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Committee on Financial Services

Hearing on CFIUS and the Role of Foreign Direct Investment in the United States
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Prepared Statement of
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Thank you for your invitation to testify this morning. I am a Professor of Law at Georgetown University Law Center and a non-resident senior fellow at the Center for American Progress. I held several economic policy positions in the Clinton Administration, ultimately as Assistant to the President for International Economic Policy. I testify today in my individual capacity as an academic, with no client interests or representation.

This hearing takes place, of course, against the backdrop of the recent controversy over the proposed acquisition by Dubai Ports World of the British-owned Peninsula and Oriental Steam Navigation Company, including its wholly-owned U.S. subsidiary, which operates two dozen terminals at various U.S. ports. In the wake of this episode and certain other recent proposed acquisitions of U.S. companies by foreign purchasers, it has become clear that there is a widespread lack of confidence within the Congress in the Administration's discharge of its responsibilities under Section 721 of the Defense Production Act of 1950, as amended, popularly known as the Exon-Florio Amendment. The central question before us is what the Congress should do as a result of its dissatisfaction, given the co-existence of important national security and economic impacts from administration of this law.

In the balance of my testimony, I will first describe the background of Section 721 and identify with more specificity the key developments that provide the context within which this

important policy question arises. Then I will suggest the principles that ought to inform our approach to national security screening of foreign investment in the United States. Finally, I will turn to an assessment of the basic tools for change that are available to the Congress and the areas in which change would be helpful.

The Context Created by Recent Exon-Florio Developments

The statutory design of the national security investment review process is an unusual one. Section 721 was added to the Defense Production Act by the Omnibus Trade and Competitiveness Act of 1988. By its own terms, Section 721 is meant to complement other laws designed to protect the national security. It establishes a system of voluntary notification by foreign investors of their intentions to make acquisitions in the United States that could raise national security concerns, along with a broad grant of authority to the President to suspend or prohibit acquisitions that would threaten the national security. The incentive of investors to notify is that, once the statutory time limits have passed, the acquisition is protected from action by the President under Section 721. The statute is generally understood to create continuing authority in the President to order divestment of transactions that have not passed through the review process, as elaborated in Treasury Department regulations.

Section 721 itself does not prescribe an administrative mechanism for conducting reviews and investigations, other than to permit reviews by the "President's designee." Shortly after passage of the 1988 legislation, President Reagan delegated his review and investigatory responsibilities to the Committee on Foreign Investment in the United States (CFIUS), a Treasury-chaired interagency group that had been established thirteen years earlier. Over the

years, the membership of CFIUS has grown to include five other Cabinet departments and numerous White House offices.

There are three developments of particular importance for understanding the policy question confronting us today.

First is the emergence since September 2001 of homeland security issues as an element of Section 721 reviews. To be sure, the breadth of the "national security" concerns in the Exon-Florio Amendment has been debatable – and debated – since before its passage. Disagreement has centered mainly on the degree to which reviews should extend beyond directly defense-related production and technologies to include those that are currently of economic, but not strategic, importance. Although the post-September 11 concern with homeland security, and specifically with critical infrastructure, can be fit into the broad language of Section 721, this concern was simply not present during the debates of the mid-1980s that produced the Exon-Florio Amendment. Thus, as with so many areas of public policy, the national security foreign investment review process has had to adapt to this new emphasis.

The addition of a new set of national security concerns highlights the *second* development creating the context for today's discussion. CFIUS practice has never been especially transparent compared to most forms of economic regulation. This is justified in part by the business sensitivity that often surrounds tender offers and other acquisitions, and in part by the relevance of classified military or defense information to CFIUS reviews. Only when CFIUS moves from a "review" to a statutory "investigation" is a reporting requirement triggered. Since there have been fewer than ten "investigations" in the last decade, the disposition of the vast majority of the roughly 600 transactions notified to CFIUS during this period has not been reported or explained by the President or CFIUS.

The result is a fairly opaque process that is very difficult for potential investors, the American public, and perhaps even the Congress to penetrate. Much of the publicly available information about CFIUS practice comes from the various reports issued by GAO in response to Congressional inquiries over the years. Of necessity, these reports are selective and sometimes dip back quite a ways into the past. At present, then, there is little systematic, publicly available knowledge as to how CFIUS has evaluated more recent transactions. Given the ongoing concerns of Congress and the public with the adequacy of homeland security measures taken in the last four and a half years, the absence of information on the CFIUS process could be worrisome.

This leads us to the *third* and, I think, most important development framing the terms of current debate over the CFIUS process – the development that has led to your hearings in March and today: Congress has obviously lost confidence in the Administration's handling of Section 721 cases. While the proposed DP World acquisition was the catalyst that elevated the issue to prominence throughout the Congress, concerns had existed beforehand, with respect to both "traditional" Exon-Florio cases and the more recent brand of homeland security cases. In 2004, Senators Shelby, Sarbanes, and Bayh requested a GAO investigation of the effectiveness of the entire Section 721 process. Last October the Senate Banking Committee held two hearings on the results of that investigation.

Although several Administration officials have, in the wake of the controversy over DP World, offered some more detail on the process followed by CFIUS in this case, the public still does not have a complete explanation of the Administration's decision not to take action. Thus it is difficult to determine how much of the problem was poor analysis, how much poor judgment, and how much poor communication. Clearly many members of Congress are

disturbed with the process, the outcome, or both. For many, this case has crystallized concerns with the CFIUS process that were already growing.

Here, then, is the crux of the challenge facing this Committee and the Congress as a whole: You have reason to believe that the process is not functioning as contemplated in the legislation passed by the 100th Congress in 1988, and as you in the 109th Congress would like. But, at least based on present information, it is hard to say with confidence why. As is often true in such situations, imposing a solution before the nature of the problem is fully understood may produce some unintended and unwanted consequences.

Principles for Effective National Security Review of Foreign Investments

There is widespread agreement, verging on consensus, that two important interests are implicated by Section 721. One, of course, is protection of the national security. The other is the nation's economic interest in receiving foreign direct investment.

The national security interest protected by Section 721, while in a sense obvious, is narrower than it is sometimes characterized. The specific interest is in foreclosing foreign acquisitions of U.S. firms where the very fact of foreign ownership is correlated with an increased risk of harm to the national security through such things as the leakage of critical defense technologies. Where this is the case, it is incumbent on CFIUS to seek special assurances or arrangements that will eliminate this particular risk to the national security or, where this is not possible, to indicate an intention to recommend action by the President to prevent the acquisition.

On the other hand, many national security risks, such as those arising from the presence of a rogue employee in a sensitive position, can exist in domestically-owned firms as well. If,

taking into account various protections required by other laws and regulations, the residual risk is roughly comparable in a given firm whether it is owned by a specific foreign entity or by a domestic entity, then the fact of foreign ownership is unlikely to be a critical variable in devising an appropriate national security response.

Inward direct foreign investment (FDI) has a number of potential economic benefits for the country.[*] The very ability of foreign entities to bid for U.S. companies increases potential demand and thus, to a greater or lesser extent, the price to be obtained by current owners for those companies. If, as is often the case, U.S. nationals are the current owners, they will thereby realize a greater return on their investment and have more capital available to redirect to other uses. Once the acquisition is made, the new foreign owner may introduce new technologies or production methods that enhance the efficiency of the productive resource. The new owner may invigorate competition in the U.S. industry, leading to lower prices, additional innovation, or both. To the degree that the new foreign owner has correctly anticipated that it can operate the acquired firm more profitably than its previous owner, the jobs at that firm may be more secure and the tax revenues paid by that firm may be higher.

The fact that inward FDI is generally a plus for the U.S. economy does not mean that every foreign acquisition of a U.S. firm is an economic success or, indeed, that every such acquisition is desirable. For example, an acquisition of a U.S. firm by a foreign firm that currently competes in the U.S. market might reduce competition enough to raise antitrust concerns. Similarly, at the heart of Section 721 is the recognition that the foreign acquisition of a U.S. firm could in some instances compromise national security. The point, then, is not that all inward FDI is good. The point, rather, is that inward FDI is in general good for the U. S.

[*] One important form of FDI – so-called "greenfield" investment, meaning the creation of new productive facilities – is not affected by Section 721, which applies only to acquisitions of, or mergers with, existing firms. In industrialized economies, there is considerably less greenfield FDI than acquisition of existing companies.

economy and thus, in the absence of strong countervailing considerations, we should avoid regulatory or political action that could discourage that form of investment.

With this understanding of the aim of Section 721, and of the economic costs that can be incurred when investment is restricted or discouraged, we can identify several principles to guide implementation of the law.

First, the resources of the CFIUS member agencies involved in the investment review process must be deployed so as to maximize the benefits for U.S. national security resulting from actions of the Committee and, where necessary, the President. This principle means, most importantly, that resources should be concentrated on proposed acquisitions that raise the most serious risks. Self-evident as this principle may seem, some proposals for change in the CFIUS process that have been discussed in recent months nonetheless seem not to pay it proper heed. For example, forcing the Committee members to review at length transactions that are unlikely to pose serious risks takes away time they could be spending on activities more likely to enhance national security:

- reviewing thoroughly the more serious cases;
- monitoring assurance agreements previously reached with foreign acquirers;
- tracking transactions that have been notified and then withdrawn to be sure they have not been completed;
- surveying other sources of information to discover transactions with national security implications that have not been notified to CFIUS; and
- conducting non-case-specific studies of categories of risk in certain kinds of industries to improve subsequent review of individual notified transactions.

Note that this principle will, if skillfully implemented, at once increase national security benefits and minimize impediments to foreign investment. That is, by focusing on the more serious risks, the CFIUS process will not hinder those transactions where foreign ownership does not, in and of itself, pose an additional significant risk. This fact may not be immediately obvious, because we sometimes think of the national security and economic goals as at odds with one another. In principle there may indeed be a trade-off. But once the basic statutory standard is set and the real-world constraints of limited resources taken into account, the most effective use of those resources to enhance national security should be generally congruent with the aim of avoiding costly disruptions of inward investment flows.

A *second* principle to guide implementation of Section 721 is that CFIUS must communicate its policies and practices effectively. This principle seems at first glance both counter-factual and counter-intuitive. Counter-factual because, since passage of the Exon-Florio Amendment eighteen years ago, CFIUS has not communicated very much to the public. So far as I am aware, there had not been much communication with Congress over the last several years, until quite recently. The principle seems counter-intuitive because of the pervasiveness of sensitive national security and business proprietary information in the CFIUS process.

Yet the costs of non-communication are apparent. Most obviously, the failure to communicate with Congress has contributed to the circumstance of mistrust that gives rise to calls for changes in Section 721. Congress cannot very well perform its oversight function if it is not adequately informed as to CFIUS practice. So too, particularly in light of the current emphasis upon homeland security, the American public deserves to know what approach to national security reviews CFIUS has taken. As the DP World situation made abundantly clear,

in the current environment if the Administration does not adequately explain its actions, Congress, the press, and the public will draw their own conclusions – without the benefit of full information.

For obvious reasons, CFIUS cannot and should not make full and immediate disclosure of all its activities. The need to preserve the integrity of the decision-making process in pending cases is particularly acute. But it is now apparent that CFIUS must change its current presumption of secrecy about its practice in completed transactions, which has been overcome only when a Congressional committee holds hearings in the wake of a controversy or on the rare occasion when the President acts on the basis of a CFIUS recommendation following an investigation. If the Government Accountability Office can summarize CFIUS practice and past CFIUS cases without violating confidentiality concerns, as it has in its various reports over the years, then CFIUS itself should be able to produce similar reports on a periodic basis.

Such a pattern of communication can also contribute to removing some of the uncertainty among potential foreign investors as to the kinds of acquisitions that may evoke CFIUS concerns. As a result, potential investors may have a better sense of such matters as whether a CFIUS filing is advisable or whether a deal needs to be restructured to meet particular kinds of national security concerns. To the degree potential acquirers have this information before they enter the CFIUS process, they can reduce the costs and delays that might otherwise affect their bid and thereby minimize impediments to investment flows.

Optimally, the CFIUS process would be both supple and rigorous. It would concentrate its resources on the situations and cases raising the most serious potential national security concerns. It would adapt to the specifics of each case in an appropriate way. It would take full advantage of all sources of information within the government, including from our intelligence

services, which could help identify unnotified transactions or potential problems in notified transactions. It would, when necessary, negotiate exacting safeguards with acquiring companies and monitor faithfully the implementation of those safeguards.

This kind of CFIUS process would require substantial discretion to be lodged in CFIUS and its member agencies. It would depend upon senior Departmental and White House officials providing guidance and exercising oversight, to assure accountability and the exercise of judgment.

Obviously the many members of Congress who have proposed changes to Section 721 believe we are a considerable distance from an optimal CFIUS process. Many – including, I suspect, some members of this Committee – are skeptical that the requisite accountability and oversight have been exercised within the Administration. Many are, accordingly, reluctant to permit CFIUS and the Administration the requisite discretion needed to arrive at an effective, reliable screening process. The remaining question is how to resolve this tension.

Congressional Methods for Enhancing Accountability

If one surveys the range of proposals for change in Section 721, a striking fact becomes evident. Nearly all the proposed changes could be effected without legislation. Some of the proposals are good ideas, some reflect good concepts but are in need of refinement, and some are not-so-good ideas. But almost all of them could be put into place very quickly if the Administration chose to do so. No additional statutory authority is necessary. A notable exception is any proposal to increase the time limits within which CFIUS must act on a review or investigation.

The lack of knowledge about what CFIUS *has* been doing makes any proposal for a program of specific changes a bit imperfect. Still, based on information gleaned from recent hearings, stories in the press, accounts from practitioners who have represented notifying investors, and GAO reports, I have identified five areas in which I would hope to see changes or, alternatively, assurances that CFIUS practice has already been conformed to the norms set forth here:

1. *Procedure for tracking the underlying transactions in withdrawn notifications.* Transactions where notification is withdrawn are likely to be of two sorts -- either the proposed acquisition has been abandoned for reasons unrelated to the CFIUS review process (such as financing or antitrust problems), or issues have been raised in the CFIUS review process that require additional analysis or modification of the transaction. In some cases the required modification may be so significant as effectively to require abandonment. It appears that withdrawals in some cases are made with the agreement and cooperation of CFIUS, to allow time for further analysis before the statutory time limits run or so that changes can be made in the transaction. If the transaction is not abandoned, it is then refiled before it is completed. This is a reasonable procedure. But GAO reports that at least some such transactions have closed without a subsequent cleared notification. This is a matter of potential great concern. While there are different ways to track withdrawals and determine if transactions have subsequently proceeded without clearance, it is important that some effective procedure be institutionalized.

2. *Monitoring assurance agreements in completed transactions.* In some cases that have raised national security concerns, CFIUS has negotiated agreements with the acquiring company that include such commitments as hiring specific security personnel, permitting

inspections of facilities, or instituting certain practices to provide an additional level of security protection. It goes without saying that, where these agreements have been negotiated, they should be scrupulously implemented. Where the agreement requires the acquiring company affirmatively to undertake action of some sort, compliance with that agreement should be monitored by CFIUS or a designated government agency that reports back to CFIUS.

3. *Systematize information-gathering on unreported transactions.* Because Section 721 is a voluntary reporting mechanism, it is possible for a foreign purchaser to acquire a U.S. company with sensitive national security relationships without a notification to CFIUS. While most purchasers will want the assurance that their transactions have passed scrutiny and will not be investigated post-acquisition, it is possible that some will choose never to file, even where national security issues may be present. Surely it would not be an efficient use of resources for CFIUS to attempt to track *all* acquisitions in the United States, the majority of which raise no national security concerns. But, insofar as there are additional reporting and monitoring mechanisms under the Defense Production Act and other laws, it seems only sensible to establish a system for cross-checking information on acquisitions obtained through these other mechanisms.

4. *Involvement of senior officials in CFIUS policies and decision-making.* There is a widespread belief in Washington that senior Treasury and White House officials were not consulted on, or notified of, the DP World notification before the review was closed. I certainly have no first-hand knowledge as to what actually occurred. Needless to say, though, one would expect regular information flows up the chain of command in cases that might raise substantive problems or public sensitivities.

5. *Achieving appropriate transparency.* I discussed this issue at some length earlier in my testimony. I will just summarize here by saying that, while nothing should be done that would compromise the integrity of ongoing reviews or investigations, and protections must exist for sensitive national security and business proprietary information even after the fact, there needs to be a system that will produce regular explanations of CFIUS practices and procedures.

* * *

Which of these changes should be legislated? There is not necessarily a clear answer. Some of the changes I have identified – such as requiring CFIUS to establish a monitoring system for negotiated assurances – seem to me entirely appropriate for legislation. Others may be less so. For example, legislating the involvement of particular senior officials in all CFIUS cases may not be the most productive way to ensure appropriate attention from those officials.

The decision on how much to legislate obviously rests with you – not just as a Constitutional matter, but because it is your trust in the Administration that is at issue. However, I would offer two observations as you decide what matters to address in your legislation and how much detail to include.

First, some measures that are motivated by unhappiness with current Administration practice may have counterproductive effects in the longer term. In some respects, you confront an unattractive trade-off between increasing the accountability of this Administration at this moment and creating difficulties in the CFIUS process into the indefinite future. For example, legislating a required investigation for a broad class of transactions would reflect mistrust that the Administration will undertake investigations where necessary in particular cases and assure that those investigations will occur. Unfortunately, since such a requirement will almost

certainly capture a broader set of transactions than those that raise significant national security issues, it also risks tying up resources that could be better utilized elsewhere. This requirement would also make some otherwise desirable foreign investment plans more costly or uncertain, and thus less likely to be made.

Second, there is another method by which Congress could seek to assure itself of the efficiency and effectiveness of the CFIUS process, one that can complement a legislative approach. Appropriate committees within the Congress can exercise frequent and extensive oversight over the CFIUS process for such time as is necessary to allow Congress to regain confidence in the CFIUS process. The Members of this Committee know better than I the variety of means available to achieve this end – from presentations by senior officials of planned changes, to updates on how those plans have been implemented, to reports or briefings on recent CFIUS practice. A combination of informal and formal means can be chosen. Where necessary, the dialogue between Congress and the Executive may be confidential or even classified.

This approach would allow Congress to determine with more precision how much of its concern arises from poor analysis, how much from poor judgment, and how much from poor communication. It may reveal that some things are better than you suspect today; it might reveal that some are worse. It would allow CFIUS the room to adapt investigatory and reporting practices if initial efforts raise unanticipated difficulties. Hearings could be scheduled – perhaps in six months' time – to take formal stock of whether the CFIUS process, and the communication of the workings of that process, had satisfactorily evolved. If adequate confidence has not been restored, then additional legislation would remain an option, and the

intervening period will have made the legislation better informed by knowledge of the CFIUS process.

Thank you for your attention. I would be happy to answer any questions you might have for me.