Committee on Foreign Investment in the United States “Reform” 2017: Risky Business?

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Key Points

• The proposed Foreign Investment Risk Review Modernization Act (FIRRMA) updates and modernizes the procedures of the Committee on Foreign Investment in the United States (CFIUS).

• Three aspects of FIRRMA are particularly troubling: The act orders CFIUS to investigate (1) potential dangers from proposed foreign acquisitions across entire industries, sectors, and areas in the US economy, with a view to possibly rejecting any transaction that “is likely to reduce the technological and industrial advantage of the United States relative to any country of special concern”; (2) whether proposed foreign acquisitions emanate from a country that has “a demonstrated or declared strategic goal of acquiring a critical technology”; and (3) various commercial transactions that are not related to foreign acquisition of US firms.

• US national interests would be best served by maintaining CFIUS’s narrow focus on specific threats that might arise from particular acquisitions. Instead of CFIUS screening commercial transactions, the US export control regime should be updated through multilateral agreement with allies and partner countries.

For more than half a century, the United States has led a global effort to liberalize flows of trade and investment across borders. The underlying philosophy has been that expanding trade and investment is a win-win process that benefits all participating nations. Liberalization of trade and investment allows countries to take advantage of natural comparative advantage and capture economics of scale and scope. Even more important, liberalization of trade and investment generates competition, disruption, and pressure for innovation and imitation that pushes the technological frontier ever outward.

The end result is improved products, goods, services, and applications that benefit consumers, firms, and communities across national borders worldwide. The contrary view embraces some form of mercantilism, or neo-mercantilism, contending that economic relations between nations are a zero-sum phenomenon in which some economies gain at the expense of others. This inevitably leads to national industrial policies that select which industries should be promoted or protected from the rigors of international competition. Committee on Foreign Investment in the United States (CFIUS) procedures have
hitherto recognized the benefits of an open, win-win approach to inward investment and eschewed the win-lose perspective, while identifying specific threats to US national security from individual foreign acquisitions.

Contemporary CFIUS Procedures: Attracting Inward Investment While Avoiding National Security Threats

American governments of all political persuasions have long recognized that foreign investors significantly contribute to the US domestic economy. Non-US multinational corporations (MNCs) in the United States join US MNCs in paying higher wages, offering greater benefits, exhibiting higher productivity, providing more value added to US domestic inputs, importing via superior access to external supply chains, exporting more goods and services, and engaging in greater research and development than purely domestic firms. At the same time, foreign investors put competitive pressure on US firms to upgrade their technologies, management practices, and quality-control procedures, and they often offer channels of learning for imitation by US firms.

Indeed, the most recent data show that 12 percent of all productivity gains by firms in the US economy over more than two decades can be traced to spillovers from foreign investors. Such spillovers originate from foreign investors from BRIC countries—such as China, Russia, and Brazil—and from foreign companies headquartered in Organisation for Economic Co-operation and Development economies.

For this reason, American authorities at the national level—as well as US state and local governments—have been eager to welcome foreign investors into the domestic economy. In the US, as in other developed-country markets, approximately 80 percent of foreign investments take place by acquiring a target firm in the target country, depending on the industry. This leads to concern that under certain circumstances the foreign takeover of a US firm might pose some kind of national security threat to the US.

In reaction to the politicization of foreign acquisition cases early in the 21st century, along with seeming denial of regulatory primacy for CFIUS, CFIUS regulations were rewritten in 2007 and received final approval in 2009 under the Foreign Investment and National Security Act (FINSA). FINSA ensured CFIUS’s legal preeminence in assessing national security threats that might arise from foreign acquisitions of US companies, regularized CFIUS reporting requirements to the US Congress, and provided a degree of insulation from congressional pressures. In the period leading up to FINSA, some in Congress had suggested that they could hold hearings to block specific foreign acquisitions quite apart from the CFIUS process.

The FINSA redraft of CFIUS regulations in 2009 left the definition of threats to national security open-ended. But an empirical examination of CFIUS cases since then shows that the committee’s threat assessments can be separated into three distinct types, and the conditions under which each threat becomes plausible can be distinguished from situations in which the harm envisioned is not credible.

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The first threat derives from a possible leakage of sensitive technology to a foreign company or government that might deploy or sell such technology so as to harm US national interests. Assessing the plausibility of this threat is a two-step process. Step one is to calculate the damage that could be done if the technology were deployed against US interests. Step two is to calculate how readily available such technology is in international markets to see if it makes sense to refuse the transfer to foreign hands. If alternative sources of the technology held by the acquired firm are widespread, national security will not be served by blocking the transaction.

The second threat springs from the foreign acquirer’s ability, acting independently or under instructions from the home government, to delay, deny, or place conditions upon provision of output from the newly acquired producer. Assessing the plausibility of this also requires a two-step analytic process. The first step is calculating how “crucial” the process or product is—“crucial” is defined as
the cost of delay or doing without. The second step is calculating how concentrated the international industry is, how abundant are near substitutes to the processes or products of the company that is being acquired, and how high are switching costs. If the goods and services of the company being acquired are widely available and switching costs are low, there is no plausible threat to US national security.

The third threat derives from the potential that acquiring a US company might allow a foreign company or its government to penetrate the US company’s systems so as to monitor, conduct surveillance, or place destructive malware in those systems. If alternative suppliers of the goods and services from the company to be acquired are readily available, any user who feared penetration could simply switch to another provider. This threat is particularly prominent in assessing foreign acquisitions involving critical infrastructure. A special version of this threat lies in surveillance via acquired properties in proximity to US military bases or defense installations.

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In each of these scenarios, CFIUS has hitherto interpreted its mandate too narrowly—despite legislative language that would permit a broader approach covering entire “areas” of the US economy—with a specific focus on whether foreign acquisition of a US firm might pose a credible national security threat to the United States. To be sure, CFIUS devotes particularly thorough investigation to proposed acquisitions in sectors, industries, or areas of the US economy that might be considered “crucial”—such as energy or semiconductors—and has a special mandate to pay careful attention to critical infrastructure. But these CFIUS investigations have hitherto been directed toward identifying what kind of national security threat might become plausible via a specific foreign acquisition of a firm in that sector, industry, or area of the US economy or via foreign control over a particular segment of infrastructure. CFIUS has never before issued a blanket prohibition against all foreign acquisitions from any specific country in an entire industry sector, or area of the US economy, nor taken as its mission to determine whether such acquisitions might erode US technological or industrial advantage in relation to the home country of the acquiring firms.

Contemporary CFIUS “Reforms”: The Shift to a Neo-Mercantilist Approach?

A key proposal in the CFIUS reform bill, the Foreign Investment Risk Review Modernization Act (FIRMA)—perhaps already beginning to be adopted by the Trump administration in practice—is that CFIUS should preclude foreign acquisitions on the part of companies from certain countries across entire sectors, industries, or areas of the US economy rather than evaluate national security threats within sectors, industries, or areas of the US economy, so as to prevent erosion of US technological and industrial superiority therein. While FIRMA does not require a “net economic benefits” test, this approach nonetheless constitutes a novel zero-sum perspective toward protecting American economic supremacy.

CFIUS’s hitherto narrow approach to identifying specific national security threats may already have been overturned by the Trump administration in the 2017 CFIUS rejection of the acquisition of Lattice Semiconductor by Canyon Bridge Partners, a Chinese private equity firm with ties to the Chinese government. The White House issued a justification for the rejection in the following terms: “The national-security risk posed by the transaction relates to, among other things, the potential transfer of intellectual property to the foreign acquirer, the Chinese government’s role in supporting the transaction, the importance of semiconductor supply chain integrity to the United States Government, and the use of Lattice products by the United States Government.”

A statement from the Treasury was subsequently issued in Secretary Steven Mnuchin’s name using the exact same language.5

The references to “the potential transfer of intellectual property to the foreign acquirer” and the “importance of semiconductor supply chain integrity” clearly represent a new, more expansive, zero-sum
rationale for a negative ruling by CFIUS. A careful examination of other semiconductor cases (e.g., CFIUS’s 2016 rejection of the acquisition of German-based Aixtron to Grand Chip Investment Group of China) reveals that the committee appeared to be concerned about leakage of a specific Aixtron technology based on gallium nitride, which is crucial for improving the performance of radar systems, in particular antimissile defense radars. CFIUS had not argued that whole industries, sectors, or areas of the US economy should be excluded from foreign acquisitions so as to protect against transfer of intellectual property of a purely commercial nature before the 2017 Lattice case.

So the Trump administration, with Treasury Secretary Mnuchin as the lead cabinet member on CFIUS, may be taking a much broader and more protectionist approach toward foreign acquisitions, in particular Chinese acquisitions, than previous administrations, even without waiting for changes in CFIUS legislation.

The CFIUS “reform” bill (FIRRMA) enshrines the concept of protecting entire industries, sectors, and areas of the US economy that contribute to US technological superiority vis-à-vis other countries. FIRRMA directs CFIUS to investigate “the potential effects of the covered transaction on United States international technological and industrial leadership in areas affecting United States national security, including whether the transaction is likely to reduce the technological and industrial advantage of the United States relative to any country of special concern.”

Excluding whole sectors, industries, and areas of the US economy from foreign investment and foreign acquisitions, even if limited to foreign investment and foreign acquisitions from a handful of specific countries (China, Russia, possibly others), so as to prevent erosion of US industrial and technological superiority, would unavoidably put the United States government in the business of designing a national industrial policy, by picking some sectors to be protected and others not. Such a move opens the door to a political process for which there is no logical end in sight.

The energy industry, for example, has rivaled the semiconductor industry in popularity for protection against foreign acquisitions. Sens. Chuck Grassley (R-IA) and Debbie Stabenow (D-MI) warn that foreign takeovers across US agribusiness should be prevented so as to preserve something called US food security. Members of Congress have repeatedly urged that foreign acquisitions by companies from Russia or China in infrastructure, telecommunications, movie studios, and financial services—as well as in energy, semiconductors, and agribusiness—must be rejected. After this long list, which industry sectors might come next?

Not only would preventing foreign acquisitions in whole industries exclude valuable technological and managerial inputs from external investors entering broad segments of the American economy, but the change in US approach would legitimate copycat sector-wide or area-wide exclusions on the part of other countries in Europe and Asia, to avoid loss of industrial or technological leadership. Once the rationale to prevent erosion of industrial or technological leadership in the home economy becomes accepted as legitimate, could the effort be limited to foreign acquisitions involving only Russia and China?

For more than four decades the US has worked to widen access for trade and investment throughout industries in foreign markets, under both Republican and Democratic administrations. This change toward zero-sum protectionism would reverse direction, quite probably undermining much progress that has been made.

The Challenge of Maintaining the Benefits of an Open System

The CFIUS “reform” bill (FIRRMA) also attempts to address the tricky predicament of how a country like the US that favors an open, welcoming approach to trade and investment should deal with acquisitions on the part of a country that does not, such as China. FIRRMA directs CFIUS to investigate “whether the covered transaction involves a country of special concern that has a demonstrated or declared strategic goal of acquiring a type of critical technology that a United States business that is a party to the transaction possesses,” so as to reject such an acquisition. But is this the most beneficial or productive approach?

The object of specific concern once again is China, in particular the Chinese government’s program known as Made in China 2025. The goal of Made in China 2025 is to upgrade China’s domestic industrial
base across the board, with 10 priority sectors: (1) new advanced information technology, (2) automated machine tools and robotics, (3) aerospace and aeronautical equipment, (4) maritime equipment and high-tech shipping, (5) modern rail transport equipment, (6) new-energy vehicles and equipment, (7) power equipment, (8) agricultural equipment, (9) new materials, and (10) biopharma and advanced medical products.

Made in China 2025 draws direct inspiration from Germany’s Industry 4.0 plan, which is aimed at bolstering intelligent manufacturing by applying the tools of information technology to production. Made in China 2025 also echoes market-oriented principles from China’s Third Plenum decision document.

But there is widespread concern that Made in China 2025 will nonetheless incorporate pressures for indigenous innovation (albeit without using the phrase); require forced technology transfer from foreign investors to Chinese firms, including state-owned enterprises (SOEs), while imposing domestic content mandates on the foreigners; and enshrine other Chinese industrial policy interventions in the marketplace. How successful these Chinese industrial policy interventions might be is the subject of considerable debate.

Using CFIUS decision-making to try to change Chinese approaches to industrial policy would be neither efficient nor effective.

How should the United States and other major advanced economies react to Chinese industrial policies between now and 2025, and what are the particular implications for CFIUS procedures?

The United States, the UK, Europe, Japan, South Korea, and other developed economies have a strong interest in pushing China to respect its World Trade Organization obligations to keep markets open to trade and investment. This push should be combined with pressures on the Chinese government to make Chinese SOEs operate more transparently and competitively, without support or protection on the part of the Chinese authorities. The United States and its economic allies should include representations to limit or minimize the subjection of foreign multinational investors to forced technology-sharing mandates and localization requirements.

But—for the United States—such pressures and representations should emanate from a united front of the US Trade Representative, the Department of Commerce, and the White House, not by charging CFIUS to try to influence Chinese government behavior by approving or disapproving individual transactions one by one. Using CFIUS decision-making to try to change Chinese approaches to industrial policy would be neither efficient nor effective.

Expanding CFIUS Jurisdiction

Section 3 of FIRRMA expands covered transactions that must be scrutinized by CFIUS to apply to other kinds of technology transfer well beyond foreign acquisition of a US company. This expansion of covered transactions includes: “The contribution (other than through an ordinary customer relationship) by a United States critical technology company of both intellectual property and associated support to a foreign person through any type of arrangement, such as a joint venture, subject to regulations prescribed under subparagraph (C).”

Section C then gives wide latitude to CFIUS to define key terms, including critical technology: “The Committee shall prescribe regulations further defining covered transactions described in clauses (iii) and (v) of subparagraph (B) by reference to the technology, sector, subsector, transaction type, or other characteristics of such transactions.”

These sections of FIRRMA thereby bring under CFIUS purview a broad array of licensing, joint development, and other commercial transactions quite outside what might occur in the foreign acquisition of a US firm. This expansion of covered transactions does not confine CFIUS to those technologies that are on the US export control list, so many could involve transfer of technologies that the US government has already determined do not warrant export controls for national security reasons.

FIRRMA’s expansion of coverage, moreover, makes no reference to multilateral agreements for export control, but rather charges CFIUS with a mandate to undertake unilateral and extraterritorial actions. Any unilateral approach to changing the export control regime that governs US firms without seek-
ing multilateral agreement undermines American firms’ ability to do business abroad while leaving foreign competitors to fill in the gaps left by American companies.

Congress and the executive branch have long recognized that control of sensitive technology works best when carried out multilaterally, in cooperation with allies. If Congress believes that current export controls are ineffective at limiting transfers of certain technologies, then the appropriate approach is to seek to modernize international control regimes on a multilateral basis under the auspices of the Departments of Defense, State, and Commerce, not through unilateral determinations by CFIUS. Current US export control regulations already provide for a temporary unilateral stopgap on technology transfers while the US government pursues an international agreement for new technology controls.

Conclusions and Policy Implications

Foreign investment in the United States—including foreign investment by way of acquisitions of US firms—generates important benefits for US workers and welfare gains for the US economy. Spillovers from foreign investors—including foreign investors from China and Russia—are responsible for some 12 percent of all productivity improvements across the entire US domestic economy during the past 20 years. So CFIUS practices should continue to be designed as a balance between keeping the United States as open as possible to foreign investment while identifying and protecting against concrete national security threats.

In attempting to maintain such a balance, US national interests would be best served by maintaining CFIUS’s narrow focus on specific threats that might arise from particular acquisitions within industries, not by excluding entire industries, sectors, or areas of the US economy from foreign acquisitions so as to prevent erosion of US industrial and technological superiority. The latter would put the US government in the position of designing a national industrial policy that specifies which industries, sectors, or areas should be protected against loss of US superiority therein. The full extent to which domestic political pressures might capture the design of a protectionist industrial policy in the US is unknown, but this change in approach would open the door to comparably broad protections with a zero-sum rationale of maintaining national economic superiority in vulnerable sectors in Europe and Asia, thereby undermining decades of effort to open domestic markets to competition from external sources.

The United States should continue to push for trade and investment liberalization around the globe and demand treatment for US companies in overseas markets comparable to what foreigners receive here. However, the most powerful and appropriate means to do so is via bilateral and multilateral negotiations led by the White House, the US Trade Representative, and the Department of Commerce, not by charging CFIUS to try to influence the behavior of other governments via approving or disapproving individual firm-level transactions, one by one.

Finally, CFIUS should not be directed to review licensing, joint development, and other commercial transactions that involve technology transfer not related to foreign acquisitions of US companies. This should be the purview of the Defense Department, State Department, and Department of Commerce in a multilateral effort to update and modernize export control regulations with partner governments and allies around the globe.

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Notes


2. The most politicized case that provoked the FINSA reforms was Dubai Ports World. For details of this case, see Moran and Oldensi, Foreign Direct Investment in the United States.


10. Foreign Investment Risk Review Modernization Act, H.R. 4311, 115th Cong., § 3.5.

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