

AN ALERT FROM THE BDO TECHNOLOGY PRACTICE

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REGULATORS TIGHTEN GRIP ON CROSS-BORDER TECHNOLOGY DEALS

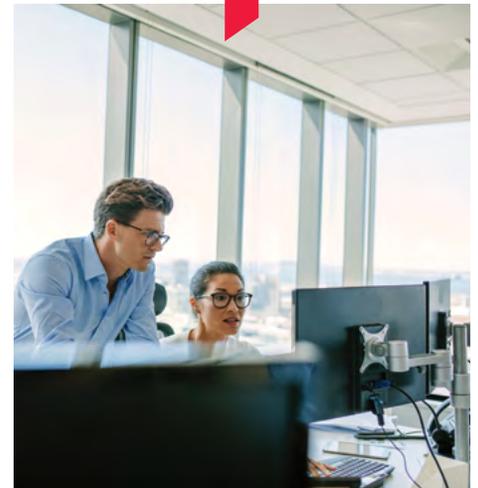
By Aftab Jamil and Mike Barba

Regulatory pressures are rising around cross-border deals in the technology sector, with trade disputes between the U.S. and China adding fuel to the fire.

The Committee on Foreign Investment in the United States (CFIUS), an interagency task force that reviews deals for potential national security threats, is continuing to strongly review transactions involving Chinese investors—particularly those in the tech sector. CFIUS filings have steadily increased over the last eight years, with companies in the aerospace and defense, manufacturing, critical technologies, and natural resources industries filing the most notices. While official numbers for 2017 aren't yet available, estimates show CFIUS reviews exceeding 250 transactions in 2017, up from 147 in 2014.

China is the U.S. tech industry's biggest foreign investor—[spending](#) a record \$18.2 billion across 679 deals involving U.S. tech startups from 2011 to Q3 2016. This investment more than quadrupled between 2012 and 2015. While the deal pipeline remains robust, the number of deals involving Chinese-headquartered investors acquiring U.S. tech companies [slowed](#) over the last two years—from 188 at its peak in 2015 to 165 in 2017. In part, this reflects the Chinese government's regulations on outbound investments, as well as recommendations by the CFIUS to reject several proposed large technology acquisitions by Chinese companies.

One of the latest recommendations to block a deal came in March 2018, when President Trump followed [CFIUS' recommendation](#) to block Broadcom Ltd.'s \$117 billion bid for U.S.-based Qualcomm Inc. While Broadcom was a Singapore-based company at the time (it redomiciled to the U.S. in early April), CFIUS feared that it would stymie research and development at Qualcomm—ultimately weakening the U.S. in its race to develop 5G wireless technology before Chinese companies, including China's Huawei Technologies Co. Another key concern CFIUS had about the Qualcomm bid was Broadcom's "relationships with third-party foreign entities," which may have included the company's many China-based investors. Sensitivities around national security will likely remain high as the global tech race continues.



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CHINA CONCERNS ESCALATE

Unsurprisingly, China's overall tech spending has prompted significant [concern](#) from U.S. lawmakers, including the U.S.-China Economic and Security Review Commission (USCC) and the President's Council of Advisors on Science and Technology (PCAST). In November 2016, the USCC issued a [report](#) recommending Congress to "amend the statute authorizing CFIUS to bar Chinese state-owned enterprises from acquiring or otherwise gaining effective control of U.S. companies." Expressing a similar sentiment, PCAST issued a [report](#) in January 2017 that advocated using CFIUS and export control laws to ensure that the U.S. semiconductor industry stays competitive. The report supported mitigating the risks posed by "a new and aggressive set of Chinese industrial policies designed to shift the competitive dynamics in the global industry in favor of Chinese production and companies."

The U.S., the report notes, is currently a leader in the semiconductor industry with a major share of the global market for integrated circuits design and fabrication. However, this position has been recently threatened by China's 2014 "IC Promotion Guidelines," a plan for the nation to become "advanced world-level in all-major segments of the industry by 2030." The plan involves allocating \$150 billion in funds over a 10-year period aimed at subsidizing investment and acquisitions and purchasing technology. This is slightly smaller than the annual average of the \$23 billion spent on semiconductor M&A by all U.S. companies from 2012-2017 but signifies a significant attempt by the Chinese government to match U.S. progress.

At the same time, U.S. startups have a compelling reason to enter deals with Chinese buyers: to raise the capital they need quickly. According to Max Versace, the chief executive of the artificial intelligence company, Neurala, in *The New York Times*, Chinese investors are often [willing](#) to make riskier deals more quickly—providing the launching pad smaller companies need to get off the ground. Cozying up to Chinese investors also means gaining a competitive entry point into the Chinese market and having the opportunity to develop local partnerships that may be otherwise difficult to establish.

CFIUS REVIEW PROCESS UNDER SCRUTINY

The laws governing CFIUS have not been updated in more than a decade. Now, momentum is building to modernize the laws to more effectively mitigate national security risks.

Where are we now?

While CFIUS review is not mandatory, many companies involved in cross-border deals will voluntarily notify CFIUS and initiate

a review to gain the benefits of a "safe harbor" provision. This provision prevents future government challenges to the transaction, including unwinding it or requiring mitigating actions, should it be cleared successfully.

Recent legislative movement

On Nov. 8, 2017, Senator John Cornyn of Texas introduced the bipartisan [Foreign Investment Risk Review Modernization Act](#) (FIRRMA) to update the review process for foreign investment in the U.S. The legislation would give the government more power to more heavily scrutinize technology transfers, the sharing of intellectual property (IP) with foreign individuals, and the ability to review proposed land sales near sensitive military and intelligence installations in the U.S. It would also widen the government's ability to review any foreign investment involving any level of equity control (including joint ventures) versus only those that give the foreign party majority control. Finally, FIRRMA would extend the formal CFIUS review process from 90 to 135 days. The bill is supported by the White House, Pentagon, Treasury and Commerce, and other intelligence community leaders.

While many agree the process is overdue for an update, the expanded government review could have broad implications not only for overseas investment in the U.S., but on U.S. companies seeking international opportunities. Nevertheless, it may still be too soon to spell out the exact benefits or consequences, as FIRRMA is still undergoing review in Congress. Much is left to be seen.

SPOTLIGHT SHINES ON EXPORT CONTROLS

Outdated export controls are also due for a refresh. On Feb. 15, 2018, House Foreign Affairs Committee Chairman Ed Royce of California introduced the bipartisan [Export Control Reform Act of 2018](#), which would replace the lapsed Cold War-era Export Administration Act of 1979 (EAA) that expired in 2001. The bill requires the President to establish controls over the export of certain "dual use" and military items that could negatively impact U.S. foreign policy and national security. "Dual use" is defined as items that have both civilian and military, terrorism, or weapons of mass destruction-related applications.

Representative Royce [noted](#) that the Chinese government has "increasingly forced U.S. companies to hand over sensitive technology as a cost of doing business in China," and stressed the need to modernize regulatory controls to ensure these technologies aren't used against the U.S.

The bill establishes an interagency review process and expands Congressional oversight of export controls. During a House Committee on Foreign Affairs hearing on March 14, 2018,

committee members expressed concern about the attempts of nations, such as China and Russia, to acquire dual-use technologies from the U.S. However, the provisions also raise concerns for U.S. companies developing new technologies, or that are owned or controlled by foreign entities, about potential over-reach.

BDO'S OUTLOOK

As legislative developments unfold, it's clear that change is coming soon.

CFIUS will likely play a larger role in cross-border M&A activity in the years ahead, with potentially more stringent reviews and/or an increased use of mitigation measures. The practical guidance for identifying factors that constitute a national security risk may also be broadened to include economic security, a net U.S.-benefit test.

Deals proposed by geopolitical rivals will be more heavily scrutinized than those from "friendlier" nations. These shifting relationships may also affect if and how the U.S. chooses to

participate in parallel national security reviews with other countries. Reciprocal market access—meaning, whether a U.S. company would be eligible to undertake a comparable investment in the same sector in the origin country—may also become a greater consideration factor in government reviews.

As the government more closely examines the type of technologies that cross the border, companies must be tuned into the potential applications of their technologies by foreign investors or acquirers. Companies should use extra diligence to identify how a potential M&A transaction could impact the reliability, availability, and integrity of their resources, transmissions, and underlying protected information.



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