in fines and potential imprisonment.

The immediate impact of the prohibition may be limited because only half of the eight—Dawning Information Industry (SSE: 603019), Leon Technology (SHE: 300603), Netposa Technologies (SHE: 300367) and Xiamen Meiya Pico Information (SHE: 300188)—now publicly trade. But the other four would be affected if they were to raise money from U.S. investors. And all eight companies were already targeted, the Treasury said, on a separate government list of companies hemmed in by U.S. export controls.

On December 16, the Bureau of Industry and Security (BIS) at Commerce added 37 Chinese organizations to that Entity List, which singles out entities deemed to pose a risk to U.S. national security or foreign-policy interests. The move bars exports of American products and technology to these institutions without a special license.

Headlines about the development focused on China's Academy of Military Medical Sciences and 11 affiliated research institutes that were blacklisted for using biotechnology to help the Chinese military develop unspecified "brain-control" weapons. Less was said about the score of Chinese electronics and tech companies added to list—and still less about how that might affect the sales and stock prices of U.S. companies.

After the BIS put Huawei Technologies on the Entity List, shares in U.S. chipmakers including Qualcomm (QCOM) plunged. Korea's Magnachip wound up taking a $1.5 million charge in 2020 for "excess and obsolete inventory" related to the restrictions.

More to come. The U.S. shows no signs of letting up the pressure. According to media reports, the Biden administration is looking to block China's largest chipmaker, Semiconductor Manufacturing International (HK: 981), from buying U.S. tools to make chips.

SMIC has been on the BIS Entity List since 2020, but only for items "uniquely required" for making advanced semiconductors. Potential amendments to the rule in the works would apply to a much larger range of semiconductor products exported to SMIC.

The Biden administration and Congress are meanwhile grappling with ways to protect American investors from Chinese companies with dubious auditing practices. Those moves could accelerate a three-year deadline for delisting many Chinese companies now traded on U.S. exchanges.

Last month, an American accounting board that works closely with the Securities and Exchange Commission reported that Chinese authorities had prevented it from fully inspecting and auditing the accounts of companies headquartered in mainland China and Hong Kong.

The finding from the Public Company Accounting Oversight Board (PCAOB) started a clock ticking on a U.S. law that empowers the SEC to delist overseas companies lacking fully approved audits for three years. But the conclusion might also boost support for new legislation that would shorten the deadline to two years, experts said.

"The conclusions from PCAOB report raise a number of questions that could substantively encourage Congress to move forward with legislation to delist Chinese public entities sooner than expected," said Cinelli at Morgan Lewis.

Investors will need to be increasingly nimble in 2022, experts said, as they pick through this deepening thicket of export controls, sanctions, listing requirements and national security probes of mergers and acquisitions.