COUNCIL on FOREIGN RELATIONS

CFR Backgrounders

Foreign Investment and U.S. National Security

Authors: **Jonathan Masters**, Deputy Editor, and **James McBride**, Senior Online Writer/Editor, Economics

Updated: November 22, 2016

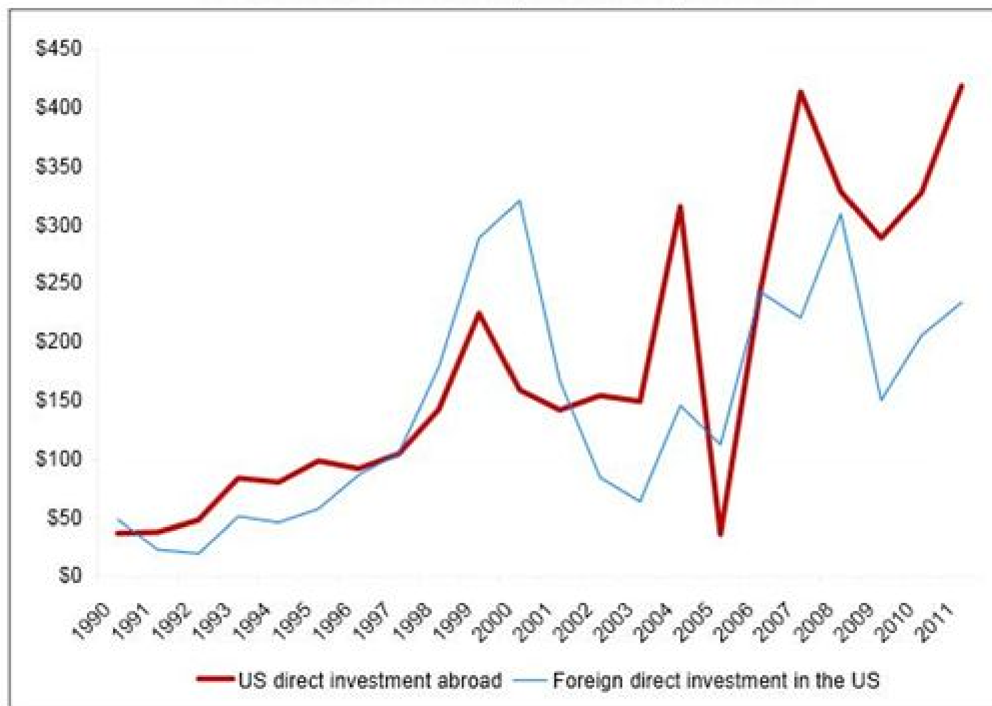
Introduction

The United States is both the world's largest foreign direct investor and the largest beneficiary of foreign direct investment (FDI). But like every sovereign country, it has sought to temper its embrace of open markets with the protection of its national security interests. Achieving this balance, which has shifted over time, has meant placing certain limitations on overseas investment in strategically sensitive sectors of the U.S. economy.

The Committee on Foreign Investment in the United States was established in 1975 to review acquisitions of U.S. firms by foreign entities that could erode national security. Recent political opposition to some high-profile foreign investment activity, including the **2006 controversy** over management of U.S. port terminals by the company Dubai Ports World and congressional criticism of increased Chinese acquisitions of U.S. companies, has fed a perception among some that the United States has stepped back from its open-door policies. The federal government, however, reviews only a small fraction of the hundreds of annual foreign acquisitions, and it blocks transactions in only the rarest of cases. Meanwhile, countries from Australia to the United Kingdom are reforming, and **often increasing**, their oversight of foreign investment.

How does the United States benefit from foreign investment?

Washington has traditionally led **international efforts to bring down barriers** to cross-border capital flows with the goals of expanding investment opportunities for U.S. multinational businesses and creating a more stable and efficient international system. At the same time, the United States relies greatly on foreign inflows to compensate for a shortage of savings at home. The United States **routinely ranks** among the most favorable destinations for foreign direct investors. Foreign direct investment—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.



Expressed in billions. Note: The drop in U.S. investment abroad in 2005 reflects actions by U.S. parent companies to take advantage of a one-time tax provsion. Source: Department of Commerce.

According to the Department of Commerce, foreign firms owned more than thirty thousand businesses in the United States in 2013, employing **over six million people** (roughly 4 percent of the civilian workforce) and paying higher average salaries than their domestic competitors. Moreover, foreign firms are disproportionately involved in manufacturing—more than twice the ratio of the total U.S. economy—and often provide **high-skill jobs and training** that lift local economies. In 2010, China-owned Pacific Century Motors bought the auto-parts maker Nexteer, saving thousands of jobs in Saginaw, Michigan. "This city went from being an exhibit of America's industrial decline to a **case study** in the impact of Chinese investment money on U.S. communities," said Joseph B. White and Norihiko Shirouzu in the *Wall Street Journal*. Indeed, many states and cities **aggressively pursue foreign direct investment**.

What are the concerns over foreign investment?

Concerns with foreign transactions are typically associated with mergers, acquisitions, and takeovers of established domestic firms rather than new investments, known as greenfields. U.S. lawmakers, much like their peers around the globe, have passed legislation that restricts or reviews foreign deals that could cause the loss of sensitive technologies, significant outsourcing of jobs, or impairment of **various sectors of critical infrastructure**. In recent years, many nations have reassessed their laws in light of fears associated with international terrorism, global investments by state-owned enterprises (i.e., foreign-government-controlled companies) and sovereign wealth funds, many of which suffer from lack of transparency and accountability.

But many economists warn policymakers that by imposing burdensome restrictions on FDI inflows, the United States could trigger other nations to enact similarly restrictive policies. To avoid this, the thirty-four members of the Organization for Economic Cooperation and Development (OECD), as well as twelve nonmember states, have signed **a nonbinding commitment** to treat foreign-controlled firms on their territories no less favorably than domestic enterprises. Governments under this agreement are, however,

provided considerable latitude to exempt sectors of their economies deemed essential to national security. As shown in Table 1, countries define "critical infrastructure" in **various ways (PDF)**.

Table 1. National Definitions of Critical Infrastructure

Australia	"Critical infrastructure is defined as those physical facilities, supply chains, information technologies and communication networks which, if destroyed, degraded or rendered unavailable for an extended period, would significantly impact on the social or economic well-being of the nation, or affect Australia's ability to conduct national defence and ensure national security."
Canada	"Canada's critical infrastructure consists of those physical and information technology facilities, networks, services and assets which, if disrupted or destroyed, would have a serious impact on the health, safety, security or economic well-being of Canadians or the effective functioning of governments in Canada."
Germany	"Critical infrastructures are organisations and facilities of major importance to the community whose failure or impairment would cause a sustained shortage of supplies, significant disruptions to public order or other dramatic consequences."
Netherlands	"Critical infrastructure refers to products, services and the accompanying processes that, in the event of disruption or failure, could cause major social disturbance. This could be in the form of tremendous casualties and severe economic damage… "
United Kingdom	"The [Critical National Infrastructure] comprises those assets, services and systems that support the economic, political and social life of the UK whose importance is such that loss could: 1) cause large-scale loss of life; 2) have a serious impact on the national economy; 3) have other grave social consequences for the community; or 3) be of immediate concern to the national government."
United States	The general definition of critical infrastructure in the overall US critical infrastructure plan is: "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." For investment policy purposes, this definition is narrower: "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 national security."

Source: OECD

Douglas Holtz-Eakin, a former director of the Congressional Budget Office, says there are legitimate security concerns, but foreign companies, whether state-owned or private, should be free to earn money from critical infrastructure provided they do not have direct operational control. "The issue is less about ownership and more about management," he says.

The federal government reviews only a small fraction of the hundreds of annual foreign acquisitions, and it blocks transactions in only the rarest of cases.

International investment experts Alan P. Larson and David M. Marchick, who coauthored a **2007 Council Special Report** on the subject, agree that state ownership of multinational firms is often benign. However, they note that concerns arise "when the foreign company's decisions become an extension of the government's policy decisions rather than the company's commercial interests." The authors cite the move by Russian energy giant Gazprom in 2006 to **cut gas supplies to Ukraine** , which some Western observers considered a politically motivated decision, as a cautionary example. More recently, leaders in Europe and the United States have **raised concerns** over growing investments by China's state-owned and state-backed enterprises.

Has the review of foreign investment changed?

Federal oversight of foreign investment has evolved over time, often in response to changing economic and security conditions. President Gerald Ford created the **Committee on Foreign Investment in the United States** in 1975 amid congressional unease with the growing investments of members of the Organization of the Petroleum Exporting Countries, or OPEC, in the United States, which many

policymakers saw as potentially suspect. The interagency CFIUS was charged with coordinating U.S. policy on foreign investment and reviewing transactions that could have significant consequences for U.S. interests.

However, in the ensuing years, many in Washington felt the oversight body was falling short of its obligations. In 1988, Congress strengthened the CFIUS review process by passing the Exon-Florio amendment to the Defense Production Act of 1950. Much as in the previous decade, the reforms stemmed from concern with growing foreign investment—this time Japanese—in sensitive U.S. industries, including a **bid by computer giant Fujitsu** to purchase U.S.-based computer chip maker Fairchild Semiconductor.

The president was granted far-reaching authority to block a foreign acquisition on "national security" grounds.

Exon-Florio granted the president far-reaching authority to block a foreign acquisition on "national security" grounds, broadly defined. Executive decisions do not require congressional approval and cannot be judicially reviewed. President Ronald Reagan, in turn, delegated to CFIUS the power to administer Exon-Florio, though the president retained ultimate decision-making authority.

"CFIUS was transformed from a purely administrative body with limited authority to review and analyze data on foreign investment to one with a broad mandate and significant authority to advise the president on foreign investment transactions and to recommend that some transactions be blocked," **explains [PDF]** the Congressional Research Service.

In February 1990, President George H.W. Bush used this enhanced authority to **void the sale of Mamco Manufacturing**, a Seattle-based aircraft parts maker, to a Chinese state-owned aviation company.

What changed after the Dubai Ports World scandal?

The CFIUS process was amended most recently by the Foreign Investment and National Security Act of 2007 (FINSA), which passed in the wake of the **Dubai Ports World scandal** (DPW). In March 2006, amid a flurry of U.S. political opposition, the Dubai-owned firm scuttled its bid to acquire control of major U.S. port operations. Many in Congress said that the controversial deal would increase the risk of a terrorist attack on the United States. President George W. Bush and CFIUS had previously approved the transaction.

FINSA provided Congress greater oversight of CFIUS and expanded the legal meaning of "national security" to include critical infrastructure (as outlined in the **2001 USA Patriot Act**). The act requires CFIUS to investigate all foreign investment deals in which the overseas entity is owned or controlled by a foreign power, irrespective of the nature of the enterprise. According to some experts, this shifted the burden of proof from CFIUS to foreign firms, which must show they do not present a security risk.

How does the CFIUS review process work?

CFIUS operates under the discretion of the president and is chaired by the secretary of the treasury. It includes the heads of the following departments: Homeland Security, Commerce, Defense, Energy, Homeland Security, Justice, and State, as well as the U.S. trade representative and director of the Office of Science and Technology Policy. Several other offices also contribute: the Office of Management and Budget, Council of Economic Advisers, National Security Council, National Economic Council, and Homeland Security Council. In addition, the director of national intelligence and the secretary of labor are nonvoting, or *ex officio*, members.

CFIUS reviews every merger, acquisition, or takeover resulting in "foreign control of any person engaged in interstate commerce in the United States." Transactions not covered are those conducted "solely for the purpose of investment" or where the foreign investor "has no intention of determining or directing the basic business decisions of the issuer."

Prior to a formal, voluntary filing, the committee encourages parties to a foreign deal that may have security implications are to consult with CFIUS staff confidentially to identify and address potential concerns. Once a formal notification is submitted, CFIUS reviews the proposed deal for up to thirty days, during which time it can request additional information and provide feedback to the parties. Most reviews conclude in the initial period; the few that raise concerns trigger a second, forty-five-day investigation. CFIUS and the transacting parties may negotiate a mitigation agreement to address any national security concerns. After the investigation period, the committee may make an adverse recommendation to the president, who then has fifteen days to make a decision.

Regulatory experts say the committee's work is "intellectually honest," and meticulous. "It's like a full physical, performed by a battery of doctors that run every conceivable test," said **David Fagan**, law partner at Covington and Burling LLP, a Washington-based firm that focuses on advising clients on CFIUS-related issues.

Only the president has the authority to block a transaction, but two conditions must be met beforehand: the president must have "credible evidence" that the deal will impair national security, and he/she must determine that **existing U.S. laws [PDF]** are insufficient to safeguard national security.

How often does CFIUS review foreign investments?

In the wake of the global financial crisis, the number of companies filing transactions with CFIUS has steadily risen, from 65 in 2009 to 147 in 2014, the most recent year for which records are available. Out of those filed during the six-year period, about 40 percent have led to an investigation. According to the committee's **latest report to Congress (PDF)**, about 7 percent of all deals reviewed were abandoned during the process, and about 8 percent required some sort of legally binding mitigation to win approval.

Only one deal during that period was blocked by the president. In 2012, President Barack Obama, acting on the committee's recommendations, ordered the **Chinese-owned Ralls Corporation** to divest its interest in Oregon wind farms, citing national security concerns. It was the first time in more than two decades that the White House formally prohibited such a deal.

But other recent high-profile deals have fallen apart under CFIUS scrutiny, and there are signs that the agency is taking a more aggressive stance, particularly toward deals involving China. In 2011, China telecom giant Huawei voluntarily divested its assets in 3Leaf, a U.S. technology firm, after opposition from CFIUS. In 2012, the U.S. House Intelligence Committee concluded that Huawei and another Chinese firm, ZTE, **posed a security risk** due to their close ties to the Chinese government.

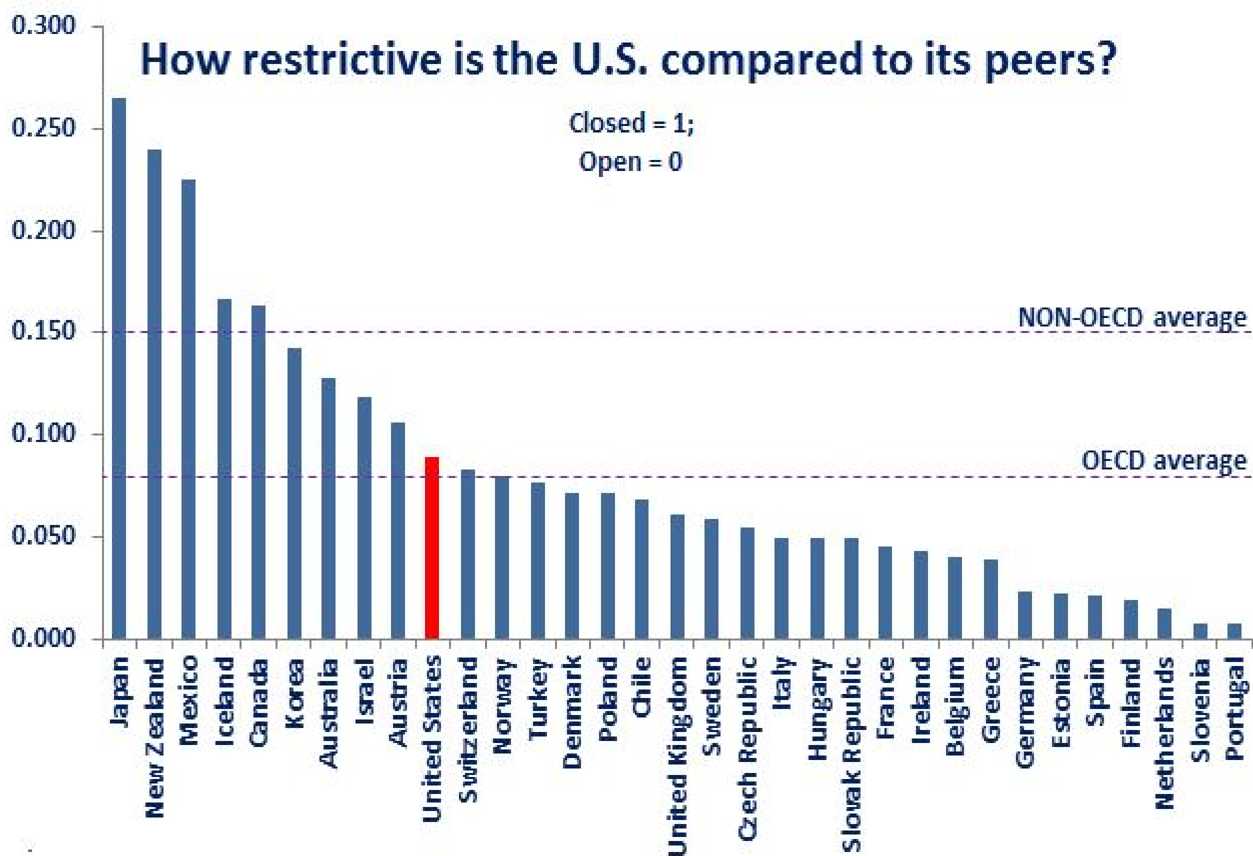
Recent high-profile deals have fallen apart under CFIUS scrutiny, and there are signs that the agency is taking a more aggressive stance, particularly toward deals involving China.

Since then, Chinese acquisitions of U.S. companies have continued to grow, from less than thirty in 2013 to more than ninety in 2016. At the same time, CFIUS has **expanded its review process** to apply more oversight to so-called non-notified transactions—that is, deals that had not been registered with the agency. Experts say that this expansion is due both to the growth of cybersecurity issues and warnings by U.S. intelligence agencies that there **may be a coordinated effort** by one or more foreign countries to acquire U.S. "critical technology companies."

However, many analysts say that since the vast majority of deals are approved, the more important story is the success of **Chinese investment** in the United States. In one **record-setting deal**, in 2013, CFIUS approved the sale of Smithfield Foods to Shuanghui International Holdings Ltd., the largest Chinese purchase of a U.S. company in history. "Most Chinese investments have not and should not raise real [security] concerns," writes Marchick. "Senior U.S. officials should highlight the many successful investments Chinese companies have made."

How do U.S. policies on foreign investment compare with the rest of the world?

In a 2012 study, the OECD ranked the United States' FDI regulatory regime as relatively closed and more restrictive than that of other developed nations (see table). While most developed countries have formal review processes with established time frames to assess security concerns, many allow the parties to appeal decisions in court or through other means, unlike with CFIUS rulings. In a **2016 report [PDF]**, however, the OECD noted that countries around the world are reevaluating, and often tightening, their oversight regimes. Most have broadened the scope of what is considered "national security sensitive" to include energy, telecommunications, infrastructure, and health care.



Source: OECD

As in the United States, governments around the world have raised concerns over the **record levels of Chinese acquisition activity**, partly driven by Beijing's "going out" policy of incentivizing foreign investment. The *Financial Times* reports that between 2015 and 2016 nearly $40 billion worth of Chinese foreign acquisition deals in Australia, Europe, and the United States **were scuttled**, because of either outright rejection or increased regulatory scrutiny that caused the deals to collapse.

Recent Chinese acquisition attempts have proven particularly controversial in Australia. The government has **stepped up its scrutiny of foreign deals** and mandated in 2016 that all acquisitions of public infrastructure be reviewed by its Foreign Investment Review Board. In April 2016, Canberra rejected a

Chinese bid to buy the country's largest agribusiness. And in August 2016, the government blocked a Chinese consortium from buying an electricity grid operator, citing national security concerns.

Some European countries have followed suit. France began requiring prior state approval for most foreign bids in 2014. And after taking office in July 2016, UK Prime Minister Theresa May promised to **strengthen the country's oversight system**, beginning with a government review of a joint French-Chinese nuclear project at Hinckley Point, which eventually gained approval contingent on the incorporation of stricter conditions.

Additional Resources

This 2016 report from the Congressional Research Service examines the **Committee on Foreign Investment in the United States**.

The Pew Research Center details the efforts of local and state governments to attract foreign investment in **this investigation**.

Countries around the world are rethinking their foreign investment oversight regimes, explains **this 2016 report** from the Organization for Economic Cooperation and Development (OECD).

CFIUS is reviewing a growing number of transactions, according to **this 2016 brief** by the law firm Skadden, Arps, Slate, Meagher & Flom.

This 2013 report from the Congressional Research Service details the major federal statutory restrictions on **foreign investment in the United States**.

This 2007 Council Special Report discusses the benefits of FDI in the United States as well as the security risks posed by **foreign ownership of certain U.S. assets**.

More on this topic from CFR

Remarks by U.S. President Obama and Chinese President Xi in Joint Press Conference

What to Expect at the U.S.-Africa Summit

Interviewee:
Jendayi E. Frazer
, Adjunct Senior Fellow for Africa Studies
Interviewer:
Zachary Laub
, Online Writer/Editor

President Obama's Remarks at SelectUSA Investment Summit, October 2013

Speaker: Barack Obama

View more from **Foreign Direct Investment**, **United States**
Back to backgrounders home