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## The Exon-Florio Amendment

The United States has formally invited foreign investment since the late 1970s. In 1983 President Ronald Reagan publicly announced, for the first time by a US president, that the United States welcomed foreign investment, stating, “The United States believes that foreign investors should be able to make the same kinds of investment, under the same conditions, as nationals of the host country. Exceptions should be limited to areas of legitimate national security concern or related interests.”<sup>1</sup> This national treatment policy, reinforced by the United States’ attractiveness as the world’s largest economy, has led to sustained increases in foreign direct investment (FDI) into the United States over the last 30 years, apart from a brief lull from 2000 to 2003. US affiliates of foreign multinational enterprises employed 5.2 million American workers in 2003, accounting for 4.2 percent of total private sector US employment. Capital expenditures by these same affiliates totaled \$109 billion in 2004.

The path of the United States’ open investment policy, however, has not been free from turbulence. As chapter 1 discussed, political pressures based on real or perceived threats to tighten the valves on FDI have arisen from time to time. While these pressures generally failed to carry the day, in 1988, they resulted in the establishment of an investment review law—the Exon-Florio Amendment—grounded in national security concerns.

In this chapter, we provide an overview of the Exon-Florio Amendment and its legislative history. We discuss how the Committee on Foreign Investment in the United States (CFIUS) has implemented Exon-Florio, including the national security issues that the committee has considered in

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1. See Reagan (1983). President George Herbert Walker Bush also issued a statement on the subject; see George H. W. Bush, “White House Statement Announcing United States Foreign Direct Investment Policy,” December 26, 1991.

applying the statute, and how the amendment has been applied more broadly since the attacks of September 11, 2001. Since, in practice, CFIUS has focused on mitigating the national security impact of a particular foreign acquisition, as opposed to blocking acquisitions altogether, we conclude this chapter with specific case studies in the telecommunications and defense sectors, and a discussion of the tools that CFIUS has used to reduce the perceived threats from foreign investments.

## Overview of the Exon-Florio Amendment

In 1988 Congress enacted the Exon-Florio Amendment to Section 721 of the Defense Production Act of 1950.<sup>2</sup> Exon-Florio authorizes the president to investigate foreign acquisitions, mergers, and takeovers of, or investments in, US companies from a national security perspective. If necessary, the president may also prohibit a transaction that appears to threaten national security when other laws, except for the International Emergency Economic Powers Act (IEEPA),<sup>3</sup> are otherwise inadequate to mitigate the threat. In the words of the amendment, the president may block an acquisition if “there is credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security,” and if other laws except for IEEPA “do not in the President’s judgment provide adequate and appropriate authority for the President to protect the national security in the matter before the President.”<sup>4</sup>

When Exon-Florio became law, the president delegated his initial review and decision-making authorities, as well as his investigative responsibilities, to CFIUS,<sup>5</sup> which had been established by executive order in 1975.<sup>6</sup> Thus an Exon-Florio review is often alternatively called a CFIUS review. CFIUS is chaired by the secretary of the Treasury and has 11 other members (box 2.1). The assistants to the president for national security affairs (the national security adviser) and economic policy (national economic adviser) are formally members of CFIUS, but they and their staff have tried not to participate actively in CFIUS deliberations in the initial 30-day review period of an investigation, in case they are called upon to

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2. *Omnibus Trade and Competitiveness Act of 1988*, § 5021, Public Law 100-418, *US Statutes at Large* 102 (1988): 1107, codified at *US Code* 50 1988, App. § 2170. The original authorization was scheduled to expire in 1991 but was made permanent by Section 8 of *Defense Production Act Extension and Amendments of 1991*, Public Law 102-99, *US Statutes at Large* 105 (1991): 487.

3. *International Emergency Economic Powers Act*, §§ 1701–1706.

4. *Omnibus Trade and Competitiveness Act of 1988*, App. § 2170(e).

5. Executive Order no. 12,661 (1988).

6. Executive Order no. 11,858 (1975). As discussed below, CFIUS originally was established primarily to monitor and evaluate the impact of foreign investment in the United States.

### **Box 2.1 Members of CFIUS**

Secretary of Treasury (Chair)  
Secretary of State  
Secretary of Defense  
Secretary of Commerce  
Secretary of Homeland Security  
Attorney General  
Director of the Office of Management and Budget  
United States Trade Representative  
Chairman of the Council of Economic Advisers  
Director of the Office of Science and Technology Policy  
Assistant to the President for National Security Affairs  
Assistant to the President for Economic Policy

mediate disputes between CFIUS agencies, or to advise the president on a particular transaction. CFIUS is unique among executive branch interagency committees in that it purposefully includes agencies with distinct missions. Certain CFIUS agencies have law enforcement, defense, and homeland security as their mandate, while others are oriented toward promoting open trade and investment policies. This tension among member agencies is designed to elicit carefully considered judgments that account for a myriad of economic and security considerations.

By statute and regulation, CFIUS is authorized to review a transaction either upon a voluntary filing by either party to the transaction, or upon an agency notice filed by one of the committee's members.<sup>7</sup> The statutorily mandated timetable for the CFIUS review process is as follows (figure 2.1):

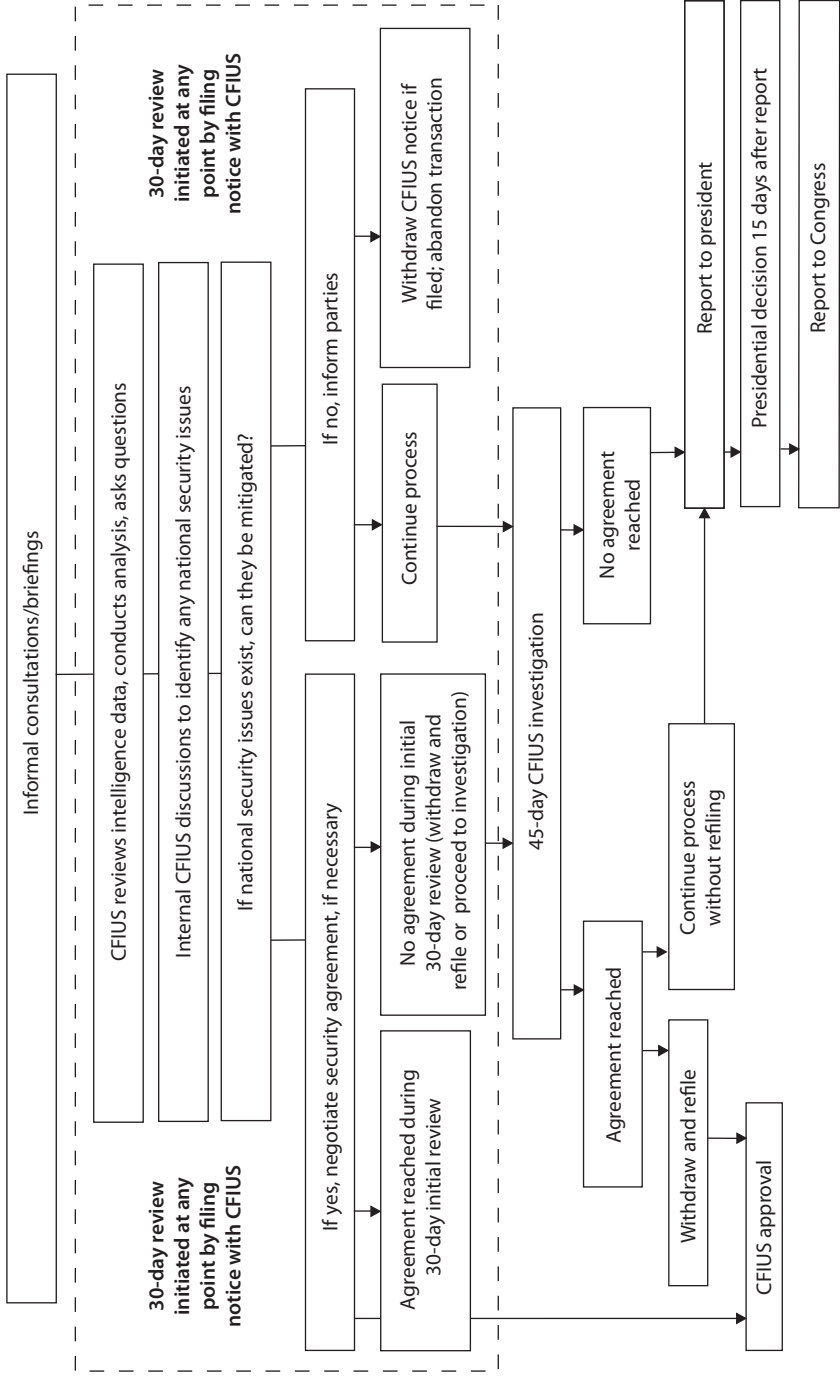
- initial 30-day review following receipt of notice;
- 45-day “investigation” period for transactions deemed to require additional review following the initial 30-day period (not all transactions are subject to this);<sup>8</sup>
- formal report to the president at the end of the 45-day investigation period;
- presidential decision within 15 days of receiving the formal report.<sup>9</sup>

7. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800, App. A (1988).

8. The term investigation is a misnomer; practically speaking, it is only an extended review.

9. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800, App. A (1988).

**Figure 2.1 CFIUS process**



The statute also mandates investigations in certain instances. In 1993 the Byrd Amendment to the National Defense Authorization Act amended Exon-Florio to mandate an investigation “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 of a US entity that could affect the national security of the United States.”<sup>10</sup> This language does not mean, however, that an investigation is required every time a company owned or controlled by a foreign government acquires a US company. CFIUS also considers whether the acquisition could affect national security. The presence of foreign government ownership is, however, a key consideration for CFIUS agencies when weighing national security risks, and typically leads to greater scrutiny.

The Byrd Amendment became the focus of intense debate in the controversy surrounding the Dubai Ports World (DP World) acquisition of P&O. Lawmakers were incredulous that CFIUS did not extend its review into the 45-day investigation period, given that DP World is owned by the government of the United Arab Emirates. Senators Carl Levin (D-MI), Hillary Clinton (D-NY), and Robert Byrd (D-WV), the last of which authored the Byrd Amendment in 1993, argued that the Bush administration was flouting the law by not pursuing an investigation of the transaction. They argued further that an investigation was mandatory under the Byrd Amendment and lambasted the administration’s view that, because of the security agreement negotiated with DP World, the transaction “could not” affect US national security.<sup>11</sup> In response, Deputy Treasury Secretary Robert Kimmitt argued that the Byrd Amendment provides CFIUS with discretion on whether to pursue an investigation.<sup>12</sup> This same issue of interpreting the Byrd Amendment was vigorously contested in briefs by New Jersey Governor Jon Corzine and the US Department of Justice (DOJ) in the case Corzine brought to block the DP World acquisition.<sup>13</sup>

The framework of the statute and implementing regulations provides broad discretion to CFIUS in a number of important ways. First, CFIUS authority is not time-limited, nor is there a statute of limitations. Exon-Florio simply authorizes CFIUS, through the president’s designation, to initiate its investigation of a foreign merger, either upon a voluntary filing or, if the parties do not file voluntarily, at the instigation of a CFIUS member at any time. This can happen even after a transaction has closed.

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10. *National Defense Authorization Act for Fiscal Year 1993*, Public Law 102-484, *US Statutes at Large* 106 (1993): 2315, 2463, § 837(a).

11. See Elana Schor, “Bush Administration Defends Ports Deal on Capitol Hill,” *The Hill*, February 23, 2006.

12. See Christopher Rubager, “Rove Opens Door to Delaying Port Deal as Senators Slam CFIUS Review,” *BNA International Trade Daily*, February 24, 2006.

13. Defendants’ Response to Order to Show Cause at 18-21, *Corzine v. Snow et al.*, No. 06-833 (D.N.J.). Complaint at 10, *Corzine v. Snow et al.*, No. 06-833 (D.N.J.).

Second, while the sole purpose of the CFIUS process is to determine whether a particular transaction could threaten US national security, the statute does not define the term “national security.” Rather, it identifies a number of criteria for the president to consider in evaluating the potential threat. These criteria include

- domestic production needed for projected national defense requirements;
- 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;
- the control of domestic industries and commercial activity by foreign citizens as it affects US capability and capacity to meet national security requirements;
- the potential effects of the transaction 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
- the potential effects of the transaction on US technological leadership in areas affecting US national security.<sup>14</sup>

CFIUS’s considerations, however, are not limited to these criteria. The legislative history of Exon-Florio makes clear that “national security” is “to be read in a broad and flexible manner.”<sup>15</sup> For this reason, and notwithstanding having received a number of comments and recommendations on what might be an appropriate definition of national security,<sup>16</sup> CFIUS intentionally decided to leave the term undefined in the US Treasury regulations implementing Exon-Florio. According to the preamble to these regulations, “The Committee rejected [all of the recommended definitions] because they could improperly curtail the President’s broad authority to protect the national security.”<sup>17</sup> Thus, CFIUS, at its discretion, has undertaken Exon-Florio reviews of transactions involving various industrial sectors beyond the defense industrial base, including technology, telecommunications, energy and natural resources, manufacturing, and transportation.

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14. Exon-Florio Amendment, App., § 2170(f).

15. Statement of Senator Exon, *Congressional Record* 134 (April 25, 1988): S4833.

16. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800, App. A (1988), noting that definitional guidance was “a major theme of the public comments” and that “[c]ommenters had a wide range of recommendations on this point.”

17. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800, App. A (1988).

Third, there is considerable breadth in the term “foreign control,” as defined in the statute and clarified in the regulations. The statute authorizes the president to act on transactions that could result in foreign control of entities engaged in interstate commerce in the United States. The regulations interpret control to mean

the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity.<sup>18</sup>

In theory, the breadth of this definition enables CFIUS to review transactions that, as a practical matter, give the foreign acquirer very little actual control. The regulations create a rebuttable presumption of foreign control if a foreign person acquires 10 percent of a US company’s equity.<sup>19</sup> They also do not distinguish between direct control, or ownership of shares in a US company by foreign citizens, governments, or other entities, and indirect control, or foreign acquisition of another foreign corporation, which then controls a US company.<sup>20</sup> Thus, CFIUS has in the past, and could in the future, determine that a foreign person controls a US entity regardless of the foreign person’s actual ownership percentage. If the foreign owner’s rights include seats on the board of directors, veto rights over certain corporate actions, or the right to appoint or reject certain key personnel, foreign control could be deemed to exist even if the percentage of equity ownership is de minimis.

Fourth, CFIUS has never defined what constitutes “credible evidence,” the standard in the statute for the first prong of the two-part test for whether the president should block an acquisition.<sup>21</sup> In practice, CFIUS views the credible evidence standard as a fairly low threshold: It accepts evidence as credible so long as it is “worthy of belief.”<sup>22</sup> CFIUS’s reluctance to define “credible evidence” is not surprising. The regulations were

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18. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800.204 (1988).

19. The rebuttable presumption of control if a foreign person acquires more than 10 percent of equity in a US entity arises in practice from the regulations exempting from the requirements of Exon-Florio a purchase of equity that results in “ten percent or less of the outstanding voting securities of the US person.” *Code of Federal Regulations*, title 31, sec. 800.302(d)(1) (1988).

20. Regulations Implementing Exon-Florio, *Code of Federal Regulations*, title 31, sec. 800.213 (1988), defines “foreign person” as a foreign national or any entity “over which control is exercised or exercisable by a foreign interest.”

21. Specifically, the first prong is whether there is “credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security.” See *Omnibus Trade and Competitiveness Act*, App. § 2170(e).

22. Interview with CFIUS official.

designed to give the president maximum discretion to make national security determinations under Exon-Florio. Even if CFIUS agencies were inclined to clarify what constitutes “credible evidence,” it would be a challenge to do so. US courts have had difficulty providing useful guidance on the terms. The US Supreme Court has never defined “credible evidence,” and state supreme courts that have attempted it have failed to do so precisely. The Missouri Supreme Court concluded that “credible evidence” exists where a “term is sufficiently plain and meaningful and does not require definition.”<sup>23</sup> The New York Supreme Court defined credible evidence as “evidence that proceeds from a credible source and reasonably tends to support the proposition for which it is offered.”<sup>24</sup> These definitions are circular, and do not substantively clarify the term.

In sum, CFIUS has given itself exceptional flexibility to decide whether a particular transaction so concerns national security that it requires an investigation or, when an investigation has been undertaken, whether the president should be advised to block the transaction.

## Enactment of the Exon-Florio Amendment

Since September 11, 2001, a number of transactions, or potential transactions, subject to Exon-Florio review have engendered heated policy debates over their impact on both economic and national security, the threats posed by investments from particular countries (e.g., China), and the loss of US leadership in purportedly sensitive industries. In reality, the legislative history of Exon-Florio demonstrates that such political pressures are not new. Many of the economic and broader policy arguments proffered today for limiting foreign investment in the United States spurred the legislation initially proposed by Senator James Exon (D-NE).

The original Exon amendment was introduced in 1988, when the Reagan administration’s open investment policy, a weak dollar following the 1985 Plaza Accord, mounting US indebtedness, and attractive stock prices were working together to create an impression that American firms were “increasingly vulnerable to takeover” (Alvarez 1989, 56).<sup>25</sup> Predictably, the perceived weakening of the American economy compared with foreign competitors created a domestic political backlash. As noted in chapter 1, the increase in FDI at this time mirrored similar increases in worldwide investment. With a wealth of capital at their disposal, Japanese companies were becoming active in acquiring, or attempting to acquire, US com-

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23. *State v. Thresher*, 350 S.W. 2d 1, 9 (Mo. 1961).

24. *Cusick v. Kerik*, 305 A.D. 2d 247, 248 (N.Y. 2003), citing *Meyer v. Board of Trustees*, 90 N.Y. 2d 139, 147 (1997).

25. For additional background information on Exon-Florio, see Menard (2002) and Shearer (1993).



panies, sparking widespread concern in the United States about Japan's supposed challenge to US economic leadership.

Two specific transactions created a stir in Congress: Sir James Goldsmith, the famous British corporate raider, attempted to take over Good-year Tire and Rubber, and the Japanese company Fujitsu attempted to acquire an 80 percent interest in Fairchild, a large semiconductor manufacturer located in California (Alvarez 1989). The proposed takeovers sparked intense debate on Capitol Hill and in the US business community. Opponents of the Fairchild takeover argued that the merger would harm US competitiveness, grant Japan access to vital US technology, and make the United States dependent on Japan for production of semiconductors (Alvarez 1989, 58). Some industry observers compared the takeover to "selling Mount Vernon to the Redcoats" (Alvarez 1989, 57).

While the Reagan administration worried that blocking the sale would chill foreign investment and hinder efforts to open the Japanese market, it nonetheless acquiesced to pressure from Capitol Hill, and had CFIUS initiate a review into any security risks that the Fairchild merger might pose. At that time, CFIUS was authorized to review any investment that "might have major implications for United States national interests."<sup>26</sup> But as a purely advisory body to the president, it was not empowered to pass regulations or take substantive action short of recommending that the president invoke the IEEPA. Accordingly, the Reagan administration, through the DOJ, said that it would scrutinize the transaction under the Hart-Scott-Rodino Act.<sup>27</sup> Even though the administration was unlikely to block the merger, Fujitsu eventually abandoned the transaction, announcing that "rising political controversy in the United States" made the deal undesirable (Alvarez 1989, 62).

Despite Fujitsu's abandonment of its attempt to acquire Fairchild, the Reagan administration's perceived lack of concern with respect to the transaction concerned a number of business leaders and policymakers. Senator Exon took the lead in criticizing the administration's inaction, introducing a bill to "grant the President discretionary authority to review and act upon foreign takeovers, mergers, acquisitions, joint ventures and licensing agreements which threaten the national security or essential commerce of the United States."<sup>28</sup> The objective of the legislation, he said, was to "encourage the Administration to protect the national interest" and create legal means for the president to block foreign takeovers of domestic companies without having to invoke the IEEPA (Alvarez 1989, 56). While the IEEPA technically empowered the president to take action in

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26. Executive Order no. 11,858, (1975).

27. See Exon-Florio Amendment, § 18(a).

28. See statement of Senator Exon, *Foreign Investment, National Security and Essential Commerce Act of 1987*, HR 3, 100th Congress, 1st sess. (1987).

the Fujitsu case, or any other foreign acquisition, its language—empowering the president to take measures to prevent “any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States, if the President declares a national emergency with respect to such threat”<sup>29</sup>—rendered a presidential veto of most foreign takeovers of US companies untenable, as it would have been “virtually the equivalent of a declaration of hostilities against the government of the acquirer company” (US Senate 1987, 17, statement by Senator Wilson). Thus the Exon bill was designed, in large measure, to give the president explicit authority to block such takeovers without declaring a national emergency, as the IEEPA required. A similar bill was introduced in the House of Representatives by Congressman James Florio (D-NJ).<sup>30</sup>

The original version of the Exon bill required the secretary of commerce, upon the motion of any head of department or agency, to undertake an investigation to determine how any merger, acquisition, joint venture, or takeover by a foreign person would affect national security, essential commerce, and economic welfare. The bill then gave the president power to block such acquisitions or investments after considering a number of factors, including the domestic production needed for projected national defense requirements; the requirements for growth in such industries; the control of such industries by foreign persons; the impact of foreign control on the economic welfare of individual domestic industries, and any substantial unemployment; or decrease in revenues of government, loss of skills or investment, or other serious effects resulting from foreign control.<sup>31</sup>

Despite Senator Exon’s assurances that he was “not trying to block foreign investment” and thought it was “vitaly necessary” (US Senate 1987), much of the debate surrounding the Exon amendment revolved around concerns over whether or how the legislation might be used to halt foreign investment that did not threaten national security.<sup>32</sup> Supporters of an open investment policy regarded three aspects of the legislation as particularly troublesome: the “essential commerce” provision, the inclusion of economic factors in the statutory criteria for assessing whether to prohibit a transaction, and the inclusion of joint ventures and licensing arrangements among those transactions subject to review. The legislation also would have placed the lead role in the US government with the secretary of commerce, a provision the Reagan administration resisted.

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29. *Omnibus Trade and Competitiveness Act*, §§ 1701–1702, emphasis added.

30. *Foreign Investment, National Security and Essential Commerce Act of 1987*, HR 3, 100th Congress, 1st sess. (May 8, 1987), § 905(a); Public Law 100-418.

31. *Foreign Investment, National Security and Essential Commerce Act of 1987*, HR 3, 100th Congress, 1st sess. (May 8, 1987), § 905(b).

32. Members of Congress and business leaders also voiced concerns that the threat of government investigations would increase transaction costs and deter foreign investment.

## Essential Commerce

The initial Exon bill required the secretary of commerce to investigate the effects that foreign mergers, acquisitions, takeovers, joint ventures, and licenses would have on “essential commerce” and “economic welfare.”<sup>33</sup> This provision drew fierce criticism from the Reagan administration and business leaders, and during the June 10, 1987, hearings held by the Senate Committee on Commerce, Science, and Transportation, a number of administration officials and senators expressed their opposition to it.

The most vocal criticism of the “essential commerce” provision came from then Secretary of Commerce Malcolm Baldrige, who summed up his position by reaffirming Reagan’s commitment to “not discourage foreign investment or trade unless it poses a risk to national security.” He added, “We are very concerned about the possibility of chilling any investment in the United States.” Furthermore, the legislation could potentially undermine the administration’s policy of “taking the lead in all kinds of trade, free trade, GATT kinds of policy” (US Senate 1987, 7). Finally, Baldrige criticized the bill’s language for being too broad. He acknowledged that the president should have the power to block investments for national security reasons, but he accused Senator Exon of “trying to kill a gnat with a blunderbuss” (US Senate 1987, 17).

US Trade Representative Clayton Yeutter also expressed his disagreement with the “essential commerce” provision. In a letter addressed to the committee, he wrote that

the notion that governmental review may be necessary to determine the *economic* effects of foreign direct investment in the United States runs directly contrary to our belief that investment flows which respond to market forces provide the best and most efficient mechanism to promote economic growth here and abroad. (US Senate 1987, 70; emphasis in original)

Secretary of the Treasury James Baker struck the heaviest blow to the legislation by hinting at a presidential veto. In a letter to the committee, he declared that “foreign investment brings us capital, jobs, new technology and management skills.” He added that “amendments of this nature could cause grave damage to the US economy” and concluded that “if this [trade] provision is in the final bill, I would find it particularly difficult to recommend that the President sign the bill” (US Senate 1987, 68).<sup>34</sup>

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33. *Foreign Investment, National Security and Essential Commerce Act of 1987*, HR 3, 100th Congress, 1st sess. (May 8, 1987), § 905(a).

34. When asked to clarify Baker’s ominous statement, Dick Darman, who had recently left the Reagan administration as deputy treasury secretary, replied, “That is the kind of language you use when you know you want to recommend veto, but you do not have the authority to say that the Administration will stand behind the veto” (US Senate 1987, 57). The chairman of the Federal Reserve, Paul Volcker, also testified in opposition to the amend-

## Economic Factors

The original version of the Exon amendment would also have required the secretary of commerce and the president to consider a number of economic factors to assess whether a transaction threatened national security or essential commerce.<sup>35</sup>

In the committee hearings, Secretary Baldrige opposed consideration of any factors that did not directly relate to national security: “The economic welfare of individual industries. Now, that could mean anything to anybody, but to me it would mean that we would have to be concerned about foreign competition coming into the United States, and that is not the right way for us to compete.” He added, “When I see words like the President shall consider the economic welfare of individual industries, that sends a shiver up anybody’s spine trying to invest here from abroad” (US Senate 1987). He then criticized the provision requiring the president to consider whether the transaction might create substantial unemployment. “How do you know that unemployment is not necessary in order to make the industry competitive and end up with more employment in total after it does become more competitive?” he asked (US Senate 1987, 11; punctuation in original). Finally, he opposed considering loss of skills or investment, concluding that “for us to deny the opportunity for foreign investment based on that is really a major, major step backwards as far as an open investment policy” (US Senate 1987, 12). Baldrige’s views did not go unchallenged. Senator John Breaux (D-LA) rebutted Baldrige’s arguments by pointing out that these considerations were discretionary: “If you think that those are not important considerations, you can close the books, slam the door, and walk away from it. You are not required to have one single investigation under the Exon Amendment” (US Senate 1987, 15).

The version of the Exon amendment that was eventually signed by the president nonetheless omitted the considerations to which Baldrige objected.<sup>36</sup> As enacted, the Exon-Florio Amendment authorized the president, in reviewing the effects of a foreign investment on national security, to take into account the domestic production needed for projected national defense requirements; the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, and other supplies and services; and the control of domestic industries and commercial activity by

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ment. He argued that the term “essential commerce” was too “broad and ambiguous” and worried that including it in the legislation could “lead to the establishment of an approval process for almost any foreign direct investment in the United States.” Such a tactic, he argued, “would be contrary to our long-standing national policy of maintaining an open economy” (US Senate 1987, 69).

35. *Foreign Investment, National Security and Essential Commerce Act of 1987*, HR 3, 100th Congress, 1st sess. (May 8, 1987), supra note 105.

36. *Omnibus Trade and Competitiveness Act*, § 5021.

foreign citizens, as it affected the capability and capacity of the United States to meet national security requirements.<sup>37</sup>

## Joint Ventures and Licensing

A number of senators and key witnesses at the Senate committee hearings on the original Exon bill objected to including “joint ventures” and “licensing agreements” as transactions under the statute, on the grounds that such transactions did not raise the same concerns as hostile takeovers or acquisitions. Senator Bob Kasten (R-WI) argued, “I do not want anything in this amendment to stop that kind of what I believe is synergistic joint ventures” (US Senate 1987). Robert McNeill, executive vice chairman of the Emergency Committee for American Trade, a protrade business group, objected to covering licensing agreements. He stated that barriers to licensing exchanges would “complicate enormously and immensely the ability of US companies to conduct their business in the international arena” (US Senate 1987, 53). These views carried the day. After the committee hearings, the terms “joint ventures” and “licensing” were omitted from the bill.

Proponents of the bill downplayed the potential adverse effects that the amendment in general, and the essential commerce provision in particular, might have on foreign investment. Senator Exon emphasized that the power granted to the secretary of commerce and the president was discretionary. He pointed out that the decision to block investment rested with the president alone, who was free to allow such mergers after reviewing the requisite determinations. Exon testified that “all that the Exon Amendment does is say that if you, as the Secretary of Commerce, want to use this tool, you can. You can consider using this tool. You do not have to” (US Senate 1987, 12). Senator Breaux was skeptical at the administration’s argument that the proposed amendment would adversely affect foreign investment. He remarked: “I get a real kick out of the reason, Mr. Chairman, why they are not supporting the legislation. What we are hearing about is this chilling effect. Do not do this because we are going to have a big chill out there and people are not going to want to invest in the United States’ companies.” He added that countries around the world grant authority to their governments to “take a look at it [investment] from a national security standpoint, or from a cultural standpoint, or from an economic standpoint” (US Senate 1987, 13), and there was therefore no reason not to allow the US government to conduct a similar review.

No one at the Senate committee hearings disputed the need to protect national security, and excepting Secretary Baldrige, the speakers generally

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37. *Omnibus Trade and Competitiveness Act*. Note that other factors were subsequently added by the Byrd Amendment.

acknowledged a need to grant the president greater authority to block investments that threatened national security. As a result of the opposition to Exon's original bill, Senator Exon and his supporters on the committee agreed to "tighten" the statutory language, to both avoid a presidential veto and address concerns about the potential chill on desired foreign investment (US Senate 1987, 34, 44, 50, 58, 61).<sup>38</sup>

On June 19, 1987, the Senate Commerce Committee adopted a revised version of the Exon amendment that addressed some of the concerns voiced at the hearing.<sup>39</sup> It changed the review criteria of foreign acquisitions to "national security and essential commerce *which affects national security*."<sup>40</sup> The committee report added that the committee "in no way intends to impose barriers to foreign investment," and that the amendment was not to have "any effect on transactions which are clearly outside the realm of national security" (Alvarez 1989, 71).

These revisions, however, could not overcome the opposition of the Reagan administration and the US business community. After the president took the extraordinary step of threatening to veto the entire trade act—one of the centerpieces of the 100th Congress—if it included the amended Exon amendment, the bill was sent back to the House-Senate Conference Committee. The version of the amendment that Congress eventually enacted amended Section 721 of the Defense Production Act of 1950. The amendment thereafter became known as the Exon-Florio Amendment, recognizing the roles of Senator Exon and Representative Florio, a member of the House Energy and Commerce Committee. Importantly, it omitted any mention of "essential commerce" or "economic welfare."

## Subsequent Attempts at Amendment

In the years since Exon-Florio's enactment in 1988, a number of members of Congress have attempted to amend the law to include the provisions in Senator Exon's original proposal that were discarded by the conference committee. These efforts have focused on economic interest as a CFIUS factor, the chairmanship of the committee, technology transfer, and enhanced monitoring. With the notable exception of the Byrd Amendment

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38. Senator Don Riegle (D-MI) stated, "I certainly support the notion of national security." He cautioned, however, that "if we stick with wording similar to national security or essential commerce, that we in fact create a level of ambiguity that probably does not serve us well" (US Senate 1987, 44).

39. Senate Committee on Commerce, Science and Transportation, *Senate Report No. 100-80 to Accompany S 907 (Technology Competitiveness Act of 1987, 100th Congress, 1st sess., Senate Report 80, 1987, 28)*.

40. Senate Committee on Commerce, Science and Transportation, *Senate Report No. 100-80 to Accompany S 907*. See also Alvarez (1989, 69).

in 1992, discussed below, these proposals uniformly have been defeated. At the time of this writing, in the wake of the Dubai Ports World controversy, more than a dozen bills had been introduced to reform Exon-Florio, and there seems to be irresistible pressure to amend the law.<sup>41</sup>

### ***Economic Interest***

In response to growing concerns that the president had not adequately exercised the powers granted to him under the Exon-Florio Amendment, Representative Mel Levine (D-CA) introduced HR 2386, entitled “The Foreign Investment and Economic Security Act of 1991.” The bill reflected frustration that CFIUS had recommended blocking only one merger out of the more than 500 proposed transactions that the committee had reviewed to date. It declared that “while foreign direct investment can generate United States economic growth, such investment in industries central to our national defense and economic security must be carefully evaluated,” and proposed amending Section 721 to read: “The President or the President’s designees may make an investigation to determine the effects on economic and national security of mergers, acquisitions.”<sup>42</sup> Not surprisingly, the bill received little support, given the strong opposition to similar language in Senator Exon’s original bill. HR 2386 was referred to several committees but never debated.<sup>43</sup>

Some efforts to amend Exon-Florio on economic interest grounds have focused on particular industries. In 2001, Representative Dennis Kucinich (D-OH) proposed HR 2394, “The Steel and National Security Act,” which contained a provision that would amend the Exon-Florio Amendment to require CFIUS to conduct an investigation any time a person or a foreign country “seeks to engage in any merger, acquisition, or takeover that could result in the control by such person of a domestic steel company.”<sup>44</sup>

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41. See *Committee on Foreign Investment in the United States Reform Act*, HR 4915, 109th Congress, 2nd sess., March 2006 (introduced by Congresswoman Maloney); *United States Security Improvement Act of 2006*, HR 4813, 109th Congress, 2nd sess., February 2006 (introduced by Congressman M. Foley); *Smart and Secure Foreign Investment Act*, S 2335, 109th Congress, 2nd sess., March 2006 (introduced by Senator Bayh); and “a bill to transfer authority to review certain mergers, acquisitions, and takeovers of United States entities by foreign entities to a designee established within the Department of Homeland Security,” S 2400, 109th Congress, 2nd sess., March 2006 (introduced by Senator Collins, hereinafter referred to as the Collins bill).

42. *Foreign Investment and Economic Security Act of 1991*, HR 2386, 102nd Congress, 1st sess. (1991).

43. On May 17, 1991, the bill was referred to the House Committee on Banking, Finance and Urban Affairs, the House Committee on Foreign Affairs, and the House Committee on Energy and Commerce.

44. *Steel and National Security Act*, HR 2394, 107th Congress, 1st sess. (2001).

This bill was referred to the House Committee on Financial Services and never debated.

A number of members of Congress have advocated including economic factors among the criteria CFIUS considers to assess investment-related risks to national security. Shortly after the statute's enactment in 1988, Senator Exon himself voiced his concern about the "unrelenting purchases of American firms by foreign interests" and encouraged the Reagan administration to use Exon-Florio "to protect the national security when foreign industries try to take over key American industries and technologies."<sup>45</sup> He added that some industries are "so crucial that they must remain under American control."<sup>46</sup> Two years later, Representative Doug Walgren (D-PA) proposed a more expansive definition of national security. He asserted that the "military and economic dimensions of national security are inseparable" and urged that "conditions should be placed on foreign purchasers to protect our national security from the erosion of the industrial base."<sup>47</sup> His bill, HR 5225, would have authorized the president to consider the "control of domestic industries and commercial activity by foreign citizens as it affects the industrial and technological base of the United States."<sup>48</sup> In a similar vein, two separate bills introduced in 1991 by Representatives Cardiss Collins (D-IL) and Mel Levine (D-CA) proposed an additional four factors that CFIUS should consider: the concentration of foreign investment in the industry in question; the US and world market positions of the persons engaged in interstate commerce in the United States, the foreign persons involved in the transaction under investigation, and global concentration in particular industry sectors; the effect on critical technologies; and whether the persons engaged in interstate commerce in the United States had received US government funds by grant or contract in the preceding 10-year period, and if so, the dollar amount of such funds.<sup>49</sup> These bills were referred to various committees but received little or no debate.<sup>50</sup>

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45. *Congressional Record* 135 (1989): 25352.

46. *Congressional Record* 135 (1989): 25352. In a separate debate, Representative Hamilton Fish (D-NY) noted that these industries may include "technology, telecommunications, semiconductors, robotics, computers, biotechnology, pharmaceuticals, strategic metals, and advanced materials." 100th Congress, 2nd sess., *Congressional Record* 134 (April 21, 1988): H2297.

47. 100th Congress, 2nd sess., *Congressional Record* 136 (1990): 27408.

48. *To Amend the Defense Production Act of 1950 to Clarify and Strengthen Provisions Pertaining to National Security Takeovers*, HR 5225, 101st Congress, 2nd sess. (1990).

49. Representatives Mel Levine (D-CA) and Cardiss Collins (D-IL) introduced HR 2386 and HR 2624 respectively in the 102nd Congress (1991).

50. Both bills were referred to the House Committee on Banking, Finance and Urban Affairs, the House Committee on Foreign Affairs, and the House Committee on Energy and Commerce.



More recently, in June 2005 Representative Donald Manzullo (R-IL) stated in testimony before the US-China Economic and Security Review Commission that Congress should “reform the CFIUS process to consider economic security as part of national security.”<sup>51</sup> As discussed below in more detail, in July 2005, in the midst of the debate over the proposed transaction between the China National Offshore Oil Corporation (CNOOC) and Unocal, Senator James Inhofe (R-OK) offered an amendment to the Defense Production Act that would have required CFIUS to consider a transaction’s impact on “national economic and energy security.”<sup>52</sup>

### ***Transferring the Chair of CFIUS***

The Collins and Levine bills would have designated the secretary of commerce as the chair of CFIUS, to transfer power away from the Department of the Treasury. Representative Collins argued that Treasury’s chairmanship of CFIUS conflicted with the department’s primary responsibility of promoting foreign investment, and therefore CFIUS should be chaired by some other agency.<sup>53</sup> The Levine bill granted authority to the secretary of commerce to annually review whether a foreign person involved in an investment was complying with the assurances provided.<sup>54</sup> Senator Inhofe’s recent bill, offered in July 2005, would move the chairmanship of CFIUS to the Department of Defense,<sup>55</sup> even though the Pentagon reportedly told Senator Inhofe that it did not seek the chairmanship of CFIUS. More recently, Senator Susan Collins (R-ME) introduced a bill—another so-called Collins bill—to transfer the chairmanship to the Department of Homeland Security (DHS).

### ***Technology Transfer***

The first Collins bill, along with the bill authored by Representative Doug Walgren (D-PA), also contained provisions that would have required the

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51. Testimony of Donald Manzullo to the US-China Economic and Security Review Commission, *Manufacturing Dragon: China’s Emerging Role As A Global Factory and Its Implications for American Innovation*, 109th Congress, 1st sess., June 23, 2005.

52. *National Defense Authorization Act for Fiscal Year 2006*, SA 1311 to S 1042, 109th Congress, 1st sess. (2005).

53. Remarks of Representative Collins, 102nd Congress, 1st sess., *Congressional Record* 137 (1991): 5117–5123. Representative Collins made these remarks in the debate leading up to enacting Public Law 102-99, which extended the expiration date of the *Defense Production Act of 1950*.

54. *Foreign Investment and Economic Security Act of 1991*, HR 2386, § III(i), 102nd Congress, 1st sess. (1991).

55. *National Defense Authorization Act for Fiscal Year 2006*, SA 1311 to S 1042, 109th Congress, 1st sess. (2005).

secretaries of commerce and defense to identify any “essential” or “critical” technology involved in mergers, acquisitions, or takeovers, while authorizing the president to consider the existence of such technology in determining the potential effect of an investment on national security.

HR 5225, the Walgren bill, would have required each member of CFIUS to identify annually the “technologies which are essential to the industrial and technological base of the United States.” The secretaries of commerce and defense would have had to request that CFIUS conduct an investigation after determining that a merger, acquisition, or takeover involved an essential technology. In a sweeping provision, the bill would also have authorized the president to consider “the control of domestic industries and commercial activity by foreign citizens as it affects the industrial and technological base of the United States.”<sup>56</sup>

Similarly, Representative Cardiss Collins’s measure would have required the secretaries of commerce and defense to collect information pertaining to mergers, acquisitions, and takeovers by foreign persons, and identify any plans to transfer technology from the United States. The two secretaries would also have had to conduct an investigation if any critical technology was involved in the transaction. Finally, the Collins bill authorized the president to consider the effect on critical technologies when deciding whether to block a merger. The bill never made it out of committee.

### ***Enhanced Monitoring***

Representative Phillip Sharp (D-IN) introduced HR 2631, entitled the International Mergers and Acquisitions Review Act, in 1991. The goal of this bill was to allow Congress to “more logically monitor, and when necessary, regulate transnational mergers, joint ventures and takeovers.” Representative Sharp argued that many mergers and acquisitions raise both antitrust and national security concerns. Thus, “it makes sense to provide linkages between the two regulatory domains. In this way, potential threats to our economic welfare and our national security can be monitored and efficiently regulated by either or both sets of competencies, operating independently.”<sup>57</sup> HR 2631 would have amended § 721(a) by requiring CFIUS to “make an investigation to determine the effects on national security of

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56. *To Amend the Defense Production Act of 1950 to Clarify and Strengthen Provisions Pertaining to National Security Takeovers*, HR 5225, 101st Congress, 2nd sess. (1990). Introduced by Representative Walgren.

57. *International Mergers and Acquisitions Review Act*, HR 2631, 102nd Congress, 1st sess., *Congressional Record* 137 (1991): 15575.

58. The Clayton Act (*US Code* 15 (1914), §§ 12–27; *US Code* 29 (1914), §§ 52–53) is one of the United States’ principal antitrust statutes. We are not aware of a National Security Liaison Committee, but assume that it was an interagency committee that referred, to the appropriate US government agencies, national security issues that may have arisen in the DOJ’s enforcement of the Clayton Act.

any proposed acquisition which the National Security Liaison Committee has referred under section 7B(c)(2)(a) of the Clayton Act<sup>58</sup> and permitting an investigation of any acquisition referred under 7B(c)(2)(b) of the Clayton Act.<sup>59</sup> The bill also would have broadened the president's powers by allowing him to take action any time "an interest exercising control, whether foreign or domestic, might take action that threatens to impair the national security." This bill was referred to several committees, but was never debated.<sup>60</sup>

### ***Enhanced Congressional Involvement***

In 2005 Senators James Inhofe (R-OK) and Richard Shelby (R-AL) introduced some of the most sweeping amendments ever offered to the Exon-Florio Amendment during a heated debate in Congress over the proposed acquisition of Unocal by CNOOC. The amendments were swiftly followed by a GAO report that was highly critical of the way that CFIUS was implementing the Exon-Florio Amendment.<sup>61</sup> The most sweeping, and likely unconstitutional,<sup>62</sup> provision in both bills would have given Congress the authority to override a presidential decision to approve a particular transaction.

The Inhofe bill, which the Shelby Amendment sought to amend, would have required the president to notify Congress of all approvals of "any proposed merger, acquisition or takeover that is investigated." It would also have prohibited a transaction, subject to an investigation and approved by the president, from being "consummated until 10 legislative days after the President" provided notice to Congress. In addition, the Inhofe bill required a delay in closing the transaction if the chairman of one of four congressional committees introduced a resolution disapproving of the transaction:

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59. *International Mergers and Acquisitions Review Act*, HR 2631, 102nd Congress, 1st sess. (1991). Proposed amendment to § 721(a).

60. This bill was referred to the House Committee on Banking, Finance and Urban Affairs, the House Committee on Foreign Affairs, the House Committee on Energy and Commerce, and the House Committee on Judiciary.

61. Inhofe Amendment, SA 1311 to S 1042, 109th Congress, 1st sess. (2005) Shelby Amendment, SA 1467 to S 1042, 109th Congress, 1st sess. (2005) US GAO (2005). As mentioned above, the Inhofe bill would require CFIUS to consider "national economic and energy security" and would have moved the chairmanship of CFIUS to the Department of Defense. Both bills also would have extended the initial 30-day period to 60 days.

62. The proposed amendments would provide that a transaction approved by the president would be blocked if both houses of Congress passed a resolution of disapproval. This provision appears to be unconstitutional. In *INS v. Chadha*, 462 US 919 (1985), the Supreme Court held that Article I of the Constitution requires not only passage by a majority of both houses of Congress, but also presentment to the president for a possible veto.

If a joint resolution objecting to the proposed transaction is introduced in either House of Congress by the Chairman of one of the appropriate Congressional committees during such period, the transaction may not be consummated until 30 legislative days after such resolution.<sup>63</sup>

Finally, if the resolution of disapproval was adopted by both houses, “the transaction may not be consummated.”<sup>64</sup> These provisions mirrored a provision in the original Exon bill that permitted Congress to enact a joint resolution to disapprove of a presidential action.<sup>65</sup>

The Shelby Amendment also would have empowered the House and Senate Banking Committees, through the request of the chairman and ranking member, to force CFIUS to investigate, or conduct an extended review of, particular transactions. Both the Inhofe and Shelby amendments would have substantially expanded CFIUS’s reporting requirements through either, in the Inhofe amendment, monthly reports on each transaction considered by CFIUS, or, in the Shelby Amendment, the same reports on a quarterly basis.<sup>66</sup>

The Inhofe and Shelby Amendments reflected a growing frustration with what many in Congress perceived as a lack of transparency within the CFIUS process, as well as a growing anxiety generally over the specter of large-scale investments in the United States by Chinese and Gulf State companies. On the issue of transparency, CFIUS has been criticized for limiting the type and amount of information it shares with Congress on particular transactions. CFIUS was heavily criticized for not even notifying Congress about the proposed acquisition of Peninsular and Oriental Steam Navigation Company (P&O) by Dubai Ports World. After all, critics argue, Congress exempted itself from the confidentiality restrictions in Exon-Florio. In the authors’ view, however, CFIUS has appropriately withheld from Congress proprietary information supplied by parties that have filed for Exon-Florio approval. We believe that the congressional veto provisions in the Inhofe and Shelby bills, which insert Congress into the CFIUS process, are excessive and unworkable. CFIUS could provide more information to Congress while protecting both the integrity of the CFIUS process and preserving confidential, proprietary information that parties to a particular transaction submit. Chapter 6 discusses ways to improve information sharing with Congress in more detail.

As of this writing, Congress was actively considering legislation to reform CFIUS, but declined to act on the Inhofe and Shelby Amendments,

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63. Inhofe Amendment, SA 1311 to S 1042, 109th Congress, 1st sess. (2005). Inhofe originally submitted an amendment to S 1042 and later submitted S 1797.

64. Inhofe Amendment, SA 1311 to S 1042, 109th Congress, 1st sess. (2005).

65. See statement of Senator Exon, *Foreign Investment, National Security and Essential Commerce Act of 1987*, supra note 92, sec. (f).

66. See statement of Senator Exon, *Foreign Investment, National Security and Essential Commerce Act of 1987*, supra note 92, sec. (f); and SA 1353.

both of which were originally offered as floor amendments to the 2006 defense authorization bill. However, in that same bill, Congress did pass language expressing the “Sense of the Congress” that the president should develop a comprehensive strategy with respect to China. Among other things, this strategy should include a

review of laws and regulations governing the Committee on Foreign Investment in the United States (CFIUS), including exploring whether the definition of national security should include the potential impact on national economic security as a criterion to be reviewed, and whether the chairmanship of CFIUS should be transferred from the Secretary of the Treasury to a more appropriate executive branch agency.<sup>67</sup>

It is unclear how and whether the Bush administration will respond to this statutory language.

## The Meaning of “National Security” in Practice

As noted above, CFIUS has retained a great deal of flexibility to define and assess national security risks on a transaction-by-transaction basis. This approach has enabled the prism through which US officials assess national security interests to shift with time and circumstances. Predictably, a number of US government agencies shifted their views on the national security implications of foreign investment after September 11. Overall, however, the data available on Exon-Florio reviews indicate that, even with a broader view of national security, Exon-Florio still captures a relatively small percentage of total FDI in the United States.

## Assessing National Security Risks

As a general matter, CFIUS uses a risk-based analytical approach to assess the national security risks associated with particular transactions. In recent years, the threshold for what constitutes a risk that might require mitigation has been lowered considerably, with US government officials citing myriad potential national security risks depending on the transaction.

CFIUS agencies have never published a list of risks associated with foreign investment. Below, we offer a summary of the most frequent threats that, in our experience and based on interviews with past and current CFIUS officials, CFIUS agencies have identified with foreign acquisitions of US companies. While some of these threats overlap with the statutorily enumerated criteria discussed above for national security, such as loss of

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67. *National Defense Authorization Act for Fiscal Year 2006*, Public Law 109-163, 109th Congress, 1st sess., 2005, *Senate Report 109-069*, § 1234(c)8.

US technical leadership in a sensitive sector, many are much broader. The threats most commonly considered by CFIUS include the following potential actions of foreign investors:

- shutting down or sabotaging a critical facility in the United States;
- impeding a US law enforcement or national security investigation;
- accessing sensitive data, or becoming aware of a federal investigation or methods used by US intelligence and/or law enforcement agencies, including moving transaction data and records offshore;
- limiting US government access to information for surveillance or law enforcement purposes;
- denying critical technology or key products to the US government or US industry;
- moving critical technology or key products offshore that are important for national defense, intelligence operations, or homeland security;
- unlawfully transferring technology abroad that is subject to US export control laws;
- undermining US technological leadership in a sector with important defense, intelligence, or homeland security applications;
- compromising the security of government and private-sector networks in the United States;
- facilitating state or economic espionage through acquisition of a US company; and
- aiding the military or intelligence capabilities of a foreign country with interests adverse to those of the United States.

Of course, a number of these reported “threats” reflect certain assumptions, which often may not be true in particular cases. The threat that a foreign acquirer might deny critical technology or key products to the US government assumes a lack of procurement options for the US government or other strategic industries in the United States. For the Department of Defense (DOD) to lack real procurement options, the relevant industry must be tightly concentrated, the number of close substitutes limited, and the switching costs to new products high.<sup>68</sup> In contrast, if there are multi-

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68. For a more detailed discussion of the factors necessary for a legitimate threat to US national security due to a company denying a product, technology, or service, see statement of Theodore Moran, House Committee on Energy and Commerce, Subcommittee on Commerce, Consumer Protection and Competitiveness, *Hearings before the Subcommittee on Commerce, Consumer Protection and Competitiveness of the House Committee on Energy and Commerce*, 102nd Congress, 1st sess, February 26 and June 12, 1991. Moran cited a number of examples

ple alternative suppliers, it would be hard to argue that a credible national security threat exists, no matter how vital the good or service.

Perhaps most important, virtually all of the examples above assume that there is something inherently less trustworthy, or suspect, about foreign corporations. Meanwhile, most of the largest companies in the world consider themselves to be global entities, rather than companies exclusively affiliated with individual countries. Every company has a home base, and some—particularly those owned and controlled by foreign governments—remain “national.” But most truly global companies seek to create a uniquely local identity for each country in which they operate, through branding, hiring local employees, and customization. C. Michael Aho and Marc Levinson (1988, 144) argue that

questions of corporate nationality have come to possess little relevance. The physical location of a company’s headquarters and the place of its incorporation are largely questions of historic accident and legal convenience. . . . Most large firms, whether their headquarters are in Europe, North America, or Japan, operate with global scope, with employees of many nationalities, and produce earnings for shareholders all over the world. To distinguish among them according to the country in which each is based is to place an inappropriate emphasis on factors that simply no longer matter.

Aho and Levinson made this argument before mutual and hedge funds and cross-border portfolio investment substantially expanded.<sup>69</sup> There are, of course, major exceptions, including major corporations, such as Lockheed Martin or Boeing, that need to maintain their American identity for security and marketing reasons. But excluding the universe of companies that for various reasons want to maintain their national identities, the

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in which governments, including the United States, instructed companies based in their countries to withhold technology from another country. He also cited several industrial segments in which industry concentration was so tight that there was potential to withhold technology from the United States or the US government. Among these industrial segments was “advanced lithography,” a highly specialized process used to make detailed patterns in silicon wafers. Moran was prescient, as in 2001, in the first year of the George W. Bush administration, a foreign acquisition of a US company in the lithography sector became highly controversial. See the discussion of the ASML-Silicon Graphics transaction in chapter 5.

69. See also Todd Malan, testimony before the House Financial Services Committee Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, March 1, 2005. Malan states, “When it comes to national security concerns arising from commercial operations of critical infrastructure, why should the nationality of the owners of the capital stock be the principal or sole concern? Certainly, there may be instances of foreign ownership that do raise special concerns as in the case of government ownership of the acquirer—a situation where CFIUS already pays special attention. But the national security risks arising from certain activities—such as infrastructure operations—are present whoever owns the capital stock and should be addressed on their merits, not only in the context of an acquisition. If we agree that there are vulnerabilities in a particular area, the solution is to address the risk comprehensively and not take the view that the risk lies only with ownership.”

largest multinational companies, which in turn are the largest global investors, increasingly seek to be branded as global companies.

In turn, the shares of most large public companies are owned by other large institutional investors, which may be US- or foreign-based, or raise capital from the United States, foreign countries, or, more likely, both. Institutional investors or mutual funds own 54 percent of General Electric's shares and 63 percent of DuPont's. In the energy sector, 54 percent of Exxon-Mobil's shares are held by institutional investors or mutual funds. BP (formerly British Petroleum) is 80 percent owned by institutional investors and mutual funds, and is owned by virtually the same number of Americans (approximately 40 percent) as British (approximately 42 percent). Which company should be considered American, BP or ExxonMobil? Under the Exon-Florio Amendment, only BP would be required to obtain CFIUS approval to acquire an American company. In our view, both Exxon and BP operate as global companies, not American or British companies. Other leading executives agree.<sup>70</sup> Even in sensitive sectors, foreign ownership of US assets by global companies based outside the United States does not create national security risks on its own. CFIUS must look at the particular facts associated with the foreign acquirer, its leadership and shareholders, and the asset being acquired to determine whether a particular transaction poses a national security risk.

## National Security Assessments under Exon-Florio

Through the end of 2005, 1,593 notices had been filed with CFIUS, representing about 10 percent of all reported FDI in the United States. After an initial burst of filings in the first four years after Exon-Florio was enacted, during which CFIUS received between 106 and 295 filings per year, the number of filings has leveled off to between 40 and 80 annually. The large number of filings early in the amendment's lifetime reflected uncertainty in the business and legal communities about how Exon-Florio would be implemented. As a result, in an abundance of caution, more filings were made than were probably necessary.

Table 2.1 summarizes CFIUS's activities. The 1,593 filings have generated 25 investigations, 13 withdrawals, and 12 decisions by the president. The president has formally rejected only one transaction. Critics of CFIUS point to the small number of transactions that have gone to an investigation, as well as that single rejection, as evidence that the provision is ineffective. In a July 21, 2005, speech on the Senate floor, Senator Inhofe stated, "CFIUS has not demonstrated an appropriate conception of national secu-

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70. Chad Holliday, chairman and CEO of DuPont, once said, "With DuPont being a global company, we cannot do it the American way everywhere." Cynthia Challener, "Gaining Executive Mindshare: US and European Chemical CEOs; Focus 2003: Chemical Leaders: CEOs and Companies," *Chemical Market Reporter*, May 26, 2003, FR8.



**Table 2.1 CFIUS notifications and investigations, 1988–2005**

Year	Notifications	Investigations	Notices withdrawn	Presidential decision
1988	14	1	0	1
1989	204	5	2	3 <sup>a</sup>
1990	295	6	2	4
1991	152	1	0	1
1992	106	2	1	1
1993	82	0	0	0
1994	69	0	0	0
1995	81	0	0	0
1996	55	0	0	0
1997	62	0	0	0
1998	65	2	2	0
1999	79	0	0	0
2000	72	1	0	1
2001	55	1	1	0
2002	43	0	0	0
2003	41	2	1	1
2004	53	2	2	0
2005	65	2	2	0
Total	1,593	25	13	12

a. Includes the China National Aero Tech (PRC)/MAMCO Manufacturing transaction, which the president ordered divested on February 2, 1990.

Source: Data obtained from the Department of the Treasury.

riety.” Inhofe continued by citing the data mentioned above: “Of more than 1,500 cases of foreign investments or acquisitions in the United States, CFIUS has only investigated 24. And only one resulted in actually stopping the transaction.”<sup>71</sup> But these data fail to present the full picture. A number of transactions were abandoned after informal consultations with CFIUS led the parties to conclude that CFIUS approval would not be forthcoming. Another 13 transactions were withdrawn after CFIUS began an investigation. Others were withdrawn within the first 30 days of the review process, and CFIUS does not keep or publish data on withdrawals that occur after a filing has been made but prior to an investigation. Even more important, CFIUS has used its power to review transactions to impose strict conditions on foreign acquisitions to mitigate national security concerns. Examples of these mitigation measures are discussed later in this chapter.

Since September 11, 2001, the number of investigations and withdrawals has increased compared with previous years, reflecting the increased level of scrutiny foreign acquisitions receive in the new security environment. Between January 2003 and December 2005, there were six investigations

71. 109th Congress, 1st sess., *Congressional Record* 151 (July 21, 2005): S8609.

and five withdrawals, more than during the previous 10 years combined. Adding the DHS to CFIUS in February 2003 also increased the level of scrutiny by CFIUS in this period.

In practice, the question before CFIUS in most transactions is not whether or not to block a particular investment, but how to mitigate any perceived threat to national security that may result from it. As discussed in detail below, CFIUS has pursued mitigation strategies primarily through agreements with, or commitment letters from, the parties to a transaction. These measures are negotiated either before or during the formal CFIUS process. In many circumstances, CFIUS agencies will proceed to the investigation simply because they have not had sufficient time during the initial 30-day review period to reach agreement with the transaction parties, or reach consensus within CFIUS, on appropriate mitigation methods.

## Exon-Florio in the Post–September 11 Environment

Since the terrorist attacks of September 11, 2001, transactions requiring CFIUS review have been subjected to greater scrutiny and tougher conditions for approval, as concern about national and homeland security has dramatically increased following the attacks. In February 2003, President Bush added the DHS to CFIUS, shifting the committee's balance of power significantly in favor of agencies prioritizing security over economic policy considerations. Despite the criticism that the Bush administration inadequately scrutinized the Dubai Ports World acquisition, a number of senior officials in the Bush Administration, particularly at the DOD, have not embraced foreign investment in the United States with the same enthusiasm as did their predecessors in the Bill Clinton, George H. W. Bush, and Ronald Reagan administrations.

The heightened emphasis on security within CFIUS has resulted in more investigations and stricter security-related conditions for CFIUS approval. In this new, more uncertain security environment, as discussed in chapter 4, CFIUS also has expanded its focus on protection of critical infrastructure, which the DHS views in broad terms.<sup>72</sup>

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72. See chapter 4. See also Homeland Security Presidential Directive-7 (HSPD-7), which sets forth government policy for protecting critical infrastructure and key resources, identifies critical infrastructure sectors, and assigns various agency responsibilities for protecting those sectors. Homeland Security Presidential Directive-7 (December 17, 2003) is available at [www.whitehouse.gov](http://www.whitehouse.gov). The operative legal definition of critical infrastructure is found in *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act*, § 1016(e), codified at *US Code* 42 (2001), § 5195c(e): "The term 'critical infrastructure' means systems 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."

## Telecommunications Transactions under Exon-Florio

The telecommunications sector provides an interesting case study of Exon-Florio for two reasons. First, it is the only sector in which security agreements negotiated pursuant to CFIUS review are made public. As mentioned above, a major focus of CFIUS has been to mitigate the national security impact of a foreign investment, rather than blocking it outright. The security agreements are made public through the US Federal Communications Commission's (FCC) Web site, because CFIUS uses the threat of revoking FCC licenses as an enforcement tool to ensure that foreign acquirers of US telecommunications companies live up to the obligations in the agreements. Second, the telecommunications sector provides plenty of data for analysis because there have been so many foreign acquisitions of US telecommunications companies, both pre- and post-September 11, given the relative openness of the US market to foreign telecommunications companies.

Two events in the mid- and late 1990s opened the US telecommunications market to foreign investors. First, Congress passed the landmark Telecommunications Act of 1996, enhancing competition in multiple telecommunications sectors, including long distance, wireless, satellite, and local service. The act spurred investment in new telecommunications companies (many of which later went out of business), led to innovative new services, and was a major catalyst for the technological revolution of the late 1990s in the United States. Second, and more significantly in its effect on foreign investment in the United States, the United States and 68 other countries reached a landmark agreement in the World Trade Organization (WTO) in 1997 to open markets for basic telecommunications services. This Basic Telecommunications Agreement of the WTO was signed by countries then representing more than 90 percent of global telecommunications revenues. It established principles of nondiscrimination and national treatment for telecommunications providers throughout the world. Most of the countries that signed the agreement made binding commitments to open their basic telecommunications and satellite markets to foreign investments, adopt procompetitive and deregulatory policies, and allow foreign companies to participate in their home markets (Foreign Participation Order).

The United States made broad and deep commitments to ensure that foreign telecommunications providers had access to the US market. To implement these commitments, in November 1997 the FCC adopted two measures, one governing foreign participation in the telecommunications market (hereinafter the Foreign Participation Order), the other providing special rules for the satellite market (together referred to as Orders). These orders sought to "significantly increase competition in the US telecommunications market by facilitating entry by foreign service providers and

investors.”<sup>73</sup> They created an open entry policy for carriers from WTO member countries.<sup>74</sup> In essence, an investment in the United States from a company based in a WTO member country would be presumed to be procompetitive by the FCC because the WTO Agreement on Basic Telecommunications created more competition in that company’s home market, thereby reducing the risk of cross-subsidization from foreign carriers that were monopolies in their home markets.

Since these regulatory changes in 1997, the FCC has considered and approved dozens of transactions involving foreign investors in multiple telecommunications sectors. Today the German telecommunications company Deutsche Telecommunications owns T-Mobile, the fourth-largest US wireless carrier, with more than 17 million subscribers in early 2005. Vodafone, the British mobile operator, owns 45 percent of Verizon Wireless, the largest US wireless carrier. Dozens of other foreign carriers, including NTT (Japan), Telnor (Norway), France Telecom, BT (formerly British Telecom) and Videsh Sanchar Nigam Limited (VSNL, India) own or control US affiliates. Indeed, in the open US market, foreign firms have acquired US-based firms owned by other foreign nationals. In 2005 BT acquired Infonet, a California-based telecommunications provider serving the enterprise market, from six foreign carriers: TeliaSonera (Sweden/Finland), Swisscom AG (Switzerland), KPN Telecommunications B. V. (Netherlands), Telefonica International Holding (Spain), Telstra (Australia), and KDDI (Japan). Thus the WTO Basic Telecommunications Agreements and the Orders have to be considered a huge success, as they accomplished their goal of substantially increasing competition in US and foreign markets.

In adopting the Foreign Participation Order, the FCC had to consider the extent to which it would defer to the executive branch on national security, law enforcement, foreign policy, and trade issues. There was some debate between interested parties over the propriety of the commission’s consideration of the latter two areas. However, with the exception of comments from German telecommunications company Deutsche Telecom, there was little debate over whether the FCC should defer to the executive branch on national security issues.

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73. US FCC press release, “Commission Liberalizes Foreign Participation in the US Telecommunications Market,” Report No. IN 97-36. November 25, 1997, available at [www.fcc.gov](http://www.fcc.gov); *Rules and Policies on Foreign Participation in the US Telecommunications Market*, Report and Order, *Federal Communications Commission Record* 12 (1997): 23,891, hereinafter the Foreign Participation Order; *Amendment of the Commission’s Regulatory Policies to Allow Non-US Licensed Space Station to Provide Domestic and International Satellite Service in the United States*, Report and Order, *Federal Communications Commission Record* 12 (1997): 24,094.

74. For WTO member countries, the FCC eliminated the “effective competitive opportunity” test, in which the commission, among other things, analyzed the extent to which the home market was open to US carriers as an indicator of whether a particular foreign company’s participation in the US market was “procompetitive” (Foreign Participation Order).

When the commission adopted the regulations to liberalize investment restrictions, terrorism was far from the minds of most Americans, the US economy was booming, and the perception that the rise of China posed a serious economic and political challenge to the United States had not yet taken root. The commission did not, and could not, have realized that its decision to defer to the executive branch on national security, law enforcement, foreign policy, and trade issues in determining whether an application was in the “public interest” would create an opening for the DOJ, DOD, and DHS to assert broad rights to regulate foreign investment in telecommunications companies.

In the Foreign Participation Order, the commission noted that “we expect national security, law enforcement, foreign policy and trade policy concerns to be raised only in very rare circumstances. Contrary to the fears of some comments, the scope of concerns that the Executive Branch will raise in the context of [foreign investments] is narrow and well defined.” The commission also noted that “during our two years in administering the *Foreign Carrier Entry Order*, with approximately 140 authorizations granted to carriers with foreign ownership, the Executive Branch has never asked the Commission to deny an application on national security or law enforcement grounds.” Finally, the commission concluded, “We expect this pattern to continue, such that the circumstances in which the Executive Branch would advise us that a pending matter affects national security, law enforcements or obligations arising from international agreements to which the United States is a party will be quite rare.”<sup>75</sup>

The FCC could not have been more wrong. Regularly, if not in all foreign acquisitions, the DOJ, DOD, and DHS, as well as the Federal Bureau of Investigation (FBI), ask the FCC to withhold approval for a transaction until they can complete their security analyses and negotiate security commitments with the parties to the transaction. Since September 11, telecommunications lawyers have grown so accustomed to the security agencies putting a hold on FCC approval for foreign investments pending a security review that, in FCC applications, lawyers now stipulate that the FCC should not process an application for a license until CFIUS security agencies have stated for the record to the FCC that their national security concerns have been satisfied. Given that foreign firms easily achieved FCC approval for acquisitions of US telecommunications firms, one could credibly argue that the only difficult and uncertain regulatory process that foreign telecommunications firms face is Exon-Florio.

Moreover, since September 11, 2001, national security concerns about the telecommunications sector have grown for certain CFIUS agencies.

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75. In the Matter of Rules and Policies on Foreign Participation in the US Telecommunications Market, IB Docket No. 97-142, Order and Notice of Proposed Rulemaking, *Federal Communications Commission Record* 12 (1997): 7847, paragraph 63.

Before September 11 and the creation of the DHS, security agencies that participated in CFIUS were typically concerned about four national security issues.

First, the DOJ and FBI wanted to make sure that their ability to pursue investigations, conduct wiretaps and other surveillance activities, and gain access to data, such as billing records, would not be impeded by virtue of a carrier's foreign ownership.<sup>76</sup> They did not want to be in the position of needing data quickly from a telecommunications carrier based in the United States, but having acquisition of such data slowed by a foreign national or government that controlled the company.

Second, the DOJ and the FBI wanted to keep sensitive data out of the hands of foreign governments, and were concerned that a foreign company, either private or government owned and controlled, might share such data with a foreign government, through either loyalty to or pressure from that government. They believed that US citizens, or companies owned by US persons, would be less likely to have incentives to share such data.<sup>77</sup> In particular, the DOJ and FBI wanted to avoid foreign governments gaining access to information concerning the targets of US national security and law enforcement investigations, the nature of those investigations, and the sources and methods used, as well as information

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76. The DOJ and the FBI typically seek three types of data through court-approved subpoenas and other law enforcement processes: subscriber data (customer names, addresses, phone numbers, etc.); transactional data (details on calls, including the call length, number called, etc.; for voice over Internet protocol, or VOIP, calls, the DOJ and the FBI will seek similar data, including the session time, login and logout records, etc.); and communications data (the content of communications, acquired through wiretapping or review of e-mails, voice mails, or other electronic data). See, e.g., statement of Kevin V. DiGregory, Deputy Assistant Attorney General, Criminal Division, Department of Justice, before the US House of Representatives Subcommittee on Telecommunications, Trade, and Consumer Protection, Committee on Commerce, *Foreign Ownership Interests and Foreign Government Ownership Interests in the American Communications Infrastructure*, 106th Congress, 2nd sess., September 7, 2000, available at [www.usdoj.gov](http://www.usdoj.gov).

77. Statement of Larry R. Parkinson, general counsel for the Federal Bureau of Investigation, at the same hearing. He stated,

These [national security] concerns exist regardless of whether the controlling entity is foreign government owned. Even when the foreign entity controlling a US communications network is privately held, there is cause for concern that the foreign-affiliated carrier may be subject to the influence and directives of the foreign government or others to compromise US investigations and carry out or assist in carrying out intelligence efforts against the US Government or US companies. On a continuum of risk, however, a service provider that is directly or indirectly owned or controlled by a foreign government or its representatives falls on the higher risk end of the spectrum.

about the extent to which the US government was aware of a foreign government's intelligence activities.<sup>78</sup>

Third, DOJ was concerned about enforcing US privacy laws and unauthorized data sharing with foreign persons or governments. In testimony to Congress, Kevin DiGregory, a senior DOJ official, articulated a number of questions DOJ considers when reviewing foreign acquisitions of US communications companies:

- Does the proposed ownership interest create an increased risk of espionage, and foreign-based economic espionage in particular, against US companies and persons?
- Does the proposed ownership interest compromise US ability to protect the privacy of US citizens and their communications?
- Will US national security, law enforcement, and public safety capabilities be impaired by the proposed foreign ownership interests?
- Does the company have existing policies for protecting privacy, handling classified information, and complying with lawful process?
- Does the company have a good record of complying with lawful process related to national security and law enforcement capabilities?
- What is the degree and nature of the proposed foreign control?
- If the ownership interest is transferred to a foreign entity, does the United States have adequate assurances that National Security Emergency Preparedness and US Infrastructure Protection requirements are met?

Fourth, the DOD was typically concerned about acquisitions of US companies that held classified or sensitive communications services contracts with the DOD or other national security agencies.

Following September 11, however, CFIUS's security concerns about the telecommunications sector grew. As reported in the *New York Times* and other leading publications, US surveillance activity grew significantly after the attacks, and security agencies ensured that they could access lines owned or controlled by foreign telecommunications companies.<sup>79</sup> As discussed above, when President Bush added the DHS to CFIUS in 2003, an additional national security concern was given unprecedented focus: protection of critical infrastructure. The Clinton administration had pre-

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78. See statement by Larry R. Parkinson.

79. Eric Lichtblau and James Risen, "Spy Agency Mined Vast Data Trove, Officials Report," *New York Times*, December 24, 2005, A1.

viously identified this as a national priority,<sup>80</sup> but the DHS has made it a major focus of policy with respect to the telecommunications sector.<sup>81</sup>

The greater focus on broader electronic surveillance and protection of critical infrastructure can best be seen through the evolution of network security agreements (NSAs) between foreign carriers and the security agencies within CFIUS. To satisfy national security concerns, the security agencies within CFIUS—the DOD, DHS, DOJ, and FBI—require the parties engaged in the transaction to enter into an NSA. An NSA typically applies to any subsidiary, division, department, branch, or other component of the US telecommunications network receiving foreign investment that provides communications between locations in the United States, or that originates or terminates in the United States. The breadth and depth of an NSA depends on the perceived security risk of a particular transaction. The security assessment, in turn, depends on a number of factors, including the importance of the telecommunications system to US critical infrastructure; the location of tangible and intangible assets; business plans and proposed practices; the organizational structure of the acquirer and target; the degree and nature of foreign control; the level of national and international controls over the system's operations; political risks associated with the acquirer's home country, and that country's security or political relationship with the US government; the existence of classified or otherwise sensitive contracts with the US government held by the target, particularly with respect to US defense, law enforcement, and national security agencies; and relevant historical intercept activity. The greater the risk that the security agencies assign to a particular transaction, the tougher the requirements the acquirer can expect in the NSA.

Before September 11, NSAs negotiated between transaction parties and the US government typically focused on the ability of US law enforcement to conduct electronic surveillance and access data in telecommunications networks through wiretaps; it also involved the service of lawful process (e.g., wiretaps or data production) and preventing foreign governments from accessing data. Pre-September 11 NSAs also permitted calls originating and terminating in the United States to be routed outside the country for bona fide commercial reasons. Likewise, a telecommunications provider subject to an NSA had to maintain data and key network equipment, including network operating centers, routers, and switches, inside the United States, absent a bona fide commercial reason to maintain them abroad. Other pre-September 11 NSA requirements typically included pro-

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80. Among other actions, President Clinton issued Presidential Decision Directive 63 (PDD 63) on May 22, 1998, which established the national security objective of protecting US cyber and information networks from attack or disruption. The FBI created the National Infrastructure Protection Center, a public-private forum to coordinate critical infrastructure protection among federal, state, local, and private-sector stakeholders.

81. See HSPD-7, *supra* note 158.



hibiting foreign governments' access to data and content related to calls originated and terminated in the United States. Companies entering into an NSA also had to comply with US law enforcement requests to access data and conduct surveillance.

Since September 11 and the DHS's appointment to CFIUS, NSAs have become tougher, pursuing the much broader US government objectives of expanded electronic surveillance and protecting critical infrastructure. A number of recent NSAs have reduced telecommunications firms' flexibility to route domestic calls and maintain network equipment outside the United States, presumably to enhance US security agencies' ability to conduct electronic surveillance and access data for counterterrorism and law enforcement purposes. Post-September 11 NSAs have also borrowed heavily from security agreements typically utilized by the DOD to mitigate security concerns associated with foreign-owned companies that have classified defense contracts. To varying degrees, these NSAs have

- eliminated the bona fide commercial exception for data storage and call routing outside of the United States;
- eliminated the bona fide commercial exception for critical network equipment located abroad, thereby requiring the network to be controlled entirely from within the United States;
- permitted only US citizens to serve in sensitive network and security positions (e.g., positions with access to monitor and control the network);
- required third-party screening of senior company officials and personnel with access to critical network functions;
- restricted or prohibited the outsourcing of functions covered by the NSA, unless such outsourcing is approved by the DHS or occurs pursuant to approval by the DHS;
- given US government agencies the right to inspect US-based facilities and to interview US-based personnel on very short notice (as short as 30 minutes);
- required third-party audits of compliance with the terms of the NSA;
- required the implementation of strict visitation policies regulating foreign national access (including by employees of the acquiring company) to key facilities, including network operating centers; and
- required senior executives of the US entity, and certain directors of its board, to be US citizens approved by the US government and responsible for supervising and implementing the NSA.

These strict requirements have been applied in a number of transactions across multiple sectors of the telecommunications industry. The first post-

September 11 NSA that included these tough new requirements was signed by Global Crossing and Singapore Technologies Telemedia (ST Telemedia), after a heavily debated CFIUS process requiring a full 45-day investigation and ultimately a personal decision by President Bush.<sup>82</sup> Global Crossing is a large, backbone network based in the United States.<sup>83</sup> ST Telemedia is owned by the Temasek Group, the state-owned investment holding company of Singapore. The DOJ and DHS are believed to consider backbone networks as the most sensitive subsector in the telecommunications industry, because of the significant consequences to the US communications system if a major backbone network were to be disrupted. Similar tough agreements were also required for four much smaller transactions:

- Pacific Telecom’s (Philippines) acquisition of Micronesian Telecommunications Corporation (MTC), the local exchange carrier in the Northern Mariana Islands.<sup>84</sup> MTC served approximately 25,000 households and businesses, and provided digital subscriber line (DSL) and wireless services on the islands of Saipan, Tinian, and Rota, each of which are considered territories of the United States and therefore subject to Exon-Florio.
- Telefonica’s (Spain) acquisition of NewComm, the fifth-largest wireless carrier in Puerto Rico.<sup>85</sup>
- VSNL’s (India) acquisition of Tyco Global Network (TGN), a large, global backbone fiber network.<sup>86</sup> Importantly, however, the TGN, unlike Global Crossing, did not include a fiber network within the United States; it connects to the United States via a cable landing station. Thus, the component of TGN subject to US jurisdiction is extremely small. The Indian government owns approximately 26 percent of VSNL.
- Arcapita’s (Bahrain) acquisition of Cypress Communications, a provider of in-building telecommunications and a reseller of telecommunications services.<sup>87</sup>

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82. David M. Marchick, “Crossing the Line,” *Legal Week Global*, December 2003, 16–17.

83. Backbone networks are traditionally considered the part of the Internet or telecommunications system that connects traffic from multiple carriers to each other.

84. In re Bell Atlantic New Zealand Holdings, Inc., Transferor, and Pacific Telecom, Transferee, Order and Authorization, IB Docket No. 03-115, *Federal Communications Commission Record* 18 (November 6, 2003): 23,140.

85. In both the Pacific Telecommunications and Telefonica transactions, the NSAs did not require the appointment of a third party to audit compliance.

86. FCC Public Notice, DA 05-1268 (April 29, 2005).

87. In the Matter of Cypress Communications Operating Company, Inc., Application for Consent to Transfer Control of a Company Holding International Authorizations and a Blanket Domestic Authorization Pursuant to Section 214 of the Communications Act of 1934, as amended, IB File No. ITC-T/C-20041112-00448 (rel. June 28, 2005).

There have been a few exceptions to the recent trend toward tougher NSAs and commitment letters, primarily involving satellite sector acquisitions by the United States' closest allies, in particular the United Kingdom.<sup>88</sup> For Intelsat's acquisition of certain satellite assets from Loral,<sup>89</sup> and News Corp's acquisition of Hughes (which also held satellite assets),<sup>90</sup> the US government required only the appointment of a security or special audit committee, made up of US citizens with authority to supervise implementation of security commitments. These requirements, which were embodied in letters to the US government rather than an NSA, did not include the more onerous restrictions dealing with network control or data storage. In another recent transaction, British Telecom's acquisition of Infonet, a US-based communications company providing telecommunications and information technology (IT) services for multinational companies, BT committed to maintaining strong security policies, creating a "security board" in the US subsidiary (rather than at the board of director level in the parent), confirming the ability to run the US network from the United States in case of national emergency, and adopting broad, third-party screening of employees in sensitive network and security positions.<sup>91</sup>

Only CFIUS agencies are privy to the precise factors determining whether the parties to a given transaction are required to negotiate a broad, Global Crossing-like NSA, or a narrow, Intelsat-like exchange of letters. However, one can observe a few patterns that suggest how CFIUS analyzes the national security risks associated with transactions, and the measures required to mitigate those risks. Backbone and fiber networks seem to be viewed as more sensitive from a national security perspective than satellite or wireless networks are. The acquisitions of Global Crossing, Tyco, and Micronesian Telecommunications Corporation required broad and tough NSAs, even though the Tyco network barely touches the United States, and MTC is a relatively small local exchange carrier. The

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88. In the Matter of Intelsat, Ltd., Transferor and Zeus Holdings Limited, Transferee, Consolidated Application for Consents to Transfers of Control of Holders of Title II and Title III Authorizations and Petition for Declaratory Ruling under Section 310 of the Communications Act of 1934, as Amended, IB Docket 04-366.

89. Order, In the Matter of Loral Satellite, Inc. (Debtor-in-Possession), Assignors and Intelsat North America, LLC, Assignee, Applications for Consent to Assignments of Space Station Authorizations and Petition for Declaratory Ruling Under Section 310(b)(4) of the Communications Act of 1934, as Amended, File Nos. SAT-ASG-20030728-00138, SAT-ASG-20030728-00139, ISP-PDR-20030925-00024 (rel. February 11, 2004).

90. Petition to Adopt Conditions to Authorizations and Licenses (submitted by the DOJ and the FBI), Application of General Motors Corporation and Hughes Electronics Corporation, Transferors, and The News Corporation Limited, Transferee, for Authority to Transfer Control, MB Docket 03-124 (November 18, 2003).

91. BT-Infonet Security Letter (January 12, 2005).

MTC and NewComm transaction came on the heels of the Global Crossing transaction. As a result, the security agencies might have felt some constraints in negotiating a more flexible arrangement with MTC and NewComm than they did with Global Crossing. Acquirers based in countries considered to be close strategic and political allies to the United States are likely to be deemed a lower security risk. The BT and Intelsat security requirements seem to confirm that British companies will be seen as a lower national security risk than companies from other countries, consistent with the extraordinarily close US-UK security and political relationship. By contrast, CFIUS scrutinized the Tyco and Arcapita acquisitions very closely, perhaps reflecting the greater security concerns within the US government toward India and Bahrain respectively. Finally, government ownership tends to result in tougher security requirements: Again, witness the tough Global Crossing and Tyco agreements. A company ultimately owned by the government of Singapore acquired Global Crossing, and a company partially owned by the government of India acquired Tyco Global Network.

The recent NSAs demonstrate that the security commitments extracted by the US government through the Exon-Florio review process can impose significant costs on business. Limiting outsourcing, routing of domestic calls, data storage, and the location of network infrastructure can have considerable competitive effects, and raise issues of disparate treatment both between US- and foreign-owned companies and between foreign-owned companies that are similarly situated. While many US telecommunications companies have strong security policies and protocols, and cooperate with the DOJ, DHS, and FBI, none are subject to requirements comparable to the oversight resulting from an NSA. Similarly, foreign telecommunications companies that have made acquisitions in the United States after September 11 may face tougher and more restrictive security requirements than similarly situated companies that cleared CFIUS prior to that date. In the mobile telecommunications sector, in 2004 and 2005 Cingular acquired AT&T Wireless and Sprint merged with Nextel. If either of the acquirers had been a foreign company, the foreign party potentially would have faced a tougher NSA than that signed by Deutsche Telecom, which acquired VoiceStream in 1999, simply because NSAs signed in 2005 tended to be tougher and more comprehensive than those negotiated in 1999.

Ultimately, if the DOJ, DHS, DOD, and FBI are to achieve one of their key goals—enhancing the security and integrity of the domestic telecommunications system—they will need congressional authority to impose tougher security requirements on all telecommunications companies, regardless of foreign ownership and whether a foreign acquisition was made before or after September 11. However, unless Congress authorizes security agencies to impose security requirements across the board, regardless of capital affiliation, disparate treatment will unfortunately remain a fact

of life.<sup>92</sup> As the only regulatory hook available to security agencies, Exon-Florio will continue to be invoked to impose requirements, on an opportunistic basis and as individual transactions arise, regardless of any resulting unfairness in the treatment of one company relative to another. In our view, CFIUS needs to identify more precisely the incremental risks that genuinely relate to foreign ownership of US telecommunications companies, and narrowly tailor NSAs to those risks. CFIUS should not, however, be used as a back door way to pursue important yet broader telecommunications security goals but impose restrictions only on foreign-owned companies.

## Defense Acquisitions and Exon-Florio

With Exon-Florio's national security focus, the amendment has been used extensively to regulate FDI in the defense industrial sector. As both the principal customer for defense companies and guardian of the nation's military secrets, the DOD has a strong interest in regulating this industry. In practice, however, these two roles frequently pull DOD in opposite directions. As a customer, DOD values the competition and innovation that foreign defense contractors contribute to developing and procuring weapons systems. But DOD's strong interest in maintaining technological superiority over actual and potential enemies, protecting operational security, and guarding against sharing classified technology make it wary allowing classified information to fall into the hands of foreign-controlled companies. Moreover, the efforts of the domestic defense industry to persuade Congress and the Pentagon to "buy American" have historically tipped the balance toward a guarded approach to investment by non-US defense suppliers in research, development, and production facilities in the United States (Adams 2002).

In the late 1990s, the combination of these factors helped stimulate the Clinton administration to break down barriers to transatlantic defense industry collaboration. In 1999, a top DOD official called for "a 'competitive, transatlantic industrial model' characterized by industrial linkages of multiple firms, operating on both sides of the ocean, effectively competing in both the large European and US markets—and sharing technology albeit with, of course, effective external technology controls being applied."<sup>93</sup>

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92. For example, the Bush administration's attempts, repeatedly rebuffed by Congress, to gain authority from Congress to impose security requirements on domestic chemical facilities have been widely covered in the press. See, e.g., editorial, "Time for Chemical Plant Security," *New York Times*, December 27, 2005.

93. Speech by Jacques S. Gansler, Under Secretary of Defense (Acquisition and Technology) at the Defense Industry Business Forum, Toulouse, France, "International Defense Cooperation: The New Environment," December 6, 1999, available at [www.acq.osd.mil](http://www.acq.osd.mil) (accessed March 7, 2006).

Notwithstanding the US government's declared enthusiasm for closer defense industrial cooperation with its allies, foreign firms to date have established only a modest presence in the United States. Two British firms, BAE Systems and Rolls Royce, have established successful US subsidiaries that compete for defense contracts. Other major European defense companies have made inroads into the US market through joint ventures with American counterparts. Thales (France) has teamed up with Raytheon Systems, and the European Aeronautic Defense and Space Company (EADS), the European consortium, collaborates with Northrop Grumman. Firms from a few select Asian allies, including Australia and Singapore, have also established an important presence in the defense industrial sector.

In addition to the war on terrorism, the growing perception within the DOD that China represents a serious long-term threat to US security has influenced the application of Exon-Florio to the defense sector. As discussed in chapter 4, US concern about Chinese espionage in the early 2000s led to a series of prosecutions of Chinese nationals and US citizens of Chinese origin for illegally transferring defense-related controlled technologies. Washington's violently negative reaction to EU plans to lift its embargo of arms exports to China in 2005 also highlighted differing perceptions of the threat posed by China. Many in the Pentagon, and in the rest of the US national security establishment, view Europe, particularly continental Europe, as a weak link in the control of exports of sensitive technology to China.

Even without Exon-Florio, the US government would possess significant means to control foreign investment in the US defense industry. Under the National Industrial Security Program Operating Manual (NIS-POM; US DOD 1995), issued pursuant to executive order in 1995 and amended in 1997 and 2001, all DOD contractors must have a facility clearance to qualify for access to classified material or be awarded a classified contract. NISPOM establishes detailed criteria to determine when US companies cleared or under consideration for a facility clearance are under foreign ownership, control, or influence (FOCI). In some respects, these criteria sweep more broadly than Exon-Florio does. As chapter 6 discusses, NISPOM designates ownership of 5 percent or more of the company's voting securities by a foreign person as one of a number of factors to be taken into consideration in determining whether a company is under FOCI (US DOD 1995).

If a company with a facility clearance is determined to be under foreign control or influence, NISPOM directs the company's facility clearance to be suspended, thereby rendering the company ineligible for classified work. However, NISPOM also specifies a series of possible "methods to negate risk in foreign ownership cases" (US DOD 1995, § 306) that can allow a company under FOCI to receive a facility clearance. These methods are basically the same as those described below as necessary mitiga-

tion measures to secure CFIUS approval for foreign investments in the defense sector.

The voluntary notification to CFIUS of a transaction involving foreign investment in the defense sector starts a process similar, in many respects, to what NISPOM requires for companies found to be under FOCI. According to the DOD, “The major difference between CFIUS and FOCI reviews is that the CFIUS review is subject to time limits while FOCI is not” (US DOD 2003). Indeed, the time limits under Exon-Florio are important procedural safeguards for foreign investors and US companies being acquired. They guarantee that a foreign investor will obtain a decision, favorable or not, in a relatively short time. Without them, foreign acquisitions could be held in regulatory limbo for months, or even years, without a decision. Exon-Florio also requires the DOD to make certain specific determinations with respect to transactions notified to CFIUS, and the 1993 amendments to Exon-Florio require the DOD to determine if the company or business unit being acquired possesses critical defense technology under development, or is otherwise important to the defense industrial and technology base.<sup>94</sup> If either criterion is met, the DOD prepares an assessment of the risk of technology diversion, which is circulated to other CFIUS members.

If the DOD believes that the risks it identifies can be managed, it may also negotiate mitigation measures with the transaction parties. These generally fall into four categories (in ascending order of restrictiveness), mirroring the measures available under NISPOM:

- **Board resolution.** A board resolution certifying that the foreign shareholder shall not be given, and can effectively be precluded from, access to all classified and export-controlled information is sufficient when the foreign party to the transaction will not acquire voting stock sufficient to elect directors, and is otherwise not entitled to representation on the US company’s board of directors. A board resolution is typically used in cases in which there is limited foreign ownership and control of a company in the defense sector.
- **Limited facility clearance.** When the US government has signed an industrial security agreement with the parent government of the foreign party, a limited facility clearance can be granted, allowing that foreign party access to classified information is limited to performance on a contract or program involving the parent government.
- **Special security agreement (SSA) and security control agreement (SCA).** SSAs are less intrusive than proxy agreements, but still substantial

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94. *National Defense Authorization Act for Fiscal Year 1993*, Public Law 102-484, *US Statutes at Large* 106 (1992): 2315, codified at *US Code* 10, § 2537(c).

ways of limiting foreign control and influencing foreign companies handling classified contracts with the Pentagon. SSAs and SCAs create a subsidiary, but allow limited involvement in and oversight of the subsidiary by the foreign owner. Under a classic SSA, the US company acquired by a foreign owner must be governed by a board of directors, a majority of whom are US citizens, cleared by the Pentagon, with no ties to the foreign investors. In contrast to a voting trust or proxy agreement, in which the foreign owner is precluded from participating on the board, under an SSA or SCA the foreign owner can participate on the board so long as the directors it names remain in the minority and do not have access to or knowledge of any classified information.

- ***Voting trust agreement and proxy agreement.*** Under a voting trust or proxy agreement—two substantially similar approaches—the DOD requires a foreign investor to create a separate subsidiary to handle classified work with the Pentagon. Through a voting trust or proxy agreement, foreign shareholders agree to eliminate completely any rights to control, influence, or direct the operations or strategic direction of the subsidiary. Through these agreements, the foreign owners vest all of their rights and privileges as shareholders—except for receiving aggregated financial information and profits—to board members, all of whom have to be US citizens eligible for security clearances, and are appointed subject to Pentagon approval.

In practice, the other CFIUS agencies typically defer to the DOD on any defense acquisition by a foreign company. The DOD will take the lead in negotiating terms to mitigate foreign control and influence; only with an agreement with the DOD in place will CFIUS approve the transaction. Most defense acquisitions enjoy smooth sailing through CFIUS for three reasons. First, the DOD is not only the potential customer, but also the agency with authority over the NISPOM process, so most foreign acquirers of defense assets consult intensively with the DOD before filing with CFIUS. In many cases, acquirers even have informal consultations with the DOD before making an acquisition. Given that the DOD is a foreign investor's future customer, parties to a transaction are understandably loath to force a decision on it through CFIUS. Second, as mentioned above, the Pentagon has authority independent of Exon-Florio to regulate foreign acquisitions through NISPOM regulations, which are not subject to time constraints. The lack of statutory time constraints to force a DOD decision under NISPOM, and CFIUS agencies' deferral to the DOD on defense matters, make it almost pointless for parties to a transaction to start the CFIUS clock before concluding negotiations with the DOD on a mitigation agreement. Finally, a large percentage of defense acquisitions are by companies that have repeatedly been through the CFIUS process. These repeat customers have such close relations with the Pentagon that they typically



know the Pentagon's boundaries for acceptable and unacceptable acquisitions. In certain cases, frequent acquirers negotiate "umbrella" SSAs, under which trusted foreign defense contractors can place future acquisitions without needing to negotiate a new agreement.

Unlike the NSAs that CFIUS imposes on foreign parties in the telecommunications sector, SSAs remain confidential between the US government and the other signatory parties. It is difficult, therefore, to discern trend lines in the DOD's and CFIUS's approaches to foreign investment in the defense sector. Some steps appear to have been taken toward the end of the second Clinton administration to relax somewhat the controls that CFIUS imposes on foreign investors. In 1999 a senior defense official cited three steps to "improve the Department's industrial security policies": issuing an SSA to the Thomson-CSF aircraft training and simulation unit in Arlington, Texas, simplifying the national interest determination process for GEC Marconi's acquisition of Tracor, Inc., and removing a previous requirement for a proxy company so that Rolls Royce/Allison could be governed by a standard SSA.<sup>95</sup> For the most part, the Bush administration appears to have shown flexibility in foreign acquisitions of defense contractors. However, given the broader strategic factors at play since September 11, 2001, it seems reasonable to conclude that there has been some retrenchment compared with the relative liberalization of the late 1990s.



As discussed above, the Exon-Florio statute establishes a review process granting the president and CFIUS agencies remarkable flexibility, which CFIUS agencies have fully utilized by broadening their view of national security since September 11, 2001, and negotiating much tougher NSAs in recent telecommunications acquisitions. Notwithstanding the enhanced scrutiny by CFIUS agencies, a number of members of Congress and the GAO have recommended giving security concerns further weight under the Exon-Florio statute. These and other ideas for reforming Exon-Florio are discussed in chapter 6. But what are the economic effects of foreign investment in the United States in the first place? How much does the United States stand to gain or lose through tougher FDI regulations? These questions are taken up in the next chapter.

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95. Speech by Jacques S. Gansler, Under Secretary of Defense (Acquisition and Technology) at the Defense Industry Business Forum, Toulouse, France, "International Defense Cooperation: The New Environment," December 6, 1999, available at [www.acq.osd.mil](http://www.acq.osd.mil) (accessed March 7, 2006).