EXECUTIVE SUMMARY

In the wake of the Dubai Ports World controversy, the process for securing approvals within CFIUS (the interagency Committee for Foreign Investment in the United States) has grown more difficult for foreign investors, adding to uncertainty and increasing the regulatory risk associated with certain foreign acquisitions. Such uncertainty could inhibit investment in the United States. Reviews are taking longer, costs for companies have increased and CFIUS-imposed conditions are tougher.

The more politicized environment surrounding CFIUS has created uncertainty for companies as to whether they should file a transaction with CFIUS. If a company does not file, then it risks CFIUS initiating its own review or opening a review after a deal has been finalized. Given CFIUS’s limited resources, a climate that encourages companies to file with CFIUS for transactions with only a limited nexus to national security actually impedes CFIUS’s ability to protect national security by compelling CFIUS staff to focus on acquisitions with few genuine security concerns rather than cases that may require greater due diligence. While CFIUS’s primary responsibility is to protect national security, a process which creates greater uncertainty for investments unrelated to national security is unlikely to make America more secure. U.S. national security depends in part on the strength of the U.S. economy, access to leading technologies and our relations with other countries. Therefore, Congress and the executive branch need to find the right balance to meet the twin objectives of protecting national security and promoting investment in the United States.

Limiting the pool of potential investors or buyers effectively lowers the value of U.S.-held assets in many sectors, harming business owners, their workers, shareholders and Americans with money invested in stocks, mutual funds, 401(k)s and pension funds. The pendulum has swung too far and unless it shifts back toward the center, much-needed investment could be chilled and U.S. jobs and economic growth will be lost.¹

To restore confidence and certainty in the process, the President should issue an executive order memorializing the significant changes CFIUS has already implemented and incorporating the positive elements of the House and Senate bills from the 109th Congress, being careful to consult with Members of Congress and also making clear America welcomes investment from abroad.

At minimum, the executive order should establish regulatory guidance on the negotiation and enforcement of mitigation agreements, a subject currently not covered in the regulations (one major exception — DOD has established clear guidance for defense acquisitions). Mitigation agreements are an important tool for CFIUS to address national security concerns but should only address the marginal increase in national risk associated with
a foreign acquisition as opposed to general security concerns that exist regardless of the ownership of a particular company. If Congress chooses to enact legislation it should use as a base and improve upon the bipartisan bill passed in the House of Representatives in 2006. The current statutory timeframes within Exon-Florio mirror the timeframes for antitrust reviews, putting foreign and domestic buyers on a level playing field. Maintaining the initial 30-day review timeframe is crucial for investors. Such legislation should also refrain from requiring CFIUS to notify Congress and governors about transactions before CFIUS completes its reviews.

This analysis identifies several trends within CFIUS, each of which contributes to greater uncertainty for foreign investors:

- **More filings, investigations, withdrawals and presidential decisions**: In 2006, there were 113 filings (up 73 percent over 2005), 7 second-stage investigations (up 250 percent) and 5 withdrawals (up 150 percent) during the second-stage investigation period. A number of other transactions were withdrawn during the initial 30-day period. The dramatic increase in filings demonstrates that foreign investors and their counsel are increasingly uncertain about the approval process for foreign acquisitions, leading them to be much more cautious in deciding whether and when to file transactions for CFIUS review. On top of that, the dramatic increase in the number of second-stage investigations and withdrawals suggests that foreign investors are having a much more difficult time closing transactions in a timely fashion. The stakes are high — the value of just one-third of the transactions that were submitted to CFIUS (those that could be calculated based on public disclosures) exceeded $95.5 billion in 2006.

- **Longer reviews**: While statutory timetables have not changed, caution within CFIUS has resulted in longer review times, causing a growing number of transactions to be withdrawn within the initial 30-day period. Seven transactions required a full investigation. Other reviews took even longer. For example, Presidential approval of the Lucent-Alcatel merger came a full seven and one-half months after the merger was announced. If the pattern of longer time periods for CFIUS reviews continues, foreign investors will either be less interested in investing in the United States or U.S. companies will simply refuse to sell to foreign investors because of the risk of lengthy closing times for deals.

- **More mitigation agreements**: CFIUS has also increased the number of “mitigation” or “national security” agreements negotiated as a condition for approval. From 2003-2005, the Department of Homeland Security (DHS) was a party to just 13 mitigation agreements, compared with 15 such agreements in 2006 alone. Foreign investors — particularly in the IT sector and other sectors considered “critical infrastructure” — now face a greater likelihood of being compelled to enter into a mitigation agreement in order to secure CFIUS approval.
• **New, unprecedented terms**: CFIUS approval has commonly been understood to provide transaction parties with a legal “safe harbor” against a future divestment order by the President. This legal certainty has been an important prerequisite for foreign investors to invest in the United States. However, in the Alcatel-Lucent case, CFIUS required the parties to agree that the CFIUS review could be reopened and divestment potentially could be ordered if the “parties materially fail to comply with any of” the terms of a negotiated security agreement.
BACKGROUND

In February 2006, a political explosion erupted over the controversial and ultimately aborted effort by Dubai Ports World, a ports operator based in the United Arab Emirates, to acquire certain U.S. port operations from a British company. This controversy became more than an “inside the beltway” event. A survey by the Pew Research Center for the People and the Press revealed at the time that a remarkable 41 percent of Americans said they closely followed the issue — just slightly less than the 43 percent of those who said they closely followed the war in Iraq.\(^2\) In 2006, 20 bills were introduced in Congress that would have restricted foreign investment. While none became law, the House and Senate both passed but did not reconcile before adjournment two very different bills on the subject.

Even without statutory changes, the process to review foreign acquisitions of U.S. companies for national security implications has changed significantly. These reviews are performed by the Committee on Foreign Investment in the United States (CFIUS), which is a twelve agency committee chaired by the Secretary of Treasury and staffed by experienced career professionals. The agencies include the Departments of Defense, Justice, Homeland Security, Commerce, State and several White House agencies, including the National Security Council. CFIUS implements the Exon-Florio Amendment, which granted the President the right to block foreign acquisitions that threaten U.S. national security.\(^3\)

In 2006, CFIUS filings increased by more than 70 percent and the number of second-stage “investigations” exceeded the previous four years combined. The stakes are high — foreign investors employ more than 5 million Americans. In 2006 alone, just the transactions CFIUS reviewed whose value could be calculated based on public disclosures by companies (approximately one-third of CFIUS-reviewed deals) were valued at more than $95 billion.\(^4\) And other countries have already shown a willingness to impose their own investment restrictions against American companies. Thus, achieving the right policy mix is of paramount importance. The dramatic increase in filings, the increase in second-stage investigations and withdrawals, as well as the greater likelihood that a mitigation agreement will be required, means that more and more foreign investment in the United States is being regulated, raising costs and uncertainty for foreign investors.

In many respects, the professional staff within CFIUS is simply responding to the criticism from Congress during the Dubai Ports World transaction. No one in CFIUS wants to have another DP World-like explosion in the media or in Congress. CFIUS also has a strong record of protecting national security. No acquisition, to my knowledge, has been approved by CFIUS and later found to undermine U.S. national security. Yet because of Congressional criticism and heightened sensitivities with respect to security, companies that make investments with only a marginal nexus to national security are finding the process difficult, costly and lengthy. The pendulum has swung too far, particularly with respect to foreign acquisitions in the IT sector.
THE RAPIDLY EVOLVING CFIUS PROCESS

CFIUS reviews foreign acquisitions of U.S. companies for national security risks upon a voluntary filing (or “notice”) by the transaction parties. The transaction parties also may — and often do — engage in informal consultations with CFIUS agencies well before a notice is filed. Under the statute, CFIUS has thirty days after a notice is filed to review a transaction. For complicated transactions, or if there are disputes between agencies, CFIUS can extend the process to a second-stage review, or “investigation,” lasting another 45 days. At the end of the second-stage investigation, CFIUS agencies provide a report to the President, who then has 15 days to decide whether to block a particular transaction. Parties to an investment also have the flexibility to withdraw and refile in order to avoid a second-stage “investigation.”

In the 18 years that Exon-Florio has been in force, there have been slightly more than 1700 CFIUS filings. Only one transaction has formally been blocked by the President — a 1990 aerospace investment by a Chinese company. From the data, one would think that CFIUS has merely been a rubber stamp, approving 99.9 percent of the acquisitions. The data belie actual practice, since tough restrictions are imposed by CFIUS as a condition for approval — typically through “mitigation” or “national security” agreements. In addition, parties typically will abandon a transaction in the face of a possible rejection rather than force the President to formally block a proposed acquisition. The public relations damage to a company if a President were to block an acquisition would be substantial.

RESTRICTIVE TRENDS WITHIN CFIUS

The CFIUS process underwent significant changes in 2006, even without new legislation. These changes included:

- **More filings, investigations, withdrawals and presidential decisions:** In 2006, there were 113 filings (up 73 percent over 2005), 7 second-stage investigations (up 250 percent) and 5 withdrawals (up 150 percent) during the second-stage investigation period (see Figures 1 and 2). A number of other transactions were withdrawn during the initial 30-day period. Some of these transactions were re-filed and other transactions never went forward. Two transactions — Dubai Holding’s acquisition of Doncasters and Alcatel’s acquisition of Lucent — were sent to the President for a decision. The data demonstrate two unassailable facts: (i) companies and their counsel are filing cases that would not have been filed the previous year; and (ii) transactions are being scrutinized like never before. All of this is evidence of CFIUS’s caution and extraordinary scrutiny in reviewing transactions post-Dubai Ports World.
• **Longer reviews**: While the statutory timetables have not changed, the more sensitive environment has resulted in longer review times for a number of transactions. Moreover, a number of transactions were withdrawn within the initial 30-day period, most likely because companies wanted to provide CFIUS with additional time to complete the review without entering the second-stage “investigation.” Another five transactions required a full investigation. Other reviews took even longer. For example, Presidential approval of the Lucent-Alcatel merger came a full seven and one-half months after the merger was announced. Pre-filing consultations and withdrawals provide CFIUS with important flexibility without expanding the statutory timelines for all transactions. At the same time, if the pattern of longer time periods for certain CFIUS reviews continues, foreign investors could be less interested in investing in the United States.
More mitigation agreements: CFIUS has also increased the number of “mitigation” or “national security agreements” negotiated as a condition for approval. For example, in 2006 DHS required more mitigation agreements than in the previous three years combined — DHS was a party, along with other agencies in certain agreements, to 15 mitigation agreements in 2006. By contrast, from 2003-2005, DHS was a party to only 13 mitigation agreements. Foreign investors now face a greater likelihood of having to enter into a mitigation agreement in order to secure CFIUS approval. This is particularly the case in the information technology sector and other sectors considered “critical infrastructure.”

New, tougher terms: CFIUS has also increasingly imposed tougher conditions on companies as a condition for approval. One of these provisions, the so-called “evergreen CFIUS” provision, which allows
CFIUS to reopen a review and potentially order divestment for non-compliance with an agreement, drew criticism when its existence became public in the Alcatel-Lucent merger. CFIUS review and approval has commonly been understood to provide transaction parties with a legal safe harbor against divestment. This legal certainty has been an important prerequisite for foreign investors to invest in the United States. In the Alcatel-Lucent case, however, CFIUS required the parties to agree that the CFIUS review could be reopened if the “parties materially fail to comply with any of” the terms of a negotiated security agreement. The U.S. business community reacted negatively to the news that the “safe harbor” had been eliminated for Alcatel and Lucent. In a December 5, 2006 letter to Treasury Secretary Paulson, four major business groups complained that:

The bedrock principle of openness [to investment], however, is challenged when the Executive imposes conditions on investments that effectively allow it to re-investigate transactions, impose new conditions, and even potentially unwind the transaction at any time....Such conditions can chill investment, make those who do invest more cautious about the types of commitments they are willing to give the government in the context of the CFIUS review, and, ultimately, harm the economy.

This “evergreen” CFIUS provision could negatively alter the incentives of foreign investors to invest and file with CFIUS.

**OTHER CHANGES TO CFIUS**

The CFIUS agencies have also taken steps to strengthen the process for national security reviews. Below are some of these additional changes to the process that bear mention:

- Higher-level reviews: One of the criticisms of CFIUS during the Dubai Ports transaction was that the issue was not handled at a sufficiently senior level. Congress complained that neither the President, the Secretaries of Treasury and Homeland Security nor other senior officials knew about CFIUS’s review. In response, most CFIUS agencies regularly brief either their Secretary or Deputy Secretary on every single transaction. CFIUS regularly meets at Deputy, Assistant or Deputy Assistant Secretary level to discuss particular cases and/or CFIUS policies and procedures.

- More reporting to Congress: CFIUS has also increased the level and frequency of reporting to Congress. The Department of Treasury and other CFIUS agencies are now promptly notifying Congressional
committees with jurisdiction over foreign investment issues upon the completion of every case before CFIUS.

- Additional Resources: A number of CFIUS agencies have significantly increased staff resources and internal coordination within agencies to ensure all relevant factors are considered in CFIUS reviews. The Department of Treasury, for example, created a new position — Deputy Assistant Secretary for Investment Security — and recruited a National Security Council (NSC) official to run the day-to-day CFIUS process. The Department of Homeland Security has significantly expanded its resources and recruited lawyers and policy experts from blue chip Washington law firms and think tanks to fill these slots. The Departments of Justice and Defense have also augmented staffing, and the Department of Justice (DOJ) has moved the CFIUS function to the newly created division at DOJ handling homeland security. The Department of Defense regularly vets transactions with more than a dozen divisions and departments in the Pentagon and regularly briefs either the Deputy Secretary or Undersecretary on particular transactions. Finally, the Director of National Intelligence (DNI), through the National Intelligence Council, has improved coordination among intelligence agencies to ensure that all relevant intelligence community agencies participate fully in the development of final intelligence assessments that are provided to CFIUS.9

- Enhanced enforcement of agreements: CFIUS agencies have also strengthened and enhanced their efforts to enforce national security agreements. These efforts include regular meetings with parties to a transaction during which the foreign investor is asked to explain and document implementation efforts provision-by-provision. CFIUS agencies have also increased the frequency of on-site audits by DOJ, the FBI or DHS.

In short, CFIUS has changed significantly over the last year. A number of these changes are positive — e.g., enhanced communications with Congress will provide those with oversight responsibility with greater visibility into the CFIUS process and hopefully greater confidence in it. The CFIUS agencies also deserve credit for devoting more resources to the CFIUS review process, being more responsive to queries from the parties and for ensuring compliance with agreements. CFIUS staff are highly professional and work extremely hard. In difficult cases, it is not unusual for officials within the CFIUS process to be working late into the night and over weekends in order to resolve issues.

On the other hand, the cautious environment within CFIUS post-Dubai Ports World has spilled over to the private sector. Transaction parties are now frequently filing cases with only a tenuous nexus to national security and withdrawals are occurring more frequently. Unless there is a change in the environment, even more transactions
will be filed without a real nexus to national security, potentially changing CFIUS from a national security review process to more of an investment review process.

The increase in filings is also problematic as it could stretch the agencies’ abilities to focus on the cases that actually might pose a threat to national security. In addition, the current environment within CFIUS often is one in which the agency that takes the hardest line position will frequently carry the day. This environment has resulted in tougher mitigation agreements.

Many of the changes discussed above are a natural reaction among the agencies to the political firestorm over Dubai Ports World. Collectively, however, the revisions to the CFIUS process over the last year have produced the undesirable result of creating uncertainty for foreign investors. Investors seek certainty that a transaction can close in a timely manner. Without certainty, investors simply won’t invest.

**IMPORTANCE OF FOREIGN INVESTMENT: WE NEED MORE, NOT LESS**

Economic literature has long established clear and convincing evidence that foreign investment in the United States supports high-wage, high-skill jobs, particularly in the manufacturing sector, and strengthens the United States’ leading position in cutting edge research and development (R&D). Majority-owned affiliates of foreign companies employed 5.2 million U.S. workers in 2004, representing close to 5 percent of total U.S. private sector employment. Importantly, the average salary for these workers was $60,000, 34 percent more than the compensation by the average American-owned firm.

Foreign investment is also critical to the vibrancy of the U.S. manufacturing sector and to R&D activity in the United States. While foreign-owned firms employ about 5 percent of all U.S. workers, almost 20 percent of all foreign investment flows to the U.S. manufacturing sector. Roughly 40 percent of U.S. jobs in foreign-owned companies are in the manufacturing sector. Finally, notwithstanding the fact that most firms tend to invest in R&D near their corporate headquarters, the data demonstrate that the United States receives a disproportionate amount of R&D spending by foreign-owned firms. Indeed, levels of expenditures in percentage terms by foreign-owned affiliates in the United States are only slightly less than R&D spending by U.S.-owned multinational companies. In some sectors, including the computer manufacturing and information technology (IT) sectors, affiliates of foreign firms spend a greater portion of overall investment on R&D than U.S. parent companies do.

The data also show that most investment comes from countries that are close allies of the United States and for which there should be little or no risk to U.S. national security. Specifically, companies based in the 25 developed democratic member countries of the OECD (Organization for Economic Cooperation and Development) own 94
percent of foreign assets in the United States, and 73 percent of all foreign investments in the United States are made by European companies.\footnote{14}

In sum, foreign-owned companies create millions of high-wage, high-skill jobs and are key to the strength of the U.S. manufacturing and research bases. If this is the case, shouldn’t the U.S. government seek to attract more, not less, foreign investment?

As Figure 4 (see Appendix) shows, jobs associated with foreign investment grew rapidly between 1985 and 2000 but have since dropped by 10 percent. While data are not yet available for 2005 and 2006, non-official data suggests that 2006 was a record year for overall merger and acquisition activity and there was strong growth of foreign acquisitions of U.S. companies in the United States, although foreign investment levels remain well below levels in 2000. Despite the apparent increase in foreign investment in 2006, one has to ask whether the overall level of foreign investment in the United States would not have been even greater in the absence of the uncertainty created by the Dubai Ports controversy. Indeed, as Figure 3 shows, merger and acquisition activity globally and between U.S. companies has grown much faster than the growth rate of foreign acquisitions of U.S. companies. Anecdotal evidence among investment bankers and CFIUS attorneys suggests that a number of significant foreign acquisitions did not go forward in 2006 due to concerns about CFIUS. These transactions did not go forward either because the foreign investor did not want to go through the CFIUS process or because of concerns that conditions imposed by CFIUS would have put them at a competitive disadvantage vis-à-vis their American competitors.

Similarly, as Figure 5 (see Appendix) shows, capital investment in the United States by U.S.-based multinationals has plummeted by 25% since 2001, while capital investment by affiliates of foreign companies has steadily inched upward. Again, while data for 2005 and 2006 have yet to be published, it is clear that maintaining an attractive climate in the United States for foreign investment is critical for overall levels of capital investment, a driver of overall economic growth.
Figure 3:
Worldwide Mergers & Acquisitions by Value

Source: Thomson Financial
WHAT NEXT FOR CFIUS?

Notwithstanding a significant amount of effort, on a bipartisan basis, toward passing CFIUS reform legislation by, among others, Senators Richard Shelby and Paul Sarbanes, and Representatives Roy Blunt, Deborah Pryce, Mike Oxley, Barney Frank, Carolyn Maloney and Joe Crowley, in 2006, Congress never reconciled the House and Senate bills amending Exon-Florio. On January 18, 2007, Representatives Maloney, Blunt, Pryce and Crowley introduced H.R. 556, which is the same bill that passed the House of Representatives in 2006. Meanwhile, the executive branch has been busy implementing its own reforms to CFIUS and has been considering whether to issue an executive order to memorialize these changes. What is the best way forward?

Senate Banking Committee Chairman Chris Dodd (D-CT) and House Financial Services Chairman Barney Frank, both of whom are strong supporters of foreign investment, have both indicated an interest in holding hearings on CFIUS and pursuing legislation to amend Exon-Florio. Regardless of whether the Congress acts, the President should issue an executive order memorializing the changes the Bush Administration has already implemented and incorporating the positive elements of the House and Senate bills from the 109th Congress. For example, an executive order could:

- Establish a process for the issuance of more detailed reports to Congress on transactions CFIUS has reviewed, as well as trends in filings, mitigation agreements, the countries from which investment is flowing and the sectors into which investment has flowed.

- Establish regulatory guidance on the negotiation and enforcement of mitigation agreements, a subject currently not covered in the regulations. In particular, the executive order should provide guidance on the roles and responsibilities of individual agencies versus CFIUS as a whole in deciding on the terms of mitigation agreements. The executive order should also clarify that the principle established in the statute for presidential action — that the President can only block a transaction if no other law or regulation other than Exon-Florio or the International Emergency Economic Powers Act enables the President to protect national security — extends to negotiation of mitigation agreements. In other words, mitigation agreements should address the marginal increase in national risk associated with a foreign acquisition as opposed to general security concerns that exist regardless of the ownership of a particular company.

- Clarify the factors to be considered in conducting national security reviews of foreign acquisitions — these factors were originally adopted in the Exon-Florio Amendment in 1988 and need to be updated.

- Articulate which cases will be reviewed by higher-level officials.
• Provide clearer guidance on the government’s view of how to protect “critical infrastructure” assets that truly are vital to U.S. national security, and how foreign ownership of critical infrastructure could create a national security risk.

• Clarify the role of the White House agencies in the CFIUS process. Unlike other national security interagency processes, which are led by the National Security Council, the NSC and other White House agencies typically take a passive role in CFIUS reviews unless a particular transaction is winding its way toward the President’s desk. But these agencies were added to CFIUS by executive order and can and should play a leadership role, particularly in resolving disagreements between other agencies.

To ensure political buy-in from Congress, the administration will need to undertake serious and extensive consultations with Congress before issuing an executive order.

New legislation would only be beneficial if it is balanced and does not chill foreign investment. The primary benefit of legislation would be the placement of Congress’s “stamp of approval” on the CFIUS process, thereby reducing Congress’s incentives to politicize the process or block a transaction after CFIUS has already completed its review, as was the case in the Dubai Ports World case. If Congress moves to pass legislation, it should be guided by the following principles:

• Timing matters most. With the exception of price, the most important factor for foreign investors or for U.S. companies selling a business is the time — and associated risk — to close a transaction. In many respects, transactions are akin to selling a house. If a seller has the choice of selling to one buyer who can close in 30 days and another who will take 60 days, a rational seller will always chose the buyer who can close first, unless the other buyer will pay a significant premium. The longer a transaction takes to close, the greater the risk and the greater the uncertainty. More uncertainty makes investors less likely to invest. The statutory timeframes within Exon-Florio mirror the timeframes for antitrust reviews, putting foreign and domestic buyers on a level playing field. CFIUS has extraordinary flexibility to extend reviews for tough cases — maintaining the initial 30-day review timeframe is crucial.

• Enhance Congressional oversight, not involvement. Legislation should find the proper balance between ensuring that Congress has sufficient confidence in the CFIUS process, while at the same time allowing CFIUS agencies to do its job without Congressional interference in particular reviews. This balance is critical in other regulatory regimes, including antitrust reviews. The House bill achieved this balance by requiring extensive reporting to Congress after CFIUS completed reviews while at the same time protecting business confidential information. It also refrained from requiring CFIUS to notify Congress and governors about transactions before CFIUS completed its review.
Interagency checks and balances are important. Unlike virtually every other regulatory process, CFIUS reviews are unique because the President’s decisions cannot be challenged in court. As a result, given the significant stakes involved, it is even more important that CFIUS get decisions right. One of the ways to improve decision making is to ensure that agencies with particular expertise have some lead responsibility while at the same time ensuring that all decisions, including with respect to mitigation agreements, are made with the concurrence and involvement of all CFIUS agencies. One model that has worked well is that within the Department of Defense, which has created a template security agreement for foreign acquisitions of U.S. companies with classified contracts. This model has increased the level of certainty for foreign investors in the defense sector because the expectations of the parties are clear. CFIUS could approve of other similar templates and give particular agencies freedom to negotiate security agreements within those parameters. Even for experienced CFIUS hands, it is often hard to anticipate what type of mitigation measures will be required for foreign investments in “critical infrastructure,” increasing the uncertainty associated with an investment.

Not all acquisitions by government-owned companies create national security risks. Both the House and the Senate bills created a mandatory requirement for second-stage investigations for acquisitions by government-owned companies. Second-stage reviews make sense for some, but not all, acquisitions by government-owned companies. Whether we like it or not, some of our closest allies still have government-owned companies. Westinghouse, for example, was until 2006 owned by the Government of the United Kingdom. Similarly, the Ontario (Canada) Teachers Pension Fund recently acquired four port operations, including two in New York and New Jersey, from Orient Overseas (International) Ltd. It is hard to see how an acquisition by a British government-owned company or a Canadian government pension fund creates any national security risk. Mandating a second-stage investigation will only force delays, thereby reducing incentives to invest. Rather, legislation should give CFIUS the flexibility to require second-stage reviews where genuine national security issues arise as a result of a foreign acquisition.

Not all investments in critical infrastructure create national security issues. One of the issues debated in the House and Senate bills in 2006 was how CFIUS should treat foreign investments in “critical infrastructure.” One of the challenges that Congress and the executive branch face is how to define critical infrastructure. The Patriot Act and Homeland Security Act define critical infrastructure narrowly: “[S]ystems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.” By contrast, the Department of Homeland Security defined critical infrastructure very broadly, covering roughly 25 percent of the U.S. economy. (See Figure 6 in Appendix). In addition to the definition, the Senate and House
bills differed in their approach. The original language of the main Senate bill required a mandatory investigation into all foreign investments in critical infrastructure. The House bill required CFIUS to consider as a “factor” foreign investments in critical infrastructure. The approach taken by the House is the better approach because not all investments in critical infrastructure create threats. It is hard to see, for example, how a foreign acquisition of a highway or toll road threatens national security.

CONCLUSION

CFIUS’s role in the U.S. economy continues to grow. Last year alone the committee reviewed more than $95 billion in transactions, a figure likely to grow. When Congress passed the Exon-Florio Amendment in 1988, it stated that “national security” should be interpreted broadly. And the statute has given CFIUS extraordinary authority to expand the scope of issues considered in CFIUS reviews. *At the same time, Exon-Florio was not established to be a generalized investment screening mechanism.*

While a chief function of the U.S. government is protecting national security, chilling foreign investment with little nexus to national security is unlikely to make America more secure. After all, U.S. national security depends on the strength of the U.S. economy and on our relations with other countries. DOD and other security agencies also rely on a diverse pool of contractors to maintain buying power and access to cutting edge technologies. Therefore, Congress and the executive branch need to find the right balance to meet the twin objectives of protecting national security and promoting investment in the United States.

Few disagree that in the wake of the Dubai Ports World controversy trends within CFIUS have become much tougher for foreign investors seeking approval of acquisitions. Reviews take longer, company costs have increased, CFIUS-imposed conditions are tougher, and more deals are being withdrawn than ever before. All of these trends have created more uncertainty for investors, raising the bar for an investment to be economically attractive. The pendulum has swung too far and unless it shifts back toward the center, much-needed investment could be chilled and flow to other countries, and U.S. jobs and economic growth will be lost.
APPENDIX

A BRIEF HISTORY OF EXON-FLORIO AND THE CFIUS PROCESS

The 18 years of Exon-Florio can be divided into four distinct periods:

- The Formative Years: During the first three full years of Exon-Florio (1989-1991), the CFIUS process was marked by significant uncertainty as the CFIUS agencies developed processes and procedures and as lawyers figured out which transactions needed to be filed. Indeed, the initial Exon-Florio regulations that provided guidance to companies and their counsel on the implementation of the law was not issued until November 1991, a full three years after Exon-Florio became law. During this time, Exon-Florio also lapsed for a period of ten months before it was made permanent in 1991. Given the legal and regulatory uncertainty during this period, companies filed a variety of transactions with no relationship to national security, including real estate and retail acquisitions. As a result, there were large numbers of filings — 204 and 295 in 1989 and 1990, respectively, and a relatively large number of investigations — five and six in 1989 and 1990, respectively.

- The Quiet Years: After the initial burst of activity, caused in large part by uncertainty in the law and regulations, CFIUS entered a relatively quiet period from 1992 - 2001. Fewer transactions were filed (ranging between a low of 55 and a high of 82 annually), despite high levels of foreign investment, particularly between 1996 and 2000, the latter of which was the record year for foreign direct investment ($330 billion). Between 1992, the last year of the George H.W. Bush Administration, and 2001, the first year of the George W. Bush Administration, there were only six second-stage investigations, five withdrawals and two Presidential decisions. With the exception of a few telecommunications acquisitions after the United States opened its telecommunications market in 1996, there were few, if any, controversial CFIUS reviews.

- The Post-September 11 period: After the terrorist attacks on the United States in September 2001, and the creation of the Department of Homeland Security (which was added to CFIUS in February 2003), the scope of CFIUS reviews increased dramatically. In particular, CFIUS’s scrutiny of investments in “critical infrastructure” intensified. Despite much lower levels of foreign direct investment and fewer filings, the number of CFIUS cases that required second-stage investigations increased. Between January 2003 (DHS joined CFIUS in February of that year) and December 2005, there were six investigations and five withdrawals, more than during the previous decade in total. This period was also marked by much tougher security agreements, particularly in the telecommunications and IT sectors.

- The Post-DPW period: After the Dubai Ports World transaction exploded in Congress and the public in February 2006 (although the Wall Street Journal first reported the transaction on October 31, 2005, and CFIUS approval occurred in early January), Members of Congress introduced more than 20 bills curtailing foreign investment and the House and the Senate passed distinct bills reforming the CFIUS process.
**Figure 4**

U.S. Employment by U.S. Subsidiaries of Foreign Companies

Sources: BEA, BLS.
**FIGURE 5**

**CAPITAL INVESTMENT BY U.S. MULTINATIONALS AND FOREIGN COMPANIES IN THE UNITED STATES**

![Capital Investment Graph](image)

*Source: BEA*
FIGURE 6

BROAD PORTION OF U.S. ECONOMY NOW DEEMED “CRITICAL INFRASTRUCTURE”

- Agriculture/Food
- Water
- Public Health
- Emergency Services
- Defense Industry
- Telecommunications

- Energy
- Transportation
- Banking and Finance
- Chemicals
- Postal/Shipping
- Information Technology

Source: National Strategy for the Physical Protection of Critical Infrastructure and Key Assets, March 2003; HSPD-7
END NOTES

1 Stuart Anderson of the National Foundation for American Policy, and Al Larson, David Fagan, Damara Griffith and Dakota Rudesill of Covington & Burling provided helpful comments and criticisms of drafts of this paper. Thanks also to Dr. Matthew Slaughter of the Council of Economic Advisors at the White House for the data in the charts on U.S. employment by foreign companies and capital investment by U.S. and foreign companies.


3 CFIUS was established by executive order in 1975 to monitor inward investment in the United States. It was not until 1988, however, amid concerns about the impact of exploding levels of investment from Japan, that Congress and the President gave CFIUS real teeth. In that year, Congress passed the Omnibus Trade and Competitiveness Act of 1988 and, through the Exon-Florio Amendment to that bill, gave the President the right to block foreign acquisitions of U.S. companies that “threaten to impair” U.S. national security. President Reagan later delegated significant authority for implementing Exon-Florio to CFIUS.

4 These data were developed by identifying all public disclosures by U.S. or foreign companies that they submitted a voluntary notice under Exon-Florio. Most of the data comes from filings to the Securities and Exchange Commission or the SEC’s counterparts in London and Toronto. Note that the $95 billion figure includes the value of the entire transaction. For example, Dubai Ports purchased all of P&O’s global assets for $5.7 billion. Only six of P&O’s ports were in the United States. This data only capture 37 of the 113 transactions that CFIUS reviewed in 2006. However, it is likely that this captures a significant portion of the value of the transactions since most large transactions either involve at least one publicly traded company or are accompanied by a press release. Since CFIUS filings are confidential, it is impossible to provide an authoritative value of the transactions reviewed by CFIUS.

5 Withdrawals can occur for a number of reasons, including: (i) CFIUS required additional time to complete the review or negotiate a mitigation agreement and the parties prefer to withdraw and refile than enter the second-stage investigation; (ii) CFIUS and the parties reach an agreement during a second-stage investigation, and in turn, the parties withdraw and re-file rather than force a Presidential determination; or (iii) the parties decided to
abandon a transaction either for business reasons or because it becomes clear that CFIUS approval will not be forthcoming.

6 For example, after initiating a post-closing review of the Venezuelan-owned company Smartmatic’s acquisition of Sequoia, a U.S. company that manufactures electronic voting machines, Smartmatic announced that it was “voluntarily” withdrawing its CFIUS notice and planned to sell Sequoia. See http://www.miami.com/mld/miamiherald/16295058.htm. Congresswoman Carolyn Maloney (D-NY) first raised concerns about the transaction in May 2006. Smartmatic initially resisted efforts to file the case with CFIUS. See http://maloney.house.gov/documents/financial/acquisitions/20060511SmartmaticRls.pdf

7 This provision was sufficiently important that Lucent and Alcatel provided notice to shareholders through an SEC filing, which stated: “Under the National Security Agreement, in the event that the Alcatel-Lucent parties materially fail to comply with any of its terms, and the failure to comply threatens to impair the national security of the United States, the parties to the National Security Agreement have agreed that CFIUS, at the request of the USG Parties at the cabinet level and the Chairman of CFIUS, may reopen review of the merger transaction and revise any recommendations submitted to the President.” William R. Carapezzi, Jr., Senior Vice President, General Counsel, and Secretary, Lucent Technologies, Inc., Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934, November 17, 2006. See also, Hitt, Greg, “A Higher Bar for Foreign Buyers: Security Terms in Alcatel's Deal for Lucent Signal New Era,” Wall Street Journal, January 5, 2007; Page A6.


9 See Statement of Clay Lowery, Assistant Secretary of Treasury, Before the House Committee on Armed Services, November 14, 2006.


11 See Hamilton/Quinlan, p. 4.
12 See Id.

13 Graham/Marchick, p. xviii.

14 Hamilton/Quinlan, p. 3.

15 See, for example, Testimony of Peter Flory, Assistant Secretary of Defense for International Security Policy, before the House Financial Services Committee, May 17, 2006, available at http://www.dod.mil/dodgc/olc/docs/TestFlory060517.pdf. Flory’s testimony lays out the criteria DOD utilizes when analyzing the national security risk of a transaction and the vetting process within the Pentagon.

16 See Graham/Marchick, p. 177.

17 The House-Senate Conference Committee wrote in its report at the time of passage of Exon-Florio: “The Conferees in no way intend to impose barriers to foreign investment….This section is not intended to authorize investigations on investments that could not result in foreign control of persons engaged in interstate commerce nor to have any effect on transactions which are outside the realm of national security.” H.R. Rep. No. 100-576, 926 (1988).

18 CFIUS received an average of 50 filings per year from 2002 - 2005, well below the averages of 217 per year during the “Formative Years” or 73 per year during the “Quiet Years.”

19 The two bills were: H.R. 5337, the National Security Foreign Investment Reform and Strengthened Transparency Act of 2006, sponsored by Representatives Blunt, Pryce, Maloney, Crowley and 84 other Representatives; and S. 3549, the Foreign Investment and National Security Act of 2006, sponsored by Senators Shelby and Sarbanes. While there were substantive debates over these bills, in the opinion of the author the managers of each bill deserve credit for developing the bills with an unusual and refreshing level of bipartisanship.
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