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FOREIGN INVESTMENT

Analyzing National
Security-Related Investments
Under the Exon-Florio
Provision

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SUMMARY OF STATEMENT BY ALLAN I. MENDELOWITZ
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The 1988 Exon-Florio Amendment to the Defense Production Act authorizes U.S. government review, and if warranted blockage, of foreign acquisitions of U.S. firms related to national security. The Amendment's review criteria, requiring "credible evidence" of a threat to national security, have applied in practice to a very narrow range of circumstances. The President has blocked only 1 of over 700 foreign investments reviewed under the provision, and that case involved the People's Republic of China.

Foreign acquisitions of U.S. firms are reviewed on a case-by-case basis at the time they are formally proposed. At this point, if the U.S. firm is in financial difficulty, the President may be faced with limited choices--either to approve the proposed investment as a welcome capital infusion helping to maintain the firm's production in the United States or to oppose the acquisition and watch the U.S. firm suffer continued business difficulties.

The Exon-Florio review process does not address public concerns about the broader issues of U.S. competitiveness in industry sectors essential to leadership in defense technology. Nor does it cover the range of international business relationships that raise technology transfer issues similar to those raised by direct equity investments.

Increasing global economic interdependence will require U.S. policies designed to assure that the U.S. technology base benefits from international relationships.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to testify today before this Subcommittee on some of the issues raised in our work regarding the administration's national security reviews of proposed foreign acquisitions.

As you know, the 1988 Exon-Florio Amendment to the Defense Production Act gave the President authority to investigate and block or suspend foreign investments that threaten to impair national security. This authority lapsed as of October 20, 1990, with the expiration of the Defense Production Act (DPA), but it was renewed in August 1991 in legislation separate from the DPA.

To assist the Subcommittee in its oversight of this statute, I will describe the results of our work on the following issues: (1) the types of difficulties experienced by the interagency Committee on Foreign Investment in the United States (known as CFIUS)¹ in applying the Exon-Florio criteria in its analyses of specific investments, (2) the government's limited ability to assure that U.S. firms that are acquired by foreign companies continue to produce defense-related items, (3) the broader public policy questions raised by foreign investments in key U.S. industry sectors, and (4) the increasing use of international partnership arrangements, in addition to direct equity investments, in U.S. high technology sectors.

DIFFICULTIES IN APPLYING EXON-FLORIO CRITERIA

The Exon-Florio provision established two key requirements for blocking proposed foreign investments in the United States. To exercise its provisions: (1) there must be a finding that credible evidence exists that the foreign interest might take action that threatens to impair U.S. security and (2) there must be a finding that provisions of law, other than the International Emergency Economic Powers Act, do not provide adequate authority to protect the national security.

Once CFIUS receives notification of a proposed national security-related investment, its focus has been on developing information, on a case-by-case basis, to address the law's specific requirements. CFIUS does not function as a means of assessing broader concerns about foreign ownership of the U.S. defense industrial base or technologically strategic industries.

We note that our previous work on the CFIUS process has indicated that even when a clear national security link has existed, CFIUS has been unable to find that the law's requirements were met as

¹By executive order, the President delegated his authority to review proposed investment transactions to CFIUS, which is chaired by the Treasury Department. The Departments of Defense, State, Commerce, the U.S. Trade Representative, and several other agencies are members or participants in the CFIUS review process.

grounds for blocking investments, except in one case involving a potential military adversary.²

Defining National Security

In practice, CFIUS first considers whether a proposed foreign investment is linked to national security. The Exon-Florio provision did not define "national security," but the accompanying conference report noted that the phrase was to be interpreted broadly and without limitation to particular industries. The implementing regulations, which were issued in final form in November 1991, also did not define national security.

Important concerns have arisen in public debate about how to define the industries and technologies that are national security related. A narrow definition could include firms that do the majority of their business with the Department of Defense (DOD) or as subcontractors to DOD prime contractors, as well as firms on which DOD is directly dependent. A broader definition could include industries and firms whose business is driven by the civilian commercial sector but, because of their leading edge technologies, are important to overall leadership in defense technology. DOD has issued a listing of what it considers to be critical technologies, but these technologies are not mentioned in the statute or its implementing regulations.

In practice, CFIUS has tended to focus on identifying the nature of the U.S. firm's relationship with defense-related work--i.e., whether it performs classified work for DOD, what contracts it may have with DOD, what percent of its production is defense related, and what portion of its research and development is defense related. CFIUS has tried to learn whether the foreign purchaser would be acquiring (1) sensitive U.S. technology subject to export licensing or (2) control over a scarce supply of goods that bear on national security.

If a national security link was evident, CFIUS has also sought information on the availability of alternate suppliers of the product, both domestic and foreign, and their market shares. Such information is not always readily available, especially for high-technology items. For these items, even minute differences in quality can be very important, and technological advances are constantly being made.

²See Foreign Investment: Analyzing National Security Concerns (GAO/NSIAD-90-94, Mar. 29, 1990); National Security Review of Two Foreign Acquisitions in the Semiconductor Sector (GAO/T-NSIAD-90-47, June 13, 1990); and National Security Reviews of Foreign Investment (GAO/T-NSIAD-91-08, Feb. 26, 1991).

The "Credible Evidence" Criterion

A key element of a CFIUS decision involves determining whether there is credible evidence that the foreign interest might take action that threatens to impair U.S. national security. To address this question, CFIUS examines the past behavior of the acquiring firms. To learn whether there may be such credible evidence, the Departments of Commerce, Defense, and State search their export control records for licensing and enforcement information. The intelligence agencies can also be called on to check, for example, for any known unauthorized technology transfers.

Past CFIUS cases make clear that it is inherently more difficult for CFIUS to argue that foreign firms from allied countries may threaten national security. The President blocked only one case out of the over 700 cases CFIUS has considered, and that case involved an investment from the People's Republic of China.

I would also like to point out, based on our previous reviews of CFIUS cases, that it is unclear whether CFIUS views anticompetitive behavior on the part of the foreign firm as constituting the type of threat to national security envisioned under the credible evidence provision. Examples of such types of anti-competitive behavior might be withholding from U.S. competitor firms supplies of the most technologically advanced components or engaging in cartel-like practices to damage U.S. competitors.

Foreign government subsidies are another type of anticompetitive behavior and have been highlighted recently as part of the public debate on the proposed purchase by Thomson-CSF, which is majority-owned by the French government, of the U.S. defense electronics business of LTV. The issue is that state-owned foreign firms may benefit from government subsidies and may thus have an advantage over U.S. firms in bidding to acquire U.S. firms and in competing with U.S. firms.

An important related issue raised in this proposed investment is that the foreign purchaser would be acquiring part of a U.S. firm whose critical technologies were initially developed with the help of U.S. tax dollars. The debate is particularly vigorous with respect to France because the French government has pursued a clear industrial policy and could be perceived as making this investment to advance the French government's strategic economic or military objectives.

Inadequacy of Other U.S. Laws

Another key element requires making a finding that other U.S. laws are inadequate to protect the national security. In past cases, such laws as the Export Administration Act, the Defense Production Act, and the antitrust laws have been considered by CFIUS in this regard.

We note that none of these laws can protect against a foreign-owned firm's decision to close down a U.S. factory or to change the firm's product line or research direction. While these laws cannot protect against a domestically owned firm's similar decision, foreign control of a U.S.-based firm means that decisions can be made abroad affecting the firm's research, product choice, and plant modernization.

ASSURING CONTINUED PRODUCTION AND SUPPLIES

In its first year of implementing the Exon-Florio provision, CFIUS had been willing to accept investments based on accompanying assurances from the foreign investor that the acquired firm would continue to maintain production and research in the United States. In subsequent years, CFIUS representatives have stated that the Exon-Florio provision does not provide the legal basis for obtaining such assurances and that such assurances tend to conflict with U.S. negotiating efforts to eliminate other countries' so-called "performance requirements". Presently, CFIUS has no capacity to monitor or enforce such assurances.

It is possible, also, that government-to-government security agreements may include assurances to DOD that defense-related supplies will be available. But we have not looked into the extent and coverage of any such agreements.

We note that the vast majority of foreign investments considered by CFIUS, and of foreign takeovers of U.S. firms in general, have been friendly, not hostile, acquisitions. In some of these acquisitions, the U.S. firm had initially sought a domestic buyer, but without success. Some of the U.S. firms were discontinuing their efforts in the industry segment as a result of low profitability, market uncertainties, or corporate realignments. In some CFIUS cases, the prospect of infusions of foreign capital appeared advantageous in actually strengthening U.S. defense-related firms, particularly when the alternative appeared to be closing or reducing the U.S. firm's operations.

BROADER PUBLIC POLICY QUESTIONS

CFIUS' reactive, case-by-case approach is focused on developing information to meet the law's specific requirements. But CFIUS is not presently set up to examine other larger questions such as (1) which industry sectors, technologies, or types of firms, if any, should be preserved for U.S. ownership; (2) why some U.S. companies have found it desirable to discontinue operations in certain high-technology sectors; (3) how to evaluate the extent and direction of technology flows resulting from foreign acquisitions; and (4) what steps need to be taken to prevent the erosion of U.S. leadership in defense technology.

CFIUS has very few options under the law; it reviews, investigates, and presents its finding to the President, who can block the investment if the law's requirements are met. When a foreign investment poses a choice between foreign control of an important U.S. firm and the firm's continuing to face business difficulties and reduced research expenditures, CFIUS has no middle ground of policy options to consider. CFIUS does not negotiate production assurances, assist in looking for a U.S. buyer for the firm, or seek to aid in facilitating carry-over financing or in improving the firm's business prospects.

Indeed, the present administration has stated that it remains strongly opposed to any sort of industrial policy, in which the government, not the market, would pick winners and losers. We note that many defense-related technologies are not market driven and that DOD provides extensive research and development funding for these technologies. When U.S. firms benefiting from such funding come before CFIUS as foreign investment cases, however, even these firms may be cleared for sale because it may not be possible to satisfy all the requirements of the Exon-Florio provision.

There is also the generic issue of foreign government ownership of U.S. defense contractors. The U.S. government does not own its defense contractors. Thus it is appropriate to ask whether it would be a good idea to have one of our prime defense contractors owned by a foreign government-controlled company. If the answer to this question is no, it should be recognized that Exon-Florio may not always provide a basis for government action.

There are also many defense-related firms whose business is driven by the civilian commercial sector but, because of their leading edge technologies, are important to overall defense technology leadership. These firms' commercial prospects can be damaged, and their defense contribution endangered, as they face competition from other countries' firms that do benefit from government encouragement to technologically important sectors. If U.S. firms are weakened as a result of such competition and need to sell some or all of their operations to investors, how will CFIUS and the U.S. government assess the proposed investment? It would only be at this late point that CFIUS might have to consider the investment.

These circumstances present the President with a very difficult choice--either permitting foreign direct investments irrespective of other considerations or seeing a security-critical firm go out of business. If the Congress and the Administration believe a wider range of alternatives would be useful, they need to consider whether a more proactive approach is needed to preserve U.S. leadership in defense-related technologies and possibly also in commercially strategic technologies. Initial steps have been taken by DOD and Commerce to identify strategically critical and emerging technologies, and some policy tools for advancing these

technologies are being considered. But we know of no administration guidance regarding the sale to foreign investors of controlling shares in U.S. firms that are developing these particularly critical technologies.

PARTICIPATING IN GLOBAL PARTNERSHIPS

As we noted in our report on Taiwan's proposed investment in the McDonnell Douglas Corporation,³ different types of international partnerships, in addition to direct equity investments, are becoming increasingly common in the aircraft sector and in other high-technology sectors. The need for such partnerships stems from (1) the very high costs and risks inherent in pursuing new projects in these sectors and (2) their usefulness in gaining access to foreign markets needed to generate economies of scale. Particularly in this period of downsizing and consolidation in defense-related industries, more such partnerships are expected.

Many of these partnerships, such as research and production agreements, can involve technology transfers similar to those possible in foreign direct investments. But unless an item or technology requiring export licensing is involved, the government may not have detailed knowledge of these partnerships, as it does when CFIUS reviews proposed foreign investments.

Governments of some industrialized countries tend to play a more active role than the U.S. government plays in tracking and encouraging their high-technology sectors. But this role is less transparent than the U.S. government role, which tends to be legally defined. For example, while the governments of France and Japan have few formally defined restrictions on inward foreign investments, the informal restrictions faced by foreign investors can be quite limiting. In France some U.S. investors seeking to acquire French firms have found that French buyers have appeared unexpectedly and succeeded in the bidding. In Japan the system of cross-shareholding has in effect meant that it is extremely difficult for a foreign firm to obtain a controlling block of equity, or even to gain representation on a board of directors.

While revisions could be made in the Exon-Florio provision with respect to foreign direct investment, the United States needs to recognize that, for some high-technology sectors such as aerospace and defense electronics, different forms of government encouragement and protection are a reality of the international marketplace. And they do affect the business prospects of U.S. high-technology firms. The U.S. government has sought in negotiations to limit such practices as government subsidization and domestic procurement preferences. But it also needs to focus

³See Foreign Investment: Issues Raised by Taiwan's Proposed Investment in McDonnell Douglas (GAO/NSIAD-92-120, Feb. 6, 1992).

on seeking assurances that U.S. firms can participate actively in the economies of other countries and benefit from their technological advances.

If international cooperative efforts are to become the hallmark of the decade of the 1990s, either through direct investments or other types of partnerships, the challenge for the U.S. government will be to see that as the United States maintains the general openness of the U.S. technology base, its companies can also benefit technologically from these global interrelationships.

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Mr. Chairman and Members of the Subcommittee, this concludes my prepared testimony. I would be pleased to try to answer any questions you may have.

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