

CRS Report for Congress

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The Exon-Florio National Security Test for Foreign Investment

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Summary

The proposed acquisition of six major U.S. ports by Dubai Ports World and Unocal by the China National Offshore Oil Corporation (CNOOC) has sparked intense concerns among some Members of Congress and the public and has reignited the debate over what role foreign acquisitions play in U.S. national security. While the United States actively promotes internationally the policy of relaxing rules concerning foreign investment, including the national treatment of foreign firms, some in Congress and others question some aspects of this policy as it relates to allowing foreign competitors unlimited access to the Nation's industrial base. Much of this debate focuses on the activities of a relatively obscure committee, the Committee on Foreign Investment in the United States (CFIUS) and the Exon-Florio provision, which gives the President broad powers to block certain types of foreign investment. This report will be updated as warranted by events.

Background

According to the Department of Commerce,¹ foreigners invested \$113 billion in U.S. businesses and real estate in 2004, which represents nearly a tripling in the amount invested in 2003. This amount, however, is about half as much as U.S. firms invested abroad and far below the record \$300 billion foreigners invested in 2000. The lower level of foreign direct investment flows, although particularly sharp for the United States, is not unique. According to the United Nation's *World Investment Report*, global foreign direct investment flows dropped by 41% in 2001 and 21% in 2002 due to slow economic growth in most of the parts of the world, falling stock market valuations, lower corporate

¹ Bach, Christopher L., "U.S. International Transactions, 2004." *Survey of Current Business*, April 2005, p. 46.

profitability, a slowdown in corporate restructuring, and a slowdown in privatization efforts in some areas.²

The cumulative amount, or stock, of foreign direct investment in the United States on a historical cost basis³ increased by \$38 billion in 2003 to nearly \$1.4 trillion. This marked an increase of less than three percent over the previous year and an improvement over the decrease in the position in the previous year when some affiliates repaid substantial loans to their foreign parent companies and the foreign parent companies wrote down the value of acquisitions they had made prior to the slowdown in the U.S. economy.⁴

With over \$230 billion invested in the United States, Great Britain is the largest foreign direct investor. Japan has moved into the position as the second largest foreign direct investor in the U.S. economy with over \$159 billion in investments. Following the Japanese are the Germans (\$149 billion) and Dutch (\$146 billion), with the French close behind (\$143 billion). Recently, China has attracted particular attention as a result of a number of proposed acquisitions. Worldwide, Chinese acquisition transactions jumped from \$2-\$3 billion in previous years to \$23 billion so far in 2005.⁵

The Exon-Florio Provision

In 1988, amid concerns over foreign acquisition of certain types of U.S. firms, particularly by Japanese firms, Congress approved the Exon-Florio provision of the Defense Production Act.⁶ This statute grants the President the authority to block proposed or pending foreign acquisitions of “persons engaged in interstate commerce in the United States” that threaten to impair the national security. In subsequent legislation, Congress directed that this process be applied “in any instance in which an entity controlled by or acting on behalf of a foreign government seeks to engage in any merger, acquisition, or takeover which could result in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.” Many in Congress were concerned at the time that foreign takeovers of U.S. firms could not be stopped unless the President declared a national emergency or regulators invoked federal

² *World Investment Report 2004: The Shift Towards Services*. New York, United Nations, 2004, p. 5.

³ The stock, or position, is the net book value of foreign direct investors' equity in, and outstanding loans to, their affiliates in the United States. A change in the position in a given year consists of three components: equity and intercompany inflows, reinvested earnings of incorporated affiliates, and valuation adjustments to account for changes in the value of financial assets. The Commerce Department also publishes data on the foreign direct investment position valued on a current-cost and market value bases. These estimates indicate that foreign direct investment increased by \$49 billion and \$410 billion in 2003, respectively, to \$1.5 and \$2.4 trillion.

⁴ Borga, Maria, and Daniel R. Yorgason, “Direct Investment Positions for 2003: Country and Industry Detail,” *Survey of Current Business*, July, 2004. P. 40.

⁵ “Special Report: The Dragon Tucks in — Chinese Companies Abroad,” *The Economist*, July 2, 2005, p. 71.

⁶ P.L. 100-418, title V, Subtitle A, Part II, or 50 U.S.C. app 2170.

antitrust, environmental, or securities laws. The Exon-Florio provision grants the President the authority to take what action he considers to be “appropriate” to suspend or prohibit proposed or pending foreign acquisitions, mergers, or takeovers of persons engaged in interstate commerce in the United States which threaten to impair the national security. Congress directed, however, that before this authority can be invoked the President is expected to believe that other U.S. laws are inadequate or inappropriate to protect the national security, and that he must have “credible evidence” that the foreign investment will impair the national security. For the purposes of this legislation, Congress purposely did not define national security, but intended to have the term interpreted broadly without limitation to a particular industry.⁷

The authority to administer the Exon-Florio provision was delegated to the Committee on Foreign Investment in the United States (CFIUS),⁸ which is housed in the Department of the Treasury. The Committee had been established under a previous Executive Order with broad responsibilities, but few powers.⁹ It was originally established with eight members, but has been expanded to twelve over time. The twelve members include the Secretaries of State, the Treasury, Defense, Homeland Security, and Commerce; the United States Trade Representative; the Chairman of the Council of Economic Advisers; the Attorney General; the Director of the Office of Management and Budget; the Director of the Office of Science and Technology Policy; the Assistant to the President for National Security Affairs; and the Assistant to the President for Economic Policy.¹⁰ The Committee has 30 days to decide whether to investigate a case and an additional 45 days to make its recommendation. Once the recommendation is made, the President has 15 days to act.

In 1992, Congress amended the statute through section 837(a) of the National Defense Authorization Act for Fiscal Year 1993. Known as the “Byrd” amendment after the amendment’s sponsor, the provision requires CFIUS to investigate proposed mergers, acquisitions, or takeovers in cases where:

- (1) the acquirer is controlled by or acting on behalf of a foreign government; and
- (2) the acquisition results in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.¹¹

Through the Exon-Florio provision, Congress directed that CFIUS, and therefore the President, should consider a short list of factors in deciding to block a foreign acquisition, merger, or takeover. This list includes the following elements:

- (1) domestic production needed for projected national defense requirements;

⁷ *Congressional Record*, Daily Edition, v. 134, April 20, 1988. p. H2118.

⁸ Executive Order 12661 of December 27, 1988, 54 F.R. 779.

⁹ Executive Order 11858 (b), May 7, 1975, 40 F.R. 20263.

¹⁰ Executive Order 11858 of May 7, 1975, 40 F.R. 20263, as amended by Executive Order 12188, January 2, 1980, 45 F.R. 969; Executive Order 12661, December 27, 1988, 54 F.R. 779; Executive Order 12860, September 3, 1993, 58 F.R. 47201

¹¹ P.L. 102-484, Oct. 23, 1992.

(2) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services;

(3) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the U.S. to meet the requirements of national security;

(4) the potential effects of the transactions on the sales of military goods, equipment, or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons; and

(5) the potential effects of the transaction on U.S. technological leadership in areas affecting U.S. national security.

In November 1991, the Treasury Department issued final regulations, after extensive public comment, implementing the Exon-Florio provision.¹² These regulations created an essentially voluntary system of notification by the parties to an acquisition, but they also allow for notice by agencies that are members of CFIUS. Despite the voluntary nature of the notification, firms largely notify voluntarily because the regulations stipulate that foreign acquisitions that are governed by the Exon-Florio review process that do not notify the Committee remain subject indefinitely to divestment or other appropriate actions by the President. Under most circumstances, notice of a proposed acquisition that is given to the Committee by a third party, including shareholders, is not considered by the Committee to constitute an official notification. The regulations also indicate that notifications provided to the Committee are considered to be confidential and the information is not released by the Committee to the press or commented on publicly.

Caseload

As a consequence of the confidential nature of the CFIUS review of any proposed transaction, there are few public sources of information concerning the Committee's work to date. For the most part, information concerning individual transactions that have been reviewed by CFIUS or any final recommendations that have been issued by CFIUS have come from announcements made by the companies involved in a transaction and not by CFIUS. Therefore public information concerning the outcome of CFIUS's reviews are incomplete. According to one source,¹³ CFIUS has received more than 1,500 notifications, of which it conducted a full investigation of 25 cases. Of these 25 cases, thirteen transactions were withdrawn upon notice that CFIUS would conduct a full review and twelve of the remaining transactions cases were sent to the President. Of these twelve transactions, one was prohibited.

The transaction that was prohibited by the President involved the acquisition in 1990 of Mamco Manufacturing Company by the China National Aero-Technology Import and Export Corporation (CATIC). Mamco was an aerospace parts manufacturer. CATIC,

¹² Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons. 31 C.F.R. Part 800.

¹³ CFIUS, *The Washington Post*, July 3, 2005. p. F3.

which is owned by the Government of the People's Republic of China, acted as the purchasing agent for the Chinese Ministry of Defense. President Reagan ordered CATIC to divest itself of Mamco under the authority of the Exon-Florio provision because of concerns that CATIC might gain access to technology through Mamco that it would otherwise have to obtain under an export license.¹⁴ One recent case that involved a Chinese firm that was reviewed by CFIUS and approved was the proposed acquisition of IBM's Personal Computing Division to Lenovo Group Limited, a Chinese manufacturing company.

Most often, CFIUS has approved proposed transactions if the parties involved agreed to certain conditions. For instance, in 2000, the Committee allowed Nippon Telephone & Telegraph Company to acquire Verio, Inc, an Internet service provider, by obtaining a strict ban on involvement by the Japanese government in the firm. Similar concerns arose with the proposed acquisition in 2003 of Global Crossing, Ltd. by Hutchinson Whampoa Ltd. of Hong Kong and Technologies Telemedia of Singapore. U.S. officials reportedly were concerned that foreign ownership of Global Crossing's fiber-optics network might make the U.S. government vulnerable to eavesdropping from overseas and some Members of Congress were concerned about Hutchinson's ties to the Chinese military. To ease these concerns, Hutchinson offered to play a passive role in the company. Nevertheless, CFIUS decided to conduct a full 45-day review of the transaction, at which point the Chinese firm backed out of the deal. Eventually, CFIUS approved the acquisition by the Singapore firm by itself, because it offered to put Americans on the board of Global Crossing.¹⁵

Concerns With Foreign Investment

A key issue for Congress is whether and in what way it should respond to essentially private economic investment activities and how to assess the impact of such investments on the Nation's security. At the time the Exon-Florio provision was debated and approved, Congress did not intend to inhibit foreign direct investment in industries which are not of national security interest. Although the Exon-Florio provision widened the scope of transactions that CFIUS reviewed for potential national security concerns, the practical application of the provision has focused more often on the implications for U.S. national defense security. The United States already prohibits foreign direct investment in such industries as maritime, aircraft, banking, resources, and power.¹⁶ Generally, these sectors were closed to foreign investors to prevent public services and public interest activities from falling under foreign control, but again primarily for national defense purposes.

¹⁴ Auerbach, Stuart. "President Tells China to Sell Seattle Firm." *The Washington Post*, February 8, 1990, p. A1; and Benham, Barbara. "Blocked Takeover Fuels Foreign Policy Flap." *Investor's Daily*, February 8, 1990. p. 1.

¹⁵ Peterson, Jonathan, "Panel Has a Big Say in Foreign Purchases; Security Clearance for a Chinese Bid for Unocal Would Hinge on Obscure U.S. Committee." *Los Angeles Times*, July 5, 2005. p. C1.

¹⁶ CRS Report 94-610, *Foreign Investment in the United States: Major Federal Statutory Restrictions*, by Michael V. Seitzinger. (available on request from the author)

The debate over foreign investment in the United States continues to be marked by differing assessments of the economic implications of foreign investment, a lack of a clear consensus on what role foreign acquisitions of U.S. firms play in U.S. national security, and philosophical and political divisions over the proper policy course to follow. Some critics have argued that the CFIUS process is too uncertain and too narrowly focused to adequately protect the Nation's long-term economic interests. For instance, some argue that the Committee does not consider the potential effects a foreign acquisition could have on the American workforce as a national security concern, even if the aim of the foreign suitor is to obtain technical information and processes, which it intends to use to shift production processes and plants abroad.

Others argue that the relative change in the economic position of the United States warrants a reassessment of some of the assumptions that underlie U.S. international economic policies, including allowing foreign competitors unlimited access to the most important components of the U.S. industrial base. At the heart of such concerns over foreign acquisitions of U.S. firms lies the lack of a national consensus over how national security should be defined as it relates to private investments in U.S. firms and how to weigh the economic impact of foreign investment in U.S. firms.