U.S. Regulatory Framework for Assessing Sovereign Investments

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Mr. Chairman, Senator Shelby and other distinguished members of the Committee, I am honored to have this opportunity to address the Committee on such an important and timely topic. My name is Jeanne Archibald; I am the Director of the International Trade Practice of Hogan & Hartson and former General Counsel of the U.S. Treasury Department.

During my service with the Treasury Department I was directly involved in the consideration of the Exon-Florio Amendment to the Defense Production Act of 1950, supervised the drafting of the regulations implementing that law and provided advice to senior Treasury officials with respect to the implementation of the law for several years following its enactment.

Throughout the last 15 years, I have assisted numerous clients, both U.S. and non-U.S., with respect to national security reviews and investigations before the Committee on Foreign Investment in the U.S. ("CFIUS"). These transactions have involved a wide variety of industry sectors, including, but not limited to, financial, telecommunications, energy, high tech, and defense. Several of these transactions have involved the negotiation of a mitigation agreement to address national security concerns raised by the acquisition. Some of these transactions included acquisitions by non-U.S. companies in which foreign governments held an ownership interest as well as by sovereign wealth funds. And, as discussed further below, many of the transactions on which I worked implicated regulatory reviews and requirements beyond the Exon-Florio Amendment.

At the outset, I want to note that I am not appearing here on behalf of any client. The views expressed are my own, developed over 20 years of working with the issue of national security aspects of foreign direct investment in the United States.

As several other witnesses who have appeared before this Committee have noted, sovereign wealth funds are not a new phenomenon, the first having been created more than 50 years ago. And the investment capital that such funds bring to the U.S. provides many economic benefits to Americans. At the same time, the recent increase in the number of sovereign wealth funds and their total asset value have raised concerns about the potential impact of investments made by these funds on U.S. national security interests. The relevant question therefore is whether the U.S. has the legal and policy tools in place to ensure that sovereign wealth fund investments do not harm the U.S. national security. I believe the answer to that question is clearly "yes."

One major tool available for this purpose is, of course, the Defense Production Act of 1950 (50 U.S.C. App. § 2170 et seq.), as recently amended by the Foreign Investment and National Security Act of 2007 ("FINSA") (Pub. L. 110-49, 121 Stat. 246). As I consider my experience with CFIUS proceedings, having notified transactions to CFIUS both prior to and following 9/ll, prior to and following the Dubai Ports World controversy, and prior to and following the enactment of FINSA, I note that CFIUS proceedings today are more probing than ever before in their examination of a transaction, the parties to the transaction, and its potential impact on national security. Based on my initial review of the proposed regulations to implement FINSA that have just been published for public comment by the Treasury Department, I fully expect that trend to continue.

Although the decision by parties to notify a transaction to CFIUS is voluntary, in my experience most companies choose to notify. There are several reasons for this. First, of course, is the fact that in the absence of a CFIUS "clearance" the foreign acquirer's investment is at risk from a later order of divestment. Therefore, it is in the economic interest of the foreign investor to seek a clearance. Second, filing with CFIUS demonstrates a desire to be viewed as a "good corporate citizen." This can be an especially strong incentive where the target of the acquisition or the identity of the acquirer is likely to draw public attention to the deal. Third, where a financial institution is funding an acquisition, the institution is virtually certain to require that all applicable regulatory approvals be obtained as a condition for providing the financing. Fourth, in instances in which a foreign investor is taking a minority stake in a U.S. company, the remaining U.S. owners often insist on a CFIUS filing to eliminate the risk from the disruption and possible financial loss that could follow from a future divestment order. Fifth, when CFIUS becomes aware of a proposed transaction, it calls the parties to ask whether they intend to file. I am not aware of any instance in which parties receiving such a call fail to notify the transaction.

But CFIUS is by no means the only regulatory tool available to the U.S. government to protect against national security risks associated with foreign direct investments in U.S. businesses. The U.S. has enacted many regulatory regimes specific to certain industry sectors. Other regulatory requirements are not industry specific but apply to foreign acquisitions. Some of these regulatory regimes directly restrict investments of a foreign investor, or a foreign government-owned investor. Others provide an avenue by which the U.S. government can be made aware of a contemplated or completed investment—thus allowing for a CFIUS review if one has not already occurred.

Consider, for example, acquisitions in the telecommunications sector. The Communications Act of 1934 absolutely prohibits any foreign government or representative of a foreign government from holding broadcast or common carrier radio licenses.. The Act also imposes a strict limit of 20% on <u>direct</u> investment in broadcast or common carrier radio licensees by any foreign entity. The Act provides for a waivable limit of 25% on <u>indirect</u> investment by a foreign entity.

Thus, a U.S. subsidiary of a foreign entity cannot purchase more than 25% in a company holding a broadcast or common carrier radio licensee without a waiver from the Federal Communications Commission ("FCC"), and the FCC has the power to impose conditions on the granting of such waivers. In fact, before the concept of mitigation agreements was codified in FINSA, it was not uncommon for foreign investors to enter into agreements that imposed conditions on their investments in the telecommunications sector in exchange for a promise by the relevant federal agencies not to object to the acquisition in the CFIUS process. In addition to the remedies for breach that were contained in these agreements, compliance with the agreement was also imposed as a condition on the FCC license.

Given changes in technology, common carrier radio licenses are not as significant today as they were previously. However, today, as a matter of policy, the FCC will not grant any application or license relating to telecommunication services to an entity with significant foreign ownership, government or private, without the approval of the Team Telecom agencies, i.e., the Department of Justice, the FBI, the Department of Homeland Security and, as appropriate, the Department of Defense. Because the Team Telecom agencies are also represented on CFIUS, foreign investors in U.S. telecommunications companies will typically discuss their proposed acquisitions with, and resolve any national security concerns of, the Team Telecom agencies in advance of making a CFIUS filing. In my experience, Team Telecom looks very carefully at any foreign investment but is even more sensitive to investments by foreign governments.

Foreign investments in the financial services sector are also subject to extensive regulation. For example, under the Change in Bank Control Act, the Federal Reserve must generally be given 60 days prior written notice of a proposed acquisition of a controlling interest in a member bank or a holding company. A controlling interest is defined as the acquisition of the ownership, control or power to vote 25% or more of any class of voting securities. Some regulated financial companies impose their own limitations on ownership shares or voting interests—applicable to all investors, including investments by sovereign wealth funds.

Another example can be found in foreign investment in companies that hold classified government contracts, which are subject to significant national security regulation under the National Industrial Security Program implemented by the Department of Defense. When a foreign company proposes to invest in a U.S. company that holds a facility security clearance, which would include virtually any company engaged in classified work, the target company is required to notify the Defense Department of the proposed foreign investment and to develop a plan to mitigate the national security risk associated with the acquisition.

Such plans typically take the form of a (i) Special Security Agreement, whereby the foreign owner is permitted to have board representation but a variety of security measures are put in place to protect the security of the classified contracts; or (2) Proxy Agreement under which the foreign owner retains an economic interest in the entity holding the classified contracts but operational control is vested exclusively in a board of directors composed of U.S. citizens approved by the Department of Defense. Depending on the nature of the classified contracts, a Proxy Agreement may be the only practical means for mitigating foreign ownership, control or influence. In the absence of an approved plan, the facility security clearance will be suspended, thus precluding the company from bidding on further classified contracts. Furthermore, the contracting agencies can terminate existing contracts. In my experience, foreign investors give careful consideration to the impact of these regulatory requirements on the nature and scope of an acquisition.

Similar types of restrictions apply in the nuclear power industry. A change in corporate ownership of an existing holder of a license from the Nuclear Regulatory Commission ("NRC") requires NRC approval to transfer the existing license prior to closing. (*See*, 10 C.F.R. §§ 70.36 and 70.65, and 10 C.F.R. § 40.46.) Where the application for a license transfer involves a foreign entity, the NRC will conduct a foreign ownership or control review. In determining whether the U.S. license holder would be owned or controlled by a foreign entity, the NRC will consider a variety of factors, including whether a foreign interest owns or has beneficial ownership in 5 percent or more of the license holder's voting securities. If the NRC finds that an applicant is considered foreign owned, controlled, or dominated, it can require the applicant to develop a plan to negate the effect of the foreign control as a condition of granting the application.

Manufacturers of goods or technology specifically designed, modified or enhanced for military use are required to register under the International Traffic in

Arms Regulations ("ITAR") (22 C.F.R. Parts 120-130). An ITAR registrant is required to provide 60 days advance notice to the Department of State of any intended sale or transfer to a foreign person of any ownership or control of the registrant or any affiliate of the registrant. For purposes of this provision, "ownership" means that more than 50% of the outstanding voting securities of the registrant are owned by one or more foreign person. "Control" means that one or more foreign persons have the authority or ability to establish or direct the general policies or day-to-day operations of the firm. Control is presumed to exist where foreign persons own 25% or more of the outstanding voting securities if no U.S. person controls an equal or greater percentage. (*See*, 22 CFR 122.)

Under the International Investment and Trade in Services Survey Act (22 U.S.C. 3101-3108), all foreign investments in U.S. business enterprises with assets of at least $3 million in which a foreign person owns a voting interest of ten percent or more are subject to reporting requirements implemented by the Department of Commerce's Bureau of Economic Analysis. The initial report of the investment must be made within 45 days after the date of the initial acquisition.

In addition to the foregoing examples of regulatory schemes that impose specific requirements or limitations on foreign ownership or control, acquisitions by sovereign wealth funds and other foreign investors can trigger other notice requirements, such as Hart Scott Rodino premerger filings (for acquisitions that meet either the size of transaction or size of person threshold tests) or SEC reporting requirements (for acquisitions of greater than 10% of any class of registered securities). The former filings are available to the Department of Justice, a member of CFIUS. The latter are a matter of public record. Thus these filings provide another source of information about proposed or completed acquisitions by foreign entities that can be tapped by CFIUS for appropriate action, where needed.

I would also point out that the reporting requirement contained in Section 721(k) of the Defense Production Act, which continues in a modified form in FINSA, requires the Department of the Treasury to complete a Quadrennial report on foreign acquisitions of, and espionage activities against, U.S. critical technology companies. Using data on completed transactions by companies from countries most active in mergers and acquisitions with U.S. critical technology companies, the Treasury Department has another opportunity to ensure that foreign investment in the United States is being undertaken solely for commercial purposes and that no pattern is developing with respect to an investor or group of investors seeking to systematically acquire U.S. critical technology companies.

The regulatory regimes described above do not constitute an exhaustive list of restrictions imposed on foreign investment in the U.S. But in addition to reviews by CFIUS, which have been strengthened as a result of the FINSA amendments, they serve to illustrate the robust nature of U.S. regulation relating to foreign investment in sectors of the economy that are significant from a national security perspective. In addition to these regimes, some of the other regulatory requirements I have described provide CFIUS with sources of information about significant investments that enable CFIUS to follow up with the parties as it deems appropriate. I would be happy to respond to any questions