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Why The Naiveté About U.S. National Security Policy Towards Foreign Investment?

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I advise, speak and write on global markets and business strategy. **FULL BIO**

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It's hardly a secret that enterprises based in large emerging markets are clamoring to invest directly in U.S. companies—as well as in companies based in other advanced countries with hospitable economic environments—particularly through the acquisition of existing businesses. Foreign direct investment (FDI)—the ownership or control by a foreign entity of 10 percent or more of a domestic enterprise—plays a modest but growing role in the U.S. economy. Problem is that an increasing number of these foreign investors are from nations where there is significant involvement in business decisions by governments whose agendas are perceived—indeed known—to go way beyond commercial objectives. China, while hardly alone in not having effective separation between government and business, and its FDI pursuits in the U.S., epitomizes the case.

The understandable response by the U.S.—and like-minded states—is to intensify its scrutiny of the national security risks such inbound transactions might pose domestically, particularly in sectors that even the most advanced of countries consider 'sensitive'. And some of the industries that used to not be considered 'sensitive' have begun to be treated so as it becomes more apparent that there is involvement of a foreign government with nefarious objectives that owns or controls the entity pursuing the investment.

While having an internal decision-making process that is a bit more opaque than comparator countries utilize, the U.S. policy framework for making these national security assessments, The Committee on Foreign Investment in the United States (CFIUS)—pronounced "syfius"—has existed since 1975. Despite the updating of its mandates in light of the profound transformation that has occurred in the tenor of the external political economy risks to which the U.S. is exposed, including terrorist threats—not to mention changes in the stance of our *own* political climate—CFIUS, which is an interagency body, does in fact have a well-spelled out set of procedures.

CFIUS is empowered to 'review' acquisitions of U.S. businesses by foreign persons—termed 'covered transactions'—to evaluate whether foreign control of such businesses will have an adverse impact on U.S. national security. Importantly, CFIUS filings are voluntary. Wisely on the part of smart acquiring parties,

filings have grown increasingly routine. In fact, many foreign buyers actually insist on filing even when there is no obvious potential national security impact. Indeed, it is now common practice before a bona fide filing with CFIUS to 'pre-file' in order to ascertain when an official filing will be deemed 'complete.'

When no national security risks are deemed to exist by CFIUS' review, a transaction will be cleared within 30 days; if a further assessment of these risks is needed, the committee can open up an 'investigation', which can last for an additional 45 days. If a 'covered transaction' is not cleared by the committee, CFIUS has the authority to unwind the transaction or impose mitigation measures on the foreign buyer if it deems there is a threat posed to the country's national security. If the committee is unable to resolve these issues and the parties to the transaction do not agree to cease proceeding, the President has 15 days to prohibit the consummation of the deal.

With full disclosure, I sat on CFIUS during my time in public service—years ago. (My doing so brought on frequent jokes from friends every time I would mention 'CFIUS', asking me, when they heard its pronunciation, if I was taking penicillin.) Occupying that position surely has subsequently given me a well-trained eye observing from the outside both how the CFIUS process has evolved and how it appears to operates today (with of course not being privy to any inside knowledge of the body's workings and deliberations whatsoever).

Notwithstanding my own experience, it should be abundantly clear from CFIUS' public track record over all these years, that like other countries' inbound investment decision-making calculus, the organization hardly operates in a domestic political vacuum. It may—though not always—be subject to various pressures both within the Executive Branch as well as from Capitol Hill.

While one might wish that not to be the case, that is the universal reality. This make all the more surprising the sometimes-sheer naiveté of potential foreign investors pursuing deals in the U.S.—not to mention that of the advisors inside the U.S. from which they seek counsel—about how to structure a strategy to deal with the CFIUS process.

The truth is that *every* economy in the world has a policy regime specifying in varying degrees the regulation of inflows of FDI. In *statutory* terms, the restrictiveness of U.S. regulation of FDI is about average for the 62 countries routinely assessed by the Organization of Economic Cooperation and Development (OECD)—the group of the world's wealthiest countries. (The OECD's assessment includes all of its 35-member countries, all the G20 countries, and a number of other countries that are less wealthy.) Moreover, as a matter of *practice*, there are exemptions granted by the U.S. from these formal regulations, particularly at the state level.

That CFIUS decisions blocking or demanding the restructuring of inbound transactions—which are actually few in number—may be subject to political pressures, sometimes based on quite spurious reasons, as politicians the world over are wont to do, overall, U.S. regulatory constraints on inbound FDI are effectively benign.

The most compelling proof of this are official data that the U.S. is the world's largest recipient of FDI flows in absolute terms, and it has been so ever since 2006 (except for the brief 2010-2014 period, when comparable inflows to China were slightly larger). Some professional services firms like to cite their surveys of foreign business executives' *perceptions* of the U.S. investment climate and aspirations for prospective transactions here—for which the U.S. is often ranked highest in the world—as evidence of the country's hospitable environment. While such findings may be heart-warming, these measures are not data-driven. Their economic meaningfulness is not robust nor can they be used to make systematic cross-country comparisons. Perception indices are 'old-school'. In a nutshell, they do not reflect investment decisions actually undertaken, which really is the only meaningful basis on which a country's policy stance can be assessed and on which policy reforms should be formulated.

Some readers will be surprised to learn that today U.S. inflows of FDI are the highest in the world, believing that China surely would have been a larger recipient. In 2016, China's inflows of FDI were US$171 billion, while those of the U.S. were US$468 billion, about 2¾ times greater. It is true that China does take in a huge amount of foreign direct investment; it's of course the largest nation in the world. Taking into account the relative sizes of countries would thus make sense in making such judgments. On this basis, FDI inflows in 2016 for China were US$97 per capita; for the U.S. they were US$1193 per capita. It is also the case that *annual flows* of FDI for any country can fluctuate greatly, especially for a year when one-time, large foreign acquisitions of domestic firms take place. For these reasons, cross-country comparisons are best made on the basis of *cumulative* inflows—or the 'stock'—of FDI. In this context, as of year-end 2016, the stock of FDI per capita in the U.S. was US$19,491; in China it was $980.

Why do I say CFIUS cases are few in number? Because, the federal government actually reviews only a small fraction of the hundreds of proposed foreign acquisitions each year. In 2016, the latest year for which data exist, a total of 172 notices were filed for 'review' with CFIUS compared to 155 notices submitted in 2008.

Since parties voluntarily file with CFIUS, they also have the right to unilaterally withdraw from proceeding with their proposed deals due to any national security concerns signaled by CFIUS during the initial 30-day review period. The share of such withdrawals has not changed much: in 2016, 19% of the review filings were voluntarily withdrawn by the parties due to such 'upstream' signals; in the 2015 the comparable figure was 23%, and in 2014 it was 17%. Moreover, while there has been a sizeable increase in the number of CFIUS filings that have progressed to the subsequent formal 'investigation' phase, 46% of the filings in 2016 versus 6% in 2006, the fraction of such transactions that were subject to mitigation measures required by CFIUS has not grown substantially in recent years—8% in 2015 compared to 6% in 2014, the only two recent years for which CFIUS has disclosed such data.

While these withdrawals are strictly speaking voluntary, of course they do reflect self-selection incentives parties to a transaction face to *not* proceed toward consummation of deals based on the signals transmitted by CFIUS, a dynamic deliberately built into the CFIUS screening process.

Over the life of CFIUS, Presidential decisions to block acquisitions have occurred only in a few instances: most notably in 1990, when President George H. W. Bush blocked the sale of Seattle-based Mamco to a Chinese state-owned aviation enterprise; in 2012, when President Barrack Obama mandated the divestiture of wind farms in Oregon by the Chinese-owned Ralls Company, and in 2016, when President Obama prohibited the takeover by a Chinese state-owned firm of a U.S.-based subsidiary of Germany's Aixtron, a semiconductor manufacturer whose products have military applications.

But the politicization of the CFIUS process has been far more evident when the U.S. legislative branch has gotten involved in the scrutiny of foreign acquisitions of U.S. business. This is because the present-day authority undergirding CFIUS' decision-making process derives from laws enacted by the U.S. Congress. Specifically, the Omnibus Trade Act of 1988 incorporated the so-called 'Exon-Florio Amendment' to the Defense Production Act of 1950, which enshrined CFIUS' erstwhile administrative functions in to law—an action spurred on by the attempt of Japan's Fujitsu to acquire Fairchild Semiconductor in 1987.

Two cases illustrate this point quite clearly. One is Capitol Hill's vehement opposition in 2006 to the acquisition by the UAE's Dubai Ports World of several major U.S. port operations. The transaction already had been consummated following the approval of both CFIUS and President George W. Bush. In the face of legislative action by the Congress, Dubai Ports World faced little choice but to sell its newly acquired assets in the U.S. to U.S. third parties.

The other case was the 2013 sale of the pork products company Smithfield Foods to the Chinese firm Shuanghui. It was the largest Chinese purchase of a U.S. company in history. As CFIUS was in the throes of its process of deciding whether or not to approve the sale, the U.S. Senate Committee on Agriculture, in an unprecedented move, held hearings on the threat the proposed transaction would pose to the safety of the U.S. food supply chain.

It was truly a poignant moment in the politicization of the CFIUS process—for two reasons, both of which have powerful lessons moving forward. First, the acquisition had little, if anything, to do with China's interest in sales of pork *within* the U.S. market; rather Shuanghui's objective was to actually increase U.S. *exports* of pork to China, which it has subsequently done. Second, Smithfield Foods and its U.S. advisors had blinders on as to their fundamental understanding of the perceived political ramifications of the deal as seen through the eyes of U.S. politicians—whether or not such perceptions were rational. They were stunned that a deal combining the elements "China" and "U.S. food" would even merit voluntary notification to CFIUS. Given all that has transpired in the political realm of Chinese investment in the U.S. over the past couple of decades, to say they were naïve would be an understatement.

Given the continuing prominent influence, whether explicit or implicit, by the state in the affairs of its largest enterprises—those who are obviously most prone to invest overseas—China's attempts to make acquisitions in U.S. sectors where Washington believes the country's national security is at risk, will continue to face significant hurdles. Indeed, because of Beijing's significant maintenance of control in the nation's businesses, coupled with the growing threat of cyber-attacks emanating from China, industries in the U.S. that might not have received the same degree of scrutiny by CFIUS in previous years are now squarely in the cross-hairs.

In this context, the U.S. financial sector is front and center. For better or worse it then really should have not been much of a surprise to the Chinese—or their U.S. advisors—that CFIUS blocked the acquisition by Alibaba's affiliate, Ant Financial, of MoneyGram in January 2018. Against this backdrop, China's Oceanside might well be prepared for disappointment in its attempt to acquire the Virginia-based insurance company Genworth.

Mind you, the objective here is not to defend the politicization of the CFIUS process. It is far simpler: to ignore it would be folly.

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