Written Testimony of

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Before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services United States House of Representatives

April 12, 2018

H.R. 4311: The Foreign Investment Risk Review Modernization Act of 2017

Mr. Chairman, Ranking Member Moore and distinguished members of the Subcommittee:

Thank you for the invitation to appear before you today. I am honored to join my fellow panel members today as the Subcommittee continues to evaluate the changes needed to key areas related to foreign direct investment that implicates national security interests of the United States. Your leadership, and that of Congressman Pittenger and the co-sponsors of HR 4311, demonstrates the foresight needed to modernize the current Committee on Foreign Investment in the United States' ("CFIUS", or "the Committee") process to address the challenges and risks we face today and those we will face in the future.

I appear before you today in my personal capacity and the views reflected in this written testimony and before you today are solely my own. My perspectives are drawn from a 34-year career advising organizations and individuals on the legal contours of CFIUS, export controls, compliance, enforcement and policy, as well as government contracts and related classified and unclassified investigations in these areas. My views also reflect 15 years of service in the United States Navy as a Special Duty Intelligence Officer responsible for former Soviet Union naval assets, US industrial base requirements, and situational awareness mandates affecting US Naval assets. I am fortunate to have addressed situations where the delicate balance between national security and legal requirements affected a range of activities. I am grateful for the opportunity to share some observations with you today based on the insights this experience has provided me, and to respond to any questions you may have.

Background

Much has been written about the dangers of today's threat and vulnerability environment – whether military, defense, intelligence, political or financial. But in one sense, every era experiences dangers, and policymakers understand that a nimble and flexible underlying legal system is needed to move effectively and efficiently to meet whatever challenges arise. Laws and regulations are sometimes the most formidable

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tools in the Government toolkit because of their ability to address current and future issues in a coordinated and consolidated way.

At times, circumstances change so dramatically that even effective legislation or regulations require a refresh. The concept of CFIUS – *i.e.*, a process by which cross-border investments are reviewed for national security implications – remains as viable today as it was when President Ford first memorialized it as an Executive branch committee in 1975. Based on the shifting landscape of foreign direct investment – a landscape that has been in dramatic transition since 2010 – it is time to update and modernize CFIUS.

I have been asked to comment on HR 4311 and its effects on national security, economic growth, job creation, innovation and continued foreign investment in the United States. My comments focus on three (3) key areas: the manner in which technology transfers occur in the cross-border environment; the review process; and CFIUS' underlying authorities.

Calls to modernize CFIUS, however, do not mean that the entire process is dysfunctional. As noted in more detail below, CFIUS' strengths include a) the exceptional and dedicated individuals who work tirelessly to manage the national security and transaction related mandates that exist in each filing; b) the more defined process ushered in through the Foreign Investment and National Security Act of 2007 ("FINSA"); c) the coordinated efforts of the intelligence community; and d) the depth of analysis applied to problematic transactions. The Committee remains sensitive to deal based considerations without sacrificing the essential goals of current CFIUS objectives.

These strengths, however, are offset by embedded weaknesses that limit CFIUS' effectiveness when it comes to reviewing more creative investment vehicles, emerging technologies and investments that extend beyond an existing "business". Acknowledging that the foreign investment landscape has changed, as have foreign investor motivations, indicates that the time is right for revisions to the CFIUS process and its authorities.

Historically, CFIUS cleared cross-border investments from a range of foreign countries that include the United Kingdom, Canada, Japan, and Germany within the top fifteen (15) applicant's countries. Each of these countries share democratic values with the United States, are viewed as close allies and share multilateral objectives across a range of foreign policy interests from nonproliferation to anti-corruption.

Within the last five (5) years, however, the top 15 foreign investors have been transformed, with the People's Republic of China ("PRC" or "China") moving to the top of the list as one of the most active countries for foreign direct investment in the US, as noted in CFIUS' Annual Reports of cleared transactions. China challenges some of the underlying assumptions that may have flavored various CFIUS reviews of cross-border investments from the UK, Canada, Japan, or Germany. China's government is not predicated on the same democratic principles nor does it shy away from identifying strategic objectives for technological superiority over the United States. The

implementation of these objectives is reflected in a number of reports[2] published since 2010 that highlight the need for China to obtain access to foreign technology in order to develop indigenous capability to challenge the primacy of other countries, including the United States. China pursues its objectives through a variety of tools, such as:

1. Acquisitions or mergers

2. Intellectual property licenses

3. Bankruptcy asset purchases

4. Joint ventures and teaming arrangements where the contribution of US partners includes advanced technology or cutting edge manufacturing techniques

5. "Talent acquisition" – the hiring and retention of established experts in certain technical fields

6. The requirement to establish research and development centers or centers of excellence in China; and

7. Direct or indirect investment through Chinese or non-Chinese funds.

See, e.g., Findings of the Investigation into China's Acts, Policies, and Practices related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974 (USTR, March 22, 2018), pp. 5, 10, 12, 16, and 19-35 ("the Section 301 Report"); *see also* "National Security: Impact of China's Military Modernization in the Pacific Region," GAO/NSA|IAD-95-84 (Report to Congressional Committees, June 1995) (China "prefers to purchase technology rather than end items" (p. 19); "military and civilian manufacturing activities in some countries are closely connected" (p. 40);[3] "China's ability to acquire and absorb technologies needed for wholesale force modernization"). While

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2 Several policy papers – *e.g.*, *Made in China 2025;* the *12th Five-year Science and Technology Development Plan; MIIT Guiding Opinions on Accelerating and Promoting Industry Mergers and Restructuring (2013);* the *National Medium- and Long-Term Science and Technology Development Plan Outline (2006-2020); State Council Decision on Accelerating and Cultivating the Development of Strategic Emerging Industries (SEI Decision);* and the *12th Five-year Strategic Emerging Industries Development Plan (2012)* – provide roadmaps through which the Chinese government encourages its industry (whether state-owned enterprises or other organizations) to advance China's primacy militarily and from a commercial perspective.

3 *See also* "Asian Aeronautics: Technology Acquisition Drives Industry Development," GAO/NSIAD-94-140 (May 4, 1994). China's interest in technology acquisition and the overlap between the military and civilian sectors has been studied since at least 1993. Today, a range of Government and private organizations have confirmed the ongoing nature of this interest and the manner in which technology acquisition occurs. *See, e.g.,* the Section 301 Report and M. Brown and P. Singh, "China's Technology Transfer Strategy: How Chinese Investments in Emerging Technology Enable a Strategic Competitor to Access the Crown Jewels of U.S. Innovation" (Defense Innovation Unit Experimental, January 2018).

policymakers across administrations have recognized that these strategies existed, addressing the consequences of China's implementation of these strategies remained diffuse, reactive or minimal.

Since 1975, Congress has legislated with respect to CFIUS three (3) times:

1. In 1988 with the passage of the Exon-Florio Amendments to the Defense Production Act ("DPA")

2. In 1993 with the Byrd Amendment to the DPA which addressed the investigatory period for state-owned enterprises or governments; and

3. In 2007 with the Foreign Investment and National Security Act of 2007 ("FINSA") which, among other updates, reinforced CFIUS' authorities and identified critical infrastructure as part of the national security review process.

In each instance, geopolitical, economic, strategic or technology concerns incentivized Congress and the Executive branch to adjust the process.

Today, the United States faces a critical juncture in its national security posture. Several factors, some of which are noted below, contribute to the crisis that the Government must address:

1. The diffusion of technology based on licit and illicit means

2. China's focus on "civil-military fusion" – a concept which draws on commercial technologies for military, defense or intelligence applications

3. The effectiveness and ineffectiveness of US export control laws

4. The loss of visibility into the technology transfers that occur – whether due to policies which deprive the Government of insight into those transfers or through theft of intellectual property, cyber breaches or insider threats

5. The failure to maintain an updated list of technologies critical to US defense, military and intelligence needs; and

6. The press towards "Commercial-Off-The-Shelf" procurements for Department of Defense programs – a push that provides foreign parties (whether commercial and government) who purchase the same or similar products a roadmap to the technologies important to US warfighting or intelligence capabilities.

The current CFIUS process – coupled with the enhancements proposed in HR 4311 – can provide a framework by which the Committee can proactively engage in the transaction before transfers occur.

Addressing the CFIUS "Delta" – Gaps in the CFIUS Process

"Laws are like cobwebs, which may catch
small flies, but let wasps and hornets break through."
Jonathan Swift

Current CFIUS authorities, while broader under FINSA than they were under Exon-Florio, nonetheless limit the Committee's ability to review some cross-border transactions that provide access to technology that is vital to US national security interests. These limitations include, but are not limited to the following:

1. The Committee currently cannot review certain important transactions – *i.e.*, greenfield investments; bankruptcy asset transfers; joint ventures where the transfers do not involve a "US business"; and minority investments that do not result in "control." Although others have commented that CFIUS may review certain transactions such as bankruptcy proceedings, real estate transactions or joint ventures, these reviews currently require the Committee to find that a "US business" exists. The need to indirectly determine that the Committee has jurisdiction results in unreviewed transactions and inconsistent results. Both substance and form do matter.

2. CFIUS filings are voluntary. While the Committee has the discretion to invite parties to submit notices, the Committee does not currently have the authority to "require" parties to file.

3. The manner in which the agencies determine whether "other laws" effectively address national security concerns is diffuse and inconsistent. Circumstances exist where foreign parties attempt to obtain technology or technical data through the export licensing process, the patent prosecution process or through misappropriation of trade secrets. When they are unable to do so, the foreign parties move instead to simply acquire or invest in the US company and access the technology or technical data as "owners" or investors.

4. Allied government concerns may be addressed but it is unclear whether these issues are consistently included in the CFIUS analysis. The same applies to any cross-border investments that occur in other countries. Examples where the United States raised concerns that were addressed late in the acquisition process or post-closing include transactions in the Netherlands, Germany and Singapore.

5. The constituent agencies with technical expertise lack detailed (and sometimes any) visibility into the state of technology development. Secretary of Defense Mattis has moved forward with a project designed to address this gap. As mentioned by other witnesses, technology research and development is no longer solely the province of the US Government or large organizations. Small, nimble start-ups with innovative, out-of-the-box ideas develop solutions to existing technical problems without Government funding. Finding these companies (or individuals) and tracking the technology being developed is a challenge.

6. The current standard for clearing a transaction – "no unresolved national security threats" – is daunting and allows too much to potentially fall through the cracks. It reflects an absolute standard which is difficult, if not impossible, to meet. CFIUS reviews cover a "slice in time." The questions and filings collect information for the transaction being conducted and the regulations do not require historical beyond that which affects the transaction or relates to previously filed CFIUS notices. CFIUS member agencies sometimes request more detailed information, but time constraints can, at times, limit the depth of responses provided or the Committee's follow-up engagement.

7. The "slice in time" approach also limits the Committee's ability to understand whether a foreign company or foreign government has aggregated technical expertise, technology, product development or critical supply chain resources. CFIUS regulations currently ask the parties to indicate whether they had filed CFIUS notices for other transactions. But the regulations do not ask the parties to indicate what transactions the foreign parties completed within the same industry or technical sector for which no notices were filed. This information may not be readily available based on corporate structure since organizations tend to meld acquired assets into existing business units or subsidiaries. Even in instances where the foreign acquirer maintains a separate subsidiary or corporate structure, unless that entity is involved in the transaction, it may not be included in the notice. Without this information, transactions could be cleared that could result in the creation of a potential supply chain or other industry consolidation concern based on the foreign purchaser's power to control the supply or market access.

8. Mitigation agreements designed to address national security concerns appear to be of limited utility because of constrained resources and a lack of authority to compel compliance with the agreed upon terms. The lack of enforcement authority is particularly acute in circumstances where foreign parties or governments invoke blocking statutes to limit what may be seen as the extraterritorial application of US laws or regulations. Two (2) cases pending before the US Supreme Court may address some of these issues, although the Court's decisions could also exacerbate the issue.

HR 4311: The Foreign Investment Risk Review Modernization Act of 2017

HR 4311 offers several enhancements to the current process that elegantly balance the need to maintain an open investment posture while achieving the primary goal of protecting national security. The legislation expands CFIUS authorities to address today's threats, provides the mechanism for increasing resources and identifies additional factors relevant to any national security assessments. Like "time, place and manner" restrictions that apply to speech, HR 4311 provides the baseline authorities needed to review cross-border transactions without unnecessarily burdening open investment.

Any investment – whether US or foreign – generally involves a number of steps including, but not limited to: a) discussions among the parties; b) identification of the assets or businesses to be sold/acquired; c) negotiations on price, liabilities, escrows (where relevant), and regulatory requirements; d) patent and other intellectual property assessments; and e) other due diligence. Depending upon the value and size of the deal, these steps may require more or less time. Even in exigent circumstances – a distressed firm, a bankruptcy or failing firm – some diligence is conducted or the investors risk challenges to their business judgment or duties of care or loyalty.

This process may take from three (3) to four (4) weeks to months and parties routinely structure transactions to address both business and regulatory considerations, such as: a) where to incorporate a purchasing vehicle; b) which tax jurisdiction provides most favorable treatment; and c) which deal structure minimizes regulatory filings. Parties consider these factors and among the regulatory issues, include a review of whether the parties should submit a CFIUS notice. While not designed to circumvent requirements, foreign purchasers and US sellers have reconfigured ownership percentages; number of board seats; management positions; access to business assets; timing of asset transfers; and surviving operations (for research and development as well as other business functions) to minimize potential CFIUS concerns. Having structured – or restructured – transactions, the parties may then decide not to file a voluntary notice.

FIRRMA does not limit the ability of the parties to independently assess whether a filing would benefit their transaction. Nor does it preclude any specific transaction or establish any presumption of denials for <u>all</u> parties, countries or types of transactions. The legislation acknowledges the United States' open investment policies (Section 2(1)-2(3)) as well as the importance of maintaining a strong industrial base and employment to ensure that the United States has access to that which is essential to its national security. And of equal importance, FIRRMA remains cognizant of the time constraints that may apply to transactions and addresses that with a 45-day period of review that provides more certainty and limits the need for withdrawals and refiling.

The legislation does expand the types of transactions subject to review but does so in alignment with the threats that have been identified by a range of sources. It clarifies the standards and documentation requirements, identifies additional risk factors, and encourages multilateral information exchanges. Far too many of the criticisms that have

been levied against the legislation sound like commentary based on the outcome of particular transactions or activities. In a time when threats are increasingly asymmetric and carried out by proxies, establishing an "industry based risk assessment" standard to national security evaluations presents an unacceptable high risk whether by errors in judgment or because the threat is underestimated.

Recommendations

As a practitioner, I have had the opportunity to advise on hundreds of cross-border transactions. Based on my experience, Congress may wish to consider some additional authorities or enhancements to HR 4311 to provide more certainty to the parties and more robust justification for some of the actions CFIUS takes:

1. Congress should at least permit, if not require, CFIUS to publish more information in its Annual Reports regarding the transactions it has reviewed and cleared. For example, the December 2008 Annual Report, at p. 33, identifies by name and country, the entities that were most active in acquiring US critical technology firms. The aggregate data concerning industries and countries, while somewhat helpful, does not adequately notify parties that transactions may be of interest to the Committee. This sometimes results in notices being filed that do not raise national security concerns – thereby impacting Committee resources.

2. I concur with other witnesses who have recommended additional resources for CFIUS. The complexity and sophistication of cross-border transactions continues to grow as does the need for Committee resources who maintain a deep understanding of the corporate, business and legal requirements. But additional resources represent only one (1) element of a greater need – one that is focused on identifying the transactions and technologies that currently escape review and thereby negatively affect national security considerations.

3. Congress should grant CFIUS the ability to publish informational press releases concerning cleared transactions in those instances when the parties publicly release information concerning a CFIUS review or clearance. This will place more detailed information in a centralized source that will assist parties in their analysis regarding whether to file a notice.

4. Congress should consider providing CFIUS enforcement authority for parties who breach mitigation agreements. While the mitigation agreement oversight agency can request information and express concerns over potential noncompliance, the process for remedying a breach is currently too limited.

Thank you for the opportunity to provide these observations and I look forward to responding to any questions.

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