Foreign Investment Laws and National Security: Lessons from Exon-Florio

David M. Marchick

Mark E. Plotkin

David N. Fagan

Last summer, French politicians expressed concerns over rumors that PepsiCo was seeking to acquire Danone, the French yogurt and water company. French Prime Minister Dominique de Villepin went so far as to identify "[t]he Danone Group [as] one of the jewels of French industry" and promised "to defend the interests of France"[1] against the potential threatening acquisition by PepsiCo. Subsequently, and notwithstanding existing mechanisms for reviewing certain foreign investments affecting security interests, the French government announced that it would establish a list of "strategic industries" to be shielded from foreign investment.

Leaving aside the merits of any claims about the strategic significance of yogurt - which, as it turned out, did not make it on the French government's list of strategic industries to be shielded from foreign ownership - the French reaction to the potential PepsiCo acquisition was not unusual or, for that matter, unexpected. Most every country provides certain sector-based limitations on foreign ownership, but often these limitations are narrowly defined to focus on particularly sensitive domestic industries. Over the last year, however, a number of countries have begun to reevaluate their laws governing permissible foreign direct investments ("FDI") and to consider proposals that would impose tighter national security-based restrictions on FDI and/or define such restrictions in broader economic and strategic terms. For example:

- Following President Vladimir Putin's call for a new law to protect "strategic industries," the Russian Ministry of Natural Resources recently presented a proposal identifying specific natural resource deposits that would be subject to a new Law on Natural Resources, which would effectively restrict the percentage of foreign ownership in those deposits. Not surprisingly, those within the Russian government supporting greater restrictions on foreign investment in "subsoil" resources have justified their position as preserving "national security."

- In Canada, the Minister of Industry last summer proposed amendments to the Investment Canada Act - which currently requires review of investments of a certain monetary value or in certain specified sensitive sectors to determine their "net benefit" to Canada - that would permit the review of any foreign investment, regardless of size or sector that could compromise "national security."

[1] LCI News, July 20, 2005, located at http://np.www.lci.fr/news/economie/0,,3232812-VU5WX0IEIDUy,00.html.

[There is] an argument that says because the United States already has a law (Exon-Florio) restricting foreign investment on national security grounds, so too should we. Thus, the U.S. experience under Exon-Florio has become a central issue for policy debate both at home and abroad.

- Closer to home, Members of the U.S. Congress have proposed legislation that, among other things, would expand the U.S. law for reviewing investments on national security grounds - the so-called "Exon-Florio Amendment" to Section 721 of the Defense Production Act of 1950 ("Exon-Florio")[2] - to include national economic or energy security as permissible bases for restricting FDI. These amendments would also give Congress the right to overturn a Presidential decision allowing a foreign acquisition to go forward.

While distinct, the proposals France, Russia, Canada, and the United States share some common ground. Fundamentally, the four proposals signify, to varying degrees, the potential appeal of protectionist sentiments, and the Canadian and U.S. legislative proposals even share a common impetus for such protectionism - both were spurred in part by failed bids by Chinese companies for leading domestic natural resource companies.[3] Perhaps most important, though, in the case of France, Russia, and Canada, there also has been a common, if overly simplified, outward-looking thread in the debate over the proposals - namely, an argument that says because the United States already has a law (Exon-Florio) restricting foreign investment on national security grounds, so too should we. Thus, the U.S. experience under Exon-Florio has become a central issue for policy debate both at home and abroad.

In light of this heightened focus on Exon-Florio, this essay reviews how Exon-Florio in practice has largely been an effective mechanism to guard U.S. national security interests while still promoting FDI, and draws from this experience lessons for lawmakers considering changes to Exon-Florio and similar national-security based revisions to investment review laws in other countries.

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[2] Omnibus Trade and Competitiveness Act of 1988 § 5021, Pub. L. No. 100-418, 102 Stat. 1107 (codified at 50 U.S.C. App. § 2170).

The United States also has certain sector-specific laws, such as in the areas of maritime and air transportation, mineral lands, and the defense sector, that include restrictions on foreign ownership. The sector-specific laws typically were adopted in the aftermath of World War I and were justified on national security grounds.

[3] In Canada, the proposed amendments in part were a reaction to China Minmetals Corp.'s bid for Noranda, Inc., a leading Canadian mining company, while supporters of expanding Exon-Florio in the United States to include economic security received a boost from the public and Congressional reaction to the failed bid of China National Offshore Oil Corp. for Unocal Corp.

Background

The Exon-Florio law, whose original three-year authorization was made permanent in 1991,[4] provides broad discretion and flexibility to the President to investigate foreign acquisitions, mergers or takeovers of, and investments in, U.S. companies from a national security perspective and to block an acquisition if (1) "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 (2) other laws, with the exception of the International Emergency Economic Powers Act (which provide the President with certain emergency authorities), "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."[5]

The President has delegated his initial review and decision-making authorities and his investigative responsibilities to the Committee on Foreign Investment in the United States ("CFIUS").[6] CFIUS is chaired by the Department of Treasury and has eleven other members, including the Departments of State, Defense, Justice, Commerce and Homeland Security and the United States Trade Representative, among other agencies. Thus, certain of the CFIUS agencies have as their mandate law enforcement, defense and homeland security, while other agencies are oriented to promoting an open trade and investment policy. This tension among the member agencies is designed to elicit thoughtful judgments that take into account diverse economic and security considerations through a consensus-building deliberative process.

In practice, the diversity among the CFIUS agencies and the consensus-based framework in which they express their views enable the Executive Branch to weigh carefully the national security impact of particular foreign direct investments in a manner that is consistent with the U.S. government's overall policy of promoting FDI. That is, for any transaction, CFIUS begins its review from the premise that FDI is welcome in the United States. From that premise, the CFIUS agencies then analyze whether the potential national security threat of a particular transaction is so great and unmitigated that it overcomes the presumption in favor of, and necessitates Presidential action to prohibit, the investment.

The assessment process undertaken by CFIUS is itself quite flexible. A number of factors - including, for example, the absence of any statute of limitation for a CFIUS review, the lack of any statutory or regulatory definition of "national security," and the breadth of the term "foreign control" in the statute and regulation - ensure that the Executive Branch has broad authority to review investments for potential national security implications while also affording the transaction parties ample opportunity to advance arguments for why a transaction does not threaten national security. The CFIUS process also affords both the transaction parties and the government broad room to negotiate arrangements that will mitigate any national security concerns and permit investments to proceed on grounds that ensure their commercial viability. Most often, this negotiation will occur prior to a formal filing that begins the statutory clock for CFIUS's review,[7] so that there is certainty once such a filing is made.

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[4] Pub. L. No. 102-99, 105 Stat. 487.

[5] 50 U.S.C. App. § 2170(e).

[6] *See* Executive Order 12661 (1988).

[7] As discussed infra, the governing statute and regulations establish a formal review process that can last between 30 and 90 days. That timeframe is triggered either upon a voluntary filing by one of the parties to the transaction or upon an agency notice filed by one of the CFIUS members, although the latter circumstance is exceedingly rare.

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The flexibility in the CFIUS process has produced at least three, related results. First, at a high-level, Exon-Florio appears to have had a minimal impact on the overall flow of FDI into the United States, which remains the leading recipient of FDI in the world. Indeed, over the last 17 years, only about ten percent of all FDI in the United States has been subject to even a minimal level of review by CFIUS, less than one percent of those transactions have been fully investigated, and only one transaction in history has been formally rejected by the President - a 1990 investment by a Chinese state-owned company in a U.S. defense contractor in the aviation sector.

Second, many transactions that potentially touch on U.S. national security interests have proceeded because the CFIUS process has enabled the government to negotiate (often creative) commitments from the transaction parties to mitigate any potential national security threat. In particular, the flexibility of the statute enables the negotiation of agreements - and, when appropriate, subsequent modifications to such negotiated agreements - that reflect an evolving threat environment. For example, in the immediate aftermath of September 11, 2001, security agreements governing foreign investment in the telecommunications sector as a general rule became significantly tougher.

Third, potential foreign bids that truly would impair the national security have been deterred. While it is impossible to know the exact number of such bids, the prospect of a CFIUS review undoubtedly has prevented potentially controversial offers from ever being made. Moreover, parties to many other agreements over the years have, once confronted with CFIUS resistance, elected to withdraw the transaction rather than have it be formally disapproved.[8] This deterrence factor and the number of withdrawals help explain the low number of transactions that have proceeded to an investigation and the fact that only one transaction has been rejected by the President.

[8] This is not to say that all withdrawals, or even a majority, result from the threat of disapproval. There may be a variety of other reasons, ranging from the parties backing out of the transaction for commercial reasons to a desire to avoid the "taint" of an investigation. Because CFIUS does not keep or publish data on withdrawal that occur prior to an investigation, it is impossible to know the exact number of such withdrawals or all their reasons.

While, in our view, CFIUS in the wake of September 11 at times has been overly cautions and imposed unnecessary and overbroad security requirements,[9] these three results demonstrate that, over the course of its 17-year history, CFIUS generally has administered the Exon-Florio statute, as its drafters intended, to be a mechanism to review the national security implications of certain inward investments but not to interfere with the United States' broader policy support for free investment flows.

Lessons from the Exon-Florio Experience to Date

CFIUS' ability to administer Exon-Florio in a manner that still permits open investment flows is potentially instructive for lawmakers abroad considering similar national security-based investment review laws, as well as those in the United States who would propose changes to Exon-Florio. The system, however, is not perfect, and there are important lessons to be gleaned not only from its successes, but also from its vulnerability to politicization, the pressures that Congress can seek to impose over the Exon-Florio review process, and the historical debate in the United States over the appropriate grounds to review foreign investment. In light of these lessons, and based on our experience advising companies on successfully navigating the Exon-Florio process, we offer seven principles that should be kept in mind as Exon-Florio is debated here and that may be helpful for debates in other countries over how to create a process that allows for a reasonable review of investments on national security grounds while still promoting overall inward direct investment.

1. A Broad National Security-Based Investment Review Process Should Be Voluntary, Not Mandatory.

To attract foreign investment, it is vital that a market avoid imposing unnecessary regulatory hurdles and provide as much flexibility to the investing parties as reasonably possible. In the context of a national security-based investment review regime, the experience under Exon-Florio has demonstrated that a process that provides the parties with discretion to file for review - and the reviewing agencies discretion to initiate a review in the absence of a voluntary filing - is more than sufficient to protect national security. In fact, as noted, companies will prefer to file first with CFIUS and receive approval if there is any reasonable argument that the transaction could touch on national security interests, rather than consummate a transaction and risk CFIUS initiating a later review that could unwind the transaction. Thus, in practice, a voluntary filing system sufficiently enables the government to review those transactions that could potentially cause concern, without being distracted by transactions that have no bearing on national security.

By contrast, a mandatory filing system for a national security review would be unwieldy. Requiring all transactions to be reported to the reviewing agencies, when only a small percentage of those transactions are relevant to the agencies' considerations, could overload the review mechanism and impose unnecessary bureaucratic delays upon uncontroversial foreign investment that should otherwise be welcomed by the receiving country. Moreover, the sheer volume of filings that would accompany a mandatory system could make it more difficult for the reviewing agencies' to identify which transactions genuinely present national security issues and could undermine the agencies' ability to devote the time and resources necessary to review and investigate such transactions and to develop appropriate mitigation measures.

[9] This shift reflects a number of factors, including the addition of the Department of Homeland Security to CFIUS and a heightened focus on protection of critical infrastructure.

Furthermore, given the very essence of national security-based investment reviews, confidentiality is imperative to preserve the interests of the government. Not only would disclosure regarding a government's judgments on national security issues embarrass the parties to the transaction and the host country of the acquirer, the government's own security interests could be compromised.

2. The Review Process Should Provide Predictability to Transaction Parties by Ensuring that Reviews Will Be Conducted Within a Definite Timeframe.

The Exon-Florio statute provides for an initial 30-day review of a transaction, which CFIUS considers to be triggered upon a completed filing by the parties. If the agencies either determine that a threat exists or the agencies are divided - or if the acquiring party is owned by a foreign government - CFIUS then conducts the statutorily mandated "investigation" for an additional 45 days, followed by a Presidential decision within 15 days.

While virtually every participant in the CFIUS process complains about the statutory deadlines - the parties to a transaction typically believe the process takes too long, while the security agencies complain that the process is too short - the deadlines have increasingly proved critical to achieving the objectives of the statute while ensuring the United States remains open to foreign investment in all sectors. Importantly, they have provided predictability for foreign investors - at a minimum, foreign investors can expect an outcome, one way or another, within at most 90 days. Without such predictability, many investors would never make an investment because of the uncertainty.

This is not to say that the exact timeframes implemented under Exon-Florio are necessarily the best ones, although a 90-day maximum should offer most governments a reasonable amount of time to complete their review and reach a decision. The breakdown of how that time is allotted among the initial review, further "investigation," and a final decision, however, can be flexible. For example, some argue that the Exon-Florio process might be improved by allowing 60 days for the initial review, followed, if necessary, by 15 days for "investigation" and 15 days for the Presidential decision. Such a 60-day initial timeframe might invite parties to file more quickly once a transaction is announced - rather than engage in a lengthy and, if the transaction is controversial, potentially unproductive consultative process before filing - and would allow both sides more time to negotiate an approval before moving to the more pressurized "investigation" stage.

3. The Review Mechanism Should Ensure Confidentiality.

Strict confidentiality within an investment review mechanism is essential to ensure parties have confidence in the government and its regulatory mechanisms and can trust that confidential business and proprietary information will not be compromised, whether by

revelation to the public or to domestic competitors. Furthermore, given the very essence of national security-based investment reviews, confidentiality is imperative to preserve the interests of the government. Not only would disclosure regarding a government's judgments on national security issues embarrass the parties to the transaction and the host country of the acquirer, the government's own security interests could be compromised.

In the United States, information submitted to CFIUS through the Exon-Florio process is exempt from public disclosure. By statute, the President must provide a quadrennial report to Congress and also report to Congress any time he personally makes a decision on a particular transaction, but the President does not have to provide detailed transactional data. Indeed, while it would be entirely appropriate for CFIUS to provide aggregate data to Congress (e.g., trends in the number of filings, investigations withdrawals and presidential decisions, data on the origins for the investments, etc.) and to provide high-level classified briefings to key congressional committees on the types of national security issues that CFIUS has reviewed, CFIUS should not share confidential business information with Congress. Members of Congress will always vigorously advocate for constituents, including business interests in their districts or state. Accordingly, providing Congress with confidential business information obtained through the CFIUS review process would increase the risk that the information could be leaked for a particular political end, for example to strengthen public opposition to a particular foreign buyer or to promote a constituent who had interest in the party being acquired. Similar concerns would attach to sharing confidential business information with the politically driven legislative body in another country.

4. Ensure That the Investment Review Law is Focused on Maintaining National Security, and Does Not Permit Review Based on Economic Factors.

In adopting the Exon-Florio amendment, and in subsequent proposals, Congress debated requiring the President to consider a number of economic factors in assessing whether a transaction threatened national security or essential commerce. On each occasion, proposals focused on economic security have been rejected as inconsistent with a policy of open investment. This undoubtedly is the right result for a country truly committed to free trade and open investment, as proposals to provide review based purely on "economic" considerations typically just give voice to protectionist concerns over foreign competition, have no grounding in the actual economic welfare of the entire nation, and would be inconsistent with well-accepted principles of international trade.

5. Investment Review Decisions Should Be Insulated from the Politics of Legislative Bodies.

Recent experience under Exon-Florio in the United States underscores the need for any national security-based investment review process to remain insulated from the political influences that often find voice in national legislatures. The Exon-Florio process has become increasingly politicized as losing bidders and other external parties seek commercial advantage by urging Congress to interject itself into the Exon-Florio review process. While the CFIUS agencies have largely remained immune from political influence in analyzing the substance of their national security considerations, Members of Congress, often catering to particular constituents' interests, have frequently made known their concerns regarding a transaction in an effort to pressure CFIUS to apply closer scrutiny or even prohibit a particular investment. Such politicization of an investment review process can distract from the primary focus of the investment review process - namely, to ensure that investments do not infringe upon national security interests. Equally important, the

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politicization can increase uncertainty for investors, employees and customers of the transaction parties, and threaten to chill the investment market, thereby lowering capitalization values for domestic companies.

6. The Review Process Should Be Led by an Economic Agency, with Consultation from the Security Agencies.

Since the enactment of Exon-Florio, there has been some debate in the United States over which agency would be most appropriate to chair the CFIUS process. The original amendment offered by Senator Exon in 1988 placed the responsibility for heading the interagency review process with the Secretary of Commerce. Indeed, the Exon-Florio Amendment does not itself designate a chair but rather leaves that decision to the discretion of the President. President Reagan designated the Department of Treasury, the most investment-friendly Cabinet agency, to chair CFIUS and implement Exon-Florio.

Designating Treasury as the chair of CFIUS was consistent with the purpose of Exon-Florio. The legislation was not intended to block or even require reviews of most investment in the United States. By designating Treasury as the CFIUS chair, the Reagan Administration signaled its intent to continue to welcome foreign investment. By contrast, the placement of a security agency (e.g., the Department of Defense or Homeland Security) as chair of CFIUS would contribute to a shift in the presumption: unless the parties could prove that national security interests were not implicated, foreign investment in particular sectors would be presumed unwelcome.

7. Where There Are Laws Designed To Protect Specific Domestic Industrial Sectors, Such Laws Must Provide Clarity to Potential Foreign Investors and Domestic Parties.

As noted, virtually every country in the world limits foreign investment in certain sectors. Even with such sector-based restrictions, though, one of the hallmarks of a sound foreign investment policy must be clarity. Such clarity is vital to maintaining an environment that promotes investment. Indeed, uncertainty often can be one of the greatest impediments that countries confront in attracting investment. Investors prefer bright lines over doubt. A lack of clarity in laws restricting investment in even only a few sectors can stigmatize investment in all sectors. Accordingly, should a country determine for national security or other reasons that it must restrict investment in particular sectors, it is vital that such restrictive laws be as transparent as possible.

Pursuing economic growth and development while preserving national security interests requires a fine balance. The United States has attempted to strike the balance between economic and national security by maintaining a formal policy of open investment while implementing certain sector-specific laws that limit foreign ownership and providing a broad-based review process for transactions that might implicate national security. While the United States' approach is not necessarily a model for every country to follow, it may be illustrative for countries that are considering implementing national security-based reviews of foreign investment. ❖

About the Authors

David M. Marchick

David Marchick is a leading authority on the Exon-Florio amendment to the Defense Production Act of 1950. Among others, Mr. Marchick advised IBM in the sale of its personal computer division to Lenovo; Global Crossing with respect to the proposed investment from Hutchison Wampoa and completed investment from ST Telemedia; and BT in its acquisition of Infonet. Mr. Marchick has also testified before the Senate Banking Committee on Exon-Florio issues, provided legal and policy advice to the Russian government on national security reviews of foreign investments and has written widely on the subject, including in the Financial Times. Along with Edward M. Graham of the Institute for International Economics, Mr. Marchick is writing a book on the national security implications of foreign investment, expected for publication in the spring of 2006.

From 1993 to 1999, Mr. Marchick served for seven years in four departments in the Clinton Administration. He served as Deputy Assistant Secretary of State for Transportation Affairs, where he was the Senior U.S. Negotiator for bilateral aviation agreements. Prior to this assignment, Mr. Marchick served as Deputy Assistant Secretary for Trade Policy at the State Department and Principal Deputy Assistant Secretary of Commerce for Trade Development. Mr. Marchick also served in various international trade policy positions at the White House and the Office of the United States Trade Representative.

Mr. Marchick holds a law degree from the George Washington University, a Masters degree in Public Policy from the LBJ School of Public Affairs at the University of Texas at Austin, and a Bachelor of Arts in History from the University of California, San Diego. He serves as Senior Advisor to Kissinger McLarty Associates, the strategic advisory firm founded by Secretary Kissinger and former White House Chief of Staff Mack McLarty.

Mr. Marchick is married to Pam Kurland, a health care attorney in Washington D.C., and has a daughter, Hannah, and son, Zachary.

Mark E. Plotkin

Mark E. Plotkin, a partner in Covington & Burling's Washington office, chairs the firm's Electronic Commerce and Information Technology practice as well as its Commercial, National and Information Security group; he also is a member of the firm's Financial Institutions practice group. Mr. Plotkin counsels clients on security, financial services regulation and technology issues, and represents them before U.S. and foreign government agencies in connection with major transactions as well as significant enforcement and regulatory matters.

Mr. Plotkin has served as advisor, counsel and strategist to such leading companies as AstraZeneca, AT&T, Bacardi, Bank of America, Bank One, Brown Brothers Harriman, Canon, Dana Corporation, FleetBoston, General Electric, Global Crossing, Goodyear, Merck, Microsoft, the National Football League, New York Life, Patagonia, Sun Life Financial, Wilmington Trust Company and Yahoo!, among others. He also represents start-up and emerging electronic commerce companies, including having served as outside general counsel to stored-value card pioneer Mondex USA since 1996.

Mr. Plotkin has testified before Congress on matters relating to electronic payments, and has worked on behalf of clients to establish new legal standards relating to the security of corporate networks, websites and electronic transactions, the regulation of financial services, and the protection of consumer and employee privacy. He also has chaired conferences, conducted seminars and spoken at forums relating to security, consumer protection, electronic transactions and financial services for the American Bankers Association, American Bar Association, American Conference Institute, Federal Trade Commission, Federal Deposit Insurance Corporation, Federal Interagency Consumer Electronic Payments Task Force, Federal Reserve Bank of San Francisco, Practicing Law Institute, Smart Card Alliance and the State Money Transmitter Regulators Association, among others.

Mr. Plotkin was graduated from Yale University with a B.A., summa cum laude, where he was elected to Phi Beta Kappa. He received his J.D. with honors from Harvard Law School, where he served as a senior editor of the Harvard Journal on Legislation. He also has undertaken post-graduate studies in Japan and is moderately conversant in Japanese.

David N. Fagan

David Fagan is an associate whose practice covers national security law, international trade, privacy and data security, and financial institutions regulation. Mr. Fagan regularly advises clients on international, federal, and state legislative and judicial issues in each of these practice areas, with a particular emphasis on developments and compliance matters in the area of technology law, including data protection, identity theft, IT security, and online liability. He also has represented clients before federal government agencies and Congress on a broad range of issues, ranging from criminal investigations implicating national security to regulatory approvals of large transactional matters.

Mr. Fagan is actively involved in the firm's commercial enterprise and national security practice. He has particular expertise in the Exon-Florio Amendment to the Defense Production Act of 1950, and has participated in the Exon-Florio-related representation of numerous foreign and domestic clients before the Committee on Foreign Investment in the United States (CFIUS). This experience has included, among others, the successful representation of IBM in the sale of its personal computer division to Lenovo, Global Crossing in its sale to ST Telemedia, and BT in its acquisition of Infonet Services Corporation.

Mr. Fagan has participated in panels and co-authored numerous articles on the Exon-Florio process as well as on privacy and data security issues, including the legal liability risks associated with network security and the loss of customer information. He received a J.D. in 2001 from New York University School of Law, where he was an editor of the NYU Law Review, and a B.S. in Foreign Service from Georgetown University in 1996, Phi Beta Kappa and magna cum laude.

Prior to law school, Mr. Fagan was a political/leadership analyst on the Near East for the CIA.