United States General Accounting Office

GAO

Report to the Honorable
Chuck Hagel, U.S. Senate

June 2000

DEFENSE TRADE

Identifying Foreign Acquisitions Affecting National Security Can Be Improved

GAO

Accountability * Integrity * Reliability

GAO/NSIAD-00-144

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United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-285111

June 29, 2000

The Honorable Chuck Hagel
United States Senate

Dear Senator Hagel:

In 1988, Congress enacted the Exon-Florio Amendment to the Defense Production Act, authorizing the President to suspend or prohibit foreign acquisitions, mergers, or takeovers of U.S. companies if there is credible evidence that a foreign controlling interest might threaten national security and if other legislation cannot adequately protect national security. Congress passed the legislation to prevent foreign acquisitions that would adversely affect national security with respect to the domestic defense industry, U.S. technological leadership in national security areas, and the sale of military equipment and technology to countries that support terrorism or proliferate missile technology or chemical and biological weapons.

The President delegated the authority to review foreign acquisitions of U.S. companies to an interagency group, the Committee on Foreign Investment in the United States. The Secretary of the Treasury chairs the Committee, which consists of 11 departments and agencies, including the departments of State, Commerce, and Defense.[1] Companies involved in a foreign acquisition of a U.S. company that may affect national security are encouraged to voluntarily report the acquisition to the Committee. The Committee then passes the report to its member agencies to determine whether the acquisition could adversely affect national security. To supplement voluntary reporting, the Committee's member agencies also have the authority to independently report foreign acquisitions that may affect national security and that have not been voluntarily reported to the Committee.

[1] Other member agencies include the Department of Justice, the Office of Management and Budget, the Council of Economic Advisers, the United States Trade Representative, the Office of Science and Technology Policy, the National Economic Council, and the National Security Council. The Department of Energy participates in the review of certain acquisitions, but is not a member of the Committee.

Because of concerns that the current process may not identify all foreign acquisitions of U.S. companies that could affect our national security, you asked us to review the process used by the Committee on Foreign Investment to identify foreign acquisitions of U.S. companies. Specifically, we evaluated the current identification process used by the Committee and the effectiveness of the Committee's follow-up on acquisitions identified by its member agencies.

Results in Brief

The identification process the Committee on Foreign Investment currently uses does not enable it to effectively identify all foreign acquisitions with possible effects on national security. The Committee depends on a system of voluntary reporting by the parties to foreign acquisitions. The Committee also encourages each member agency to inform the Committee of any acquisitions that comes to the agency's attention. We did not attempt to identify foreign acquisitions of U.S. companies with potential national security implications that were not reported voluntarily. However, we did find that member agencies become aware of such acquisitions in the course of their daily operations. In some instances member agencies reported foreign acquisitions to the Committee, but in other instances agencies did not. Defense and Treasury Department officials informed us of three acquisitions that were known to officials in these agencies but the agencies did not inform the Committee. For example, in March 1999, a German-owned firm acquired a U.S. manufacturer of ceramic body armor. The U.S. company reported the acquisition to the Defense Security Service and the State Department's Office of Defense Trade Controls because the company manufactures classified defense products and was required by law to report the acquisition to the Defense and State Departments (but not to the Committee). The company, the Defense Security Service and the Office of Defense Trade Controls did not inform or report this acquisition to the Defense, State, or Treasury Departments' Committee representatives because there is no requirement to do so. As a result, the Committee did not conduct a full assessment of this acquisition.

The Committee does not keep records of acquisitions referred by member agencies, does not document all contacts made with the parties to acquisitions to encourage voluntary reporting, and does not track whether these contacts led the parties to report the acquisition to the Committee. As a result, Treasury officials could not tell us which acquisitions were identified by member agencies but not reviewed by the Committee. Further, the Committee has no process to inform all member agencies that potentially relevant unreported acquisitions have been identified. As a

result, not all member agencies have the opportunity to review acquisitions identified by other member agencies for potential national security risks using relevant information available only to individual agencies.

We are making recommendations aimed at improving (1) the current process used by the Committee on Foreign Investment to identify foreign acquisitions of U.S. companies with national security implications and (2) the Committee's use of available information about acquisitions that may have potential implications for national security to determine whether the acquisitions warrant further review. In commenting on a draft of this report, the Commerce, Defense, and Treasury Departments agreed with our recommendations. The State Department said that they would take our recommendations under advisement.

Background

The President established the Committee on Foreign Investment in the United States in 1975 to monitor foreign investment.[2] The Treasury Department's Office of International Investment coordinates the Committee's activities and has the dual responsibility of monitoring foreign investment in the United States and advocating U.S. policy on open investment—that is, U.S. policy of advocating free trade and world markets open to foreign investment.

Voluntary reporting of a foreign acquisition requires the U.S. company or the foreign company to submit detailed information to the Committee concerning the organization, background, assets, and products of each company and how these areas relate to national security. Since legal fees associated with a submission can be a burden to a company, and because reviewing all acquisitions could create a large workload for the Committee's member agencies, the Committee does not require reporting of acquisitions that do not involve national security issues. Committee officials told us, however, that it is in the interest of the foreign investor to voluntarily report because the President retains the authority to force divestiture for acquisitions that are not reviewed by the Committee. Committee member agencies also have the authority to report any foreign

[2] Executive Order 11858 (May 9, 1975) as amended by Executive Order 12661 (Dec. 27, 1988) and Executive Order 12860 (Sept. 3, 1993).

acquisition that comes to their attention and that may adversely affect national security.[3]

Once companies involved in an acquisition provide the required information, the Treasury Department distributes the companies' reports to its member agencies for an initial 30-day review. If the Committee decides during this 30-day review that there could be credible evidence to support the belief that the foreign entity may take action that threatens to impair national security, it can initiate a 45-day investigation. After it completes the investigation, the Committee submits a report and a recommendation to the President. The President has 15 days to decide whether to allow the acquisition to proceed or suspend or prohibit it. The Committee retains the right to review at any time any acquisition that is not reported to the Committee. Such a subsequent review could result in an order to divest.

Before the Exon-Florio Amendment,[4] a foreign acquisition could not be stopped unless the President declared a national emergency or regulators invoked federal antitrust, environmental, or securities laws. To take action under Exon-Florio, the President must find that (1) credible evidence exists that the foreign interest might take action that threatens to impair national security and (2) provisions of law, other than this legislation and the International Emergency Economic Powers Act,[5] do not provide adequate and appropriate authority to protect national security.

Process Does Not Ensure Acquisitions Are Identified

The Committee does not know the extent of foreign acquisitions of U.S. companies that have effects on national security. To ensure that national security-related acquisitions are reviewed, Treasury depends on voluntary reporting by the companies involved, and Treasury officials encourage the

[3] 31 C.F.R. Section 800.401.

[4] The amendment is a provision of the Omnibus Trade and Competitiveness Act of 1988 and part of the Defense Production Act of 1950, 50 U.S.C. app. 2170, which has been extended until the end of fiscal year 2000 by Section 1063 of the National Defense Authorization Act of Fiscal Year 2000.

[5] The International Emergency Economic Powers Act gives the President broad powers to deal with any "unusual and extraordinary threat" to the national security, foreign policy, or economy of the United States (50 U.S.C. 1701). To exercise this authority, however, the President must declare a national emergency to deal with any such threat. Under this legislation, the President has the authority to investigate, regulate, and, if necessary, block any foreign interests' acquisition of U.S. companies (50 U.S.C. 1702(a)(1)(B)).

Committee's member agencies to inform the Committee of any national security-related foreign acquisitions they identify in the course of their work.

Voluntary reporting results in some acquisitions not being reported by the companies. For example, in November 1999, the Commerce Department informed the Committee of a January 1999 acquisition of a U.S. ultra-precision machine tools manufacturer by a Swiss-owned company. The Commerce Department became aware of the acquisition when the Swiss-owned company applied for a Commerce Department license to sell products to a Chinese manufacturer of jet engine turbine blades. Treasury contacted the company, which agreed to voluntarily report the acquisition to the Committee. However, the Committee does not keep records of acquisitions identified by member agencies and does not document all contacts made with the parties to these acquisitions to encourage voluntary reporting.

Some national security-related foreign acquisitions are reported to individual agencies on the basis of other laws and regulations, but no requirement exists to inform the Committee of these acquisitions. For example, companies that manufacture certain controlled items are required to report their acquisition by a foreign entity to the State Department's Office of Defense Trade Controls. The Office of Defense Trade Controls is required to report these acquisitions to the U.S. Customs Service but is not required to inform Committee representatives at either the State or Treasury Departments of these acquisitions. As a result, agencies do not always inform the Committee of foreign acquisitions and diverse agency perspectives on national security may not be considered.

Since the Exon-Florio legislation was enacted in 1988, nearly 1,300 foreign acquisitions have been reported voluntarily to the Committee. These acquisitions represent about 17 percent of the nearly 7,400 foreign acquisitions of U.S. companies that have been reported to the Commerce Department's Bureau of Economic Analysis over the same period.[6] However, many of these acquisitions had no effect on U.S. national security. In December 1995, we reported that although many companies

[6] Data reported by the Bureau includes only foreign acquisitions of U.S. companies that had total assets of more than $1 million. Beginning in 1998, the threshold was raised to $3 million. Exon-Florio regulations do not specify a minimum investment or asset value for notification.

voluntarily reported proposed foreign acquisitions to the Committee, nearly 600 foreign acquisitions in the high-technology industry were not reported between October 1988 and May 1994.[7] However, we did not gauge to what extent these foreign acquisitions may have had an effect on national security.

Table 1 shows foreign acquisitions annually reported by the Commerce Department, acquisitions reported voluntarily to the Committee, and dispositions of the acquisitions voluntarily reported. Committee officials attribute the large drop in reports after 1990 to companies and their legal representatives obtaining a better understanding of the criteria for reporting foreign acquisitions "affecting national security," after the Committee had several years of experience in conducting reviews.

Table 1: Foreign Acquisitions, Voluntary Reports to the Committee, and Dispositions, 1988-99

Year	Foreign acquisitions	Reports to Committee	Reports investigated	Offers withdrawn	Blocked by President
1988	869	[a]14	1	0	0
1989	837	200	5	2	1
1990	839	295	6	2	0
1991	561	152	1	0	0
1992	463	106	2	1	0
1993	554	82	0	0	0
1994	605	69	0	0	0
1995	644	81	0	0	0
1996	686	55	0	0	0
1997	640	62	0	0	0
1998	[b]673	63	2	2	0
1999	Not available	79	0	0	0
Total	**7,371**	**1,258**	**17**	**7**	**1**

[a]Filings began in September 1988.

[b]1998 data is not complete.

Sources: Committee, Department of Commerce Bureau of Economic Analysis.

[7] See *Foreign Investment: Implementation of Exon-Florio and Related Amendments* (GAO/NSIAD-96-12, Dec. 21, 1995).

In 7 of the 17 investigations, the companies voluntarily withdrew their investment offers and terminated the foreign acquisitions. The President decided not to intervene in 9 of the 10 remaining acquisitions. In one case, the President ordered divestiture of a Chinese company's interest in a U.S. aircraft parts company because the technology used by the U.S. company was under export controls, the Chinese company had close ties to the People's Liberation Army, and the acquisition would have given the Chinese company unique access to U.S. aerospace companies.

Process Depends on Voluntary Reporting and Agency Identification of Acquisitions

To ensure that foreign acquisitions with national security implications are reported, the Committee relies on U.S. and foreign companies to voluntarily report foreign acquisitions and on the Committee's member agencies to inform the Committee of foreign acquisitions. According to Treasury officials, there is no requirement for member agencies to inform the Committee when they identify a potential national security-related foreign acquisition. Although the Committee's member agencies have informed Treasury officials of acquisitions, agencies have never initiated the process that would require companies involved in an acquisition to provide information to the Committee as described in the regulations.[8] Instead, Treasury officials generally encourage agencies to bring foreign acquisitions to their attention informally so that the officials may contact the companies involved and encourage them to report the acquisition voluntarily.

Treasury officials told us that Committee member agencies obtain information about acquisitions that may be of concern by reviewing business media sources. The Committee also relies on each agency to inform it of acquisitions as it carries out its responsibilities in areas such as government contracting, export controls, and industry analysis. In response to our 1995 report, Treasury officials provided guidance reminding agencies to bring to the Committee's attention acquisitions that have not been reported voluntarily. However, our latest review showed inconsistent compliance with this guidance:

- According to an official at the Defense Threat Reduction Agency, which coordinates the Committee's work for the Department of Defense, the agency does not regularly search for foreign acquisitions of U.S. companies, although agency staff have on occasion searched the

[8] 31 C.F.R. Sections 800.401-404.

Internet and other sources to identify proposed acquisitions involving U.S. companies and foreign investors. The official noted that the Department of Defense has to prioritize its work on the basis of what is required by statute and regulation. Other tasks such as identifying non-reporting acquisitions are done as time and resources allow. The official also stated that his office has no additional resources to regularly devote to identification efforts.

- State Department officials told us that they do not search for foreign acquisitions and have not informed the Committee of any acquisitions.
- Commerce Department officials told us that they have occasionally informed the Committee of acquisitions.
- According to the Justice Department's Committee representative, the Department considers Exon-Florio as it reviews mergers and acquisitions, including acquisitions notified under the Hart-Scott-Rodino Antitrust Improvement Act of 1976.[9] Using various sources, the Justice Department has identified several foreign acquisitions to the Committee for review since 1988.
- The Treasury Department's Office of International Investments has an informal method for identifying foreign acquisitions: an official in the Office reads various trade publications and advises the Committee's staff chairperson of pending acquisitions.
- Other officials from Committee member agencies we spoke with, including those from the Council of Economic Advisors, the U.S. Trade Representative, and the Office of Science and Technology Policy, do not attempt to identify acquisitions for the Committee.

The Committee Was Not Informed of Some Known Foreign Acquisitions

In the course of our work, we identified three acquisitions of U.S. companies that had been identified by the departments of Defense, State, and Treasury as having potential implications for national security but that had not been reported voluntarily to the Committee. The Committee was not aware of the acquisitions because it was informed neither by the agencies involved nor by the parties to the acquisitions. As we did not set out to identify such acquisitions, we do not know whether there may be other similar unreported acquisitions. The three acquisitions are the following.

[9] The act (15 U.S.C. 18a) requires parties to a merger or acquisition to notify the Department of Justice and the Federal Trade Commission of the proposed merger or acquisition in order for them to assess whether the acquisition violates antitrust laws.

U.S. company acquired by a German firm. In March 1999, a German-owned firm acquired a U.S. manufacturer of ceramic body armor and a nuclear-related material. The U.S. company manufactures and exports items on the State Department's U.S. Munitions List and is the sole source supplier of ceramic body armor to the Defense Department. It also has several classified contracts with the Army. The company reported the acquisition to the Defense Security Service and the State Department's Office of Defense Trade Controls.[10] However, the company did not report the acquisition to the Committee. Defense Security Service officials told us that they advised company officials of the Committee's reporting process. A company official stated that the board of directors believed the company's obligation was met when it reported to the Defense Security Service. The Defense Security Service did not inform Defense Department Committee representatives of this acquisition because it was not required to do so. The Office of Defense Trade Controls, while notified of the acquisition, did not refer the acquisition to the Committee because it has no process for informing the Committee of foreign acquisitions. The Defense Security Service, the U.S. manufacturer, and the German firm signed a Special Security Agreement[11] to guard against unauthorized disclosure of classified information. However, other national security issues, such as the company's status as a sole source supplier of ceramic body armor, were not considered because a general review by the Committee did not occur. In March 2000, we informed Committee representatives of this acquisition. They subsequently contacted the company, and company representatives agreed to report the acquisition to the Committee.

U.S. company acquired by a French firm. In August 1998, a French-owned firm acquired a U.S. manufacturer of laser systems. The U.S. manufacturer had several classified Army contracts to maintain equipment and also makes lasers used in rocket launches. The U.S. manufacturer contacted the Defense Security Service shortly after the acquisition occurred. The manufacturer chose not to enter into a Special Security

[10] Companies with defense contracts that entail the use of classified national security information are required to report acquisition by a foreign entity to the Defense Security Service. Companies that manufacture items on the Munitions List (22 C.F.R. Part 121) are required to report acquisition by a foreign entity to the State Department. The Munitions List consists of defense articles, services, and related technical data that are controlled.

[11] Industrial Security Regulations require that a company obtain a facility clearance before working on a classified Department of Defense Contract. To obtain clearance, a U.S. defense contractor that is majority-owned by a foreign company must first accept a voting trust, proxy agreement, or Special Security Agreement to insulate it from its foreign owners.

Agreement with the Defense Security Service and canceled its classified contracts. Defense Security Service officials told us that they advised company officials of the Committee's reporting process. A company official told us that most of its business had been in the defense sector but was now primarily in the commercial sector and that as a result, the company did not believe it needed to report the acquisition to the Committee. However, the company manufactures some sensitive products that require Commerce Department approval for export. Defense Security Service officials did not inform Committee representatives at the Department of Defense or the Committee itself of the acquisition because they were not required to do so. As a result, the Committee did not have the opportunity to determine whether the acquisition would adversely affect national security. In March 2000, we informed Committee representatives of this acquisition. They subsequently contacted the company, and company representatives agreed to send a letter to the Committee explaining why they do not intend to report.

U.S. company acquired by a Hong Kong firm. In December 1995, a Hong Kong firm purchased a U.S. bearing manufacturer. The U.S. company has various contracts and purchase orders with the Department of Defense and the National Aeronautics and Space Administration. The company's bearings are used in military aircraft, submarines, satellites, and vehicles. A major U.S. business trade publication had featured the acquisition in August 1996 and reported on the Hong Kong investor's connection with the People's Republic of China. The article noted the planned transfer of sensitive technology. Records show that a Treasury Department Committee representative had transmitted a copy of the publication to a Defense Department Committee representative. Yet neither Treasury nor Defense officials informed the Committee of the acquisition. Defense Department officials could not recollect why they took no action to refer the acquisition for review when they saw the publication.

During the acquisition, the parties involved were not aware of the Committee's reporting process and did not report the acquisition to the Committee until November 1997, nearly 2 years after the acquisition. Committee representatives explained that a new legal counsel at the company identified the need to report to the Committee. During the 30-day review, the Committee discovered that the company had not properly registered as a manufacturer of controlled items with the State Department as required by the International Traffic in Arms Regulations. In December 1997, the Committee permitted the company to withdraw its voluntary

report to avoid a Committee 45-day investigation and gave the company time to address the Committee's concerns.

In September 1998, the company resubmitted its acquisition notification to the Committee. The Committee conducted a full investigation and determined that the company had not met its obligations to classify its technology or bearings for licensing purposes and to identify whether there had been any illegal exports. According to the Committee's investigation documents, the foreign buyer's reason for the acquisition was to transfer the company's technology to China to upgrade a bearing factory there. The investigation concluded that continued ownership and control of the U.S. company by the Hong Kong firm posed a threat to national security because it risked unauthorized transfer of products and technology and that existing laws would not be effective in preventing the transfer of specific technology. The company agreed to withdraw its report of the acquisition to avoid the possibility of a divestiture order from the President. As part of the agreement, the Hong Kong company is divesting its interest and has appointed a U.S. citizen as an interim trustee to oversee operations of the U.S. manufacturer until divestiture is complete.

Follow-Up Not Effective

Treasury officials believe that using informal agency referrals allows them to remain aware of foreign acquisitions with potential national security implications and that this informal process precludes the need for formal agency reports to the Committee. Treasury Department officials gave us several recent examples in which a member agency informed them of unreported acquisitions and followed up by encouraging the parties to the acquisitions to voluntarily report. The officials said that they contact companies several times a year to encourage voluntary reporting. However, Treasury does not maintain records of these contacts and officials there were unable to provide data on the results of these informal referrals.

Committee member agencies maintain information that could help identify sensitive foreign acquisitions with potential effects on national security. However, the Committee does not have a process in place to inform all member agencies when it becomes aware of an acquisition that has not been voluntarily reported. If they do not know about such foreign acquisitions, agencies cannot determine whether acquisitions have national security implications. Below are examples of some government and commercial information sources that are currently available and that, had they been used to share information about foreign acquisitions among all

Committee agencies, could have helped identify the national security implications of the three foreign acquisitions we found:

Office of the Deputy Under Secretary of Defense for Industrial Affairs and Installations. The Office of the Deputy Under Secretary of Defense for Industrial Affairs and Installations reviews filings under the Hart-Scott-Rodino Antitrust Improvement Act of 1976 to address mergers within the defense industry. The office subscribes to a private database service that provides access to over a dozen commercial databases, including one that provides extensive information on defense-related mergers, acquisitions, buyouts, and joint ventures. According to officials in the Office of Industrial Affairs, analysts in the office notify the Defense Threat Reduction Agency, which coordinates Defense Department Committee activities, of 5-10 foreign acquisitions identified by their information sources annually. However, the officials could not provide documents on these acquisitions and could not recollect the specifics of these acquisitions or whether the companies ultimately reported to the Committee.

Defense Security Service. Under the National Industrial Security Program, U.S. companies that have classified defense contracts are required to notify the Service when they are acquired by a foreign entity so that the Service can ensure that unauthorized disclosure of classified information to the foreign buyer does not occur. These companies must also report any material change concerning foreign ownership, control, or influence and update their ownership status every 5 years. Defense Security Service officials told us that whenever a change of ownership involves a foreign buyer, they advise the parties to file with the Committee. However, the Defense Security Service does not consistently inform the Committee when it is aware of acquisitions involving foreign buyers and does not follow up to ensure that companies report to the Committee because there is no requirement to do so.

Department of State. The Department's Office of Defense Trade Controls maintains a database of companies that manufacture or export defense articles or furnish defense services controlled under the International Trade in Arms Regulations. All companies that manufacture covered defense articles or furnish defense services are required to register with the Office even if they do not export these defense articles or services. An Office of Defense Trade Controls official told us that the Office's databases can identify companies that manufacture controlled defense articles. Additionally, registered companies must notify the Office of an intended

sale or transfer of ownership to a foreign entity. The Office provides this information to the U.S. Customs Service but not to Committee representatives at the State and Treasury Department because there is no requirement to do so.

Department of Commerce. The Bureau of Export Administration has a list of companies that have been granted licenses to export controlled commodities, as well as information on the status of applications for export licenses and violations of Export Administration Regulations. This list could be used to identify potential national security implications of foreign acquisitions.

Department of Justice. The Department's Antitrust Division reviews filings reported under the Hart-Scott-Rodino Antitrust Improvement Act of 1976. The Department maintains a database of reported acquisitions. However, the database includes only acquisitions valued at $10 million or more and does not specifically isolate foreign acquisitions of industries with links to national security. Using various sources, the Justice Department Committee representative has notified Committee staff at the Treasury Department several times of acquisitions involving foreign buyers.

Defense Intelligence Agency. The Agency assesses the risk of diversion of critical defense technology for each acquisition that is voluntarily reported. Among the tools the agency uses to assess this risk are commercial databases containing information on thousands of high-technology companies. Agency officials told us that their databases could identify acquisitions with national security implications if the Committee provided the names of the parties to these acquisitions.

Private sector databases. A number of private sector companies develop and maintain financial management information databases, many of which are accessible by subscription on the Internet. One company has several on-line databases, including one covering worldwide mergers and acquisitions. Another company conducts research into and provides information on private investment activities. Still another company maintains a comprehensive database covering thousands of international journals, books, and other publications.

Conclusions

In an era of increasing global markets that are open to foreign investment and rapid technological innovation, understanding the impact that foreign acquisitions of U.S. companies have on national security is increasingly

important. The Committee's member agencies do not always inform the Committee of known foreign acquisitions with national security implications. These unreported acquisitions may be reviewed from only one perspective, for example, from the viewpoint of protection of classified material, while other important national security concerns, such as technology transfers, weapon technology proliferation, or foreign sources of supply, may not be considered.

Committee member agencies maintain information that could help identify sensitive foreign acquisitions that could have an impact on U.S. national security. However, the Committee does not have a process in place to inform all member agencies when it becomes aware of an acquisition that has not been voluntarily reported. If they do not know about foreign acquisitions, agencies cannot use their resources to determine whether acquisitions have national security implications. If agencies had been informed that another member agency was aware of foreign acquisitions, existing agency resources could have been used to identify the three acquisitions we found during the course of our review.

Recommendations

To improve the Committee's process for identifying foreign acquisitions with potential national security implications, we recommend that the Secretaries of Commerce, Defense, Treasury, and State establish procedures requiring agency officials to submit all known foreign acquisitions of companies with potential national security implications to the Committee on Foreign Investment.

We further recommend that the Secretary of the Treasury, in his role as Chair of the Committee on Foreign Investment in the United States, establish a process for sharing information on all foreign acquisitions submitted by one member agency with all of the Committee's member agencies, so that agencies can check their databases to determine whether any potential national security implications exist.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Departments of Commerce, Defense, State, and Treasury and have included them as appendixes I to IV. Commerce, Defense, and Treasury agreed with the report and recommendations, and provided information on the ways they plan to address them. The three agencies also provided technical comments that we have incorporated as appropriate. The

Department of State, while not expressing a view on our recommendations, commented that it would take our recommendations under advisement and would discuss them with the other interested federal agencies. Since the State Department collects information from U.S. companies that identify foreign acquisitions of U.S. weapon manufacturers, we believe the Department should share this information with Committee representatives because it is an important body of information that can be used to identify acquisitions that should be reviewed.

While agreeing with our recommendations, Treasury questioned our finding concerning the adequacy of the Committee's procedures for ensuring that relevant foreign acquisitions are reported. Treasury commented that our report does not emphasize the safeguards the Committee uses to help ensure that acquisitions that affect national security are reported. Treasury stated that there is a procedure in the Exon-Florio regulations that allows member agencies to notify the Committee of a foreign acquisition. While we agree that this provision exists, our report points out that it has never been used. Since we are aware of acquisitions that have not been reported to the Committee, the provision alone does not appear to ensure reporting of foreign acquisitions. Further, our report describes in great detail the Committee's processes for identifying and reporting foreign acquisitions and shows that the system for identifying and reporting unreported acquisitions is flawed. Our recommendations are intended to help correct these flaws.

Scope and Methodology

To evaluate the current identification process, we spoke with officials and collected data from the Committee's member agencies, including the Departments of Commerce, Defense, Justice, State, and Treasury; the Council of Economic Advisors; the U.S. Trade Representative; and the Office of Science and Technology Policy. The objective of these discussions was to determine what processes member agencies use to identify foreign acquisitions. As for agencies that attempt to identify foreign acquisitions, we queried them on their processes and collected documents on the unreported acquisitions they have identified. We also spoke with officials at two companies to understand their rationale for not reporting acquisitions. We did not set out to identify the extent of national security-related foreign acquisitions that are not reported to the Committee. Instead, we relied on officials from member agencies to identify foreign acquisitions, mergers, and takeovers that were not reported to the Committee. Therefore, we do not know to what extent, if any, there are other national security-related acquisitions that were not reported to the Committee.

We relied on the Treasury and the Commerce Departments' data to break down the number of acquisitions that were reported by the companies and investigated by the Committee. To describe the universe of foreign acquisitions in the United States, we used data collected by the Commerce Department's Bureau of Economic Analysis. Because Committee agencies do not maintain information on all foreign acquisitions, we were unable to quantify the number of national security-related foreign acquisitions.

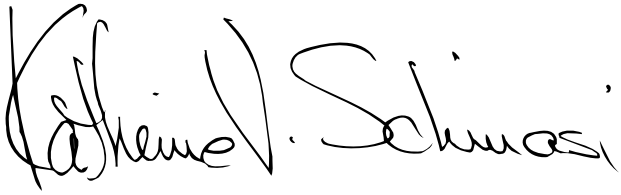
To evaluate how the Committee follows up on agency identifications, we met with officials at member agencies to understand the Committee's follow-up process. We discussed with officials at Treasury and other member agencies how they track identified foreign acquisitions. We also queried member agencies and private sector sources to determine what data they currently use to identify acquisitions and what other data they have that would be helpful in identifying the national security implications of foreign acquisitions.

We conducted our work from November 1999 through April 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this report to Senator Phil Gramm and Senator Paul Sarbanes in their capacities as Chairman and Ranking Minority Member, respectively, of the Senate Committee on Banking, Housing and Urban Affairs, and to Representative James A. Leach and Representative John J. LaFalce in their capacities as Chairman and Ranking Minority Member, respectively, of the House Committee on Banking and Financial Services. We are also sending copies to the Honorable William M. Daley, Secretary of Commerce; the Honorable William S. Cohen, Secretary of Defense; the Honorable Madeleine K. Albright, Secretary of State; the Honorable Lawrence H. Summers, Secretary of the Treasury; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will also make copies available to others on request.

Please contact me on (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report were Blake Ainsworth, Raymond H. Denmark, Jr., and Thomas J. Denomme.

Sincerely yours,



Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues

Comments From the Department of Commerce

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES DEPARTMENT OF COMMERCE
The Deputy Under Secretary for International Trade
Washington, D.C. 20230

May 30, 2000

Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Schinasi:

Thank you for your letter providing the opportunity to comment on your draft report "Defense Trade: Identifying Foreign Acquisitions Affecting National Security Can Be Improved." The Department of Commerce concurs with your recommendations for sharing information on foreign acquisitions provided by one member agency among all Committee members. In that regard, the Commerce Department maintains valuable databases of industry information which will contribute to the evaluation of the national security effects of foreign acquisitions. This should increase the overall awareness of CFIUS agencies regarding foreign acquisitions in areas beyond the immediate scope of their own responsibilities.

There are three comments I would like to suggest for your consideration:

Now on p. 3.

On page 2, paragraph 2, the third sentence should be clarified to state, "~~United States and foreign companies involved in an acquisition~~ The parties involved in an acquisition of a U.S. company by a foreign company that may affect national security are encouraged to voluntarily report the acquisition to the Committee."

Now on p. 4.

See comment 1.

On page 4, the first sentence of the first full paragraph should be revised to better support the statement in the next sentence. It should be modified to read, "The Committee does not keep records of acquisitions identified by member agencies, does not document all contacts made with the parties to these acquisitions to encourage voluntary reporting, and does not track whether or not these contacts led the parties to report to the Committee."

Now on pp. 7 and 8.

See comment 2.

On page 7, first full paragraph, the commentary accompanying Table 1 states correctly that many of the foreign acquisitions reported to the Commerce Department's Bureau of Economic Analysis (BEA), but not to CFIUS, have no effect on U.S. national security. It is then stated in the text that "In December 1995, we reported that although many companies voluntarily reported proposed foreign acquisitions to the Committee, nearly 600 foreign acquisitions in the high-technology industry did not report between October 1988 and May 1994." The reader should be informed that, as in the case with BEA data, it is not possible to gauge these data in the 1995 report for their effect on national security.

If you have any further questions or need additional information on this matter, please have your staff contact Jerry Bonham, Director of the International Trade Administration's Office of Legislative and Intergovernmental Affairs, at (202) 482-3015.

Sincerely,

Timothy J. Hauser

The following are GAO's comments that address the Department of Commerce's suggested changes to our report.

GAO Comments

1. We revised the text to include a statement that the Committee does not track whether or not agency referrals of foreign acquisitions led the parties to report to the Committee.

2. We added a sentence to the text stating that we did not gauge the extent that foreign acquisitions may have had an effect on national security.

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE
2000 DEFENSE PENTAGON
WASHINGTON, DC 20301-2000

POLICY

JUN 14 2000

Ms. Katherine V. Schinasi
Associate Director, Defense Acquisitions Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Schinasi:

This responds to your request for comments on the GAO draft report, "DEFENSE TRADE: Identifying Foreign Acquisitions Affecting National Security Can Be Improved, dated April 28, 2000 (GAO Code 707466/OSD Case 1990").

As described in the attached comments, the Department of Defense concurs with the GAO recommendations in this report.

We appreciate the opportunity to comment on this draft report.

Sincerely,

James M. Bodner

Attachment:
As stated

GAO draft report, "DEFENSE TRADE: Identifying Foreign Acquisitions Affecting National Security Can Be Improved, dated April 28, 2000"

DoD Response to GAO:

Recommendation 1: "The GAO recommended that the Secretaries of Commerce, Defense, Treasury and State establish procedures requiring agency officials to identify all known foreign acquisitions of companies with potential national security implications to the Committee on Foreign Investment in the United States."

Response: we are establishing procedures to inform CFIUS of foreign acquisitions that may not have been the subject of a CFIUS filing. If the Defense Security Service (DSS) becomes aware of a transaction that is reportable under the statute and the parties to the transaction do not voluntarily file with CFIUS within a reasonable time, DSS will initiate action through OASD (C3I) to notify CFIUS via DoD's point of contact for CFIUS filings. The Industrial Security Regulation (DoD 5220.22-R) will be revised to formalize this requirement. In addition, we are working with DoD components and our CFIUS counterparts in other agencies to examine ways to identify pending and/or completed foreign acquisitions with potential national security implications that were not notified to CFIUS.

Recommendation 2: "The GAO recommended that the Secretary of Treasury, in his role as Chair of the Committee on Foreign Investment in the United States, establish a process to share information on all foreign acquisitions identified by one member agency among all the Committee's member agencies so that agencies can check their databases to identify whether national security implications exist."

Response: DoD already has begun work internally as well as with other CFIUS agencies to improve communication so that DoD can check its databases to identify potential national security implications of foreign acquisitions that have not been the subject of CFIUS filings.

Additional DoD Comments:

We recommend the following two technical changes to the report text that we believe improve the clarity of the report:

The following language be added to the end of the last sentence, page

Now on pp. 4 and 14.
See comment 1.

three and the top of page 4, and the end of the last sentence, paragraph one, page 15: "because there is no requirement to do so."

Now on p. 14.
See comment 2.

Change second sentence, last paragraph, page 14 to read, "These companies must also report immediately any material change in information concerning foreign ownership, control or influence (FOCI) that was previously reported and also execute a new form regarding their FOCI factors every five years."

The following are GAO's comments that address the Department of Defense's suggested changes to our report.

GAO Comments

1. We revised the text to include a statement in the report that there is no requirement to report known foreign acquisitions with national security implications to the Committee on Foreign Investment in the United States.

2. We clarified this sentence, which now states that companies must also report any material change concerning foreign ownership, controls or influence and update their ownership status every 5 years.

Comments From the Department of State

United States Department of State

Chief Financial Officer

Washington, D.C. 20520-7427

June 2, 2000

Dear Mr. Hinton:

We appreciate the opportunity to review your draft report "DEFENSE TRADE: Identifying Foreign Acquisitions Affecting National Security Can Be Improved," GAO/NSIAD-00-144, GAO Job Code 707466.

Technical comments were provided directly to your staff. We take the recommendation under advisement and will discuss with other interested federal agencies.

If you have any questions concerning this response, please contact Mr. Wesley Scholz, Director, Office of Investment Affairs, International Finance and Development, Bureau of Economic and Business Affairs, at (202) 736-4247.

Sincerely,

Bert T. Edwards

cc:
GAO/NSIAD – Mr. Ainsworth
State/EB/OIA – Mr. Scholz
State/PM/DTC – Mr. Dixon

Mr. Henry L. Hinton, Jr.,
Assistant Comptroller General,
National Security and International Affairs,
U.S. General Accounting Office.

Comments From the Department of the Treasury

Note: GAO comment supplementing those in the report text appears at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

June 2, 2000

Ms. Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues
National Security and International Affairs
Division
United States General Accounting Office
Washington, DC 20548

Dear Ms. Schinasi:

Thank you for your letter dated April 28, 2000 to the Secretary which requested comments on the GAO draft Final Report, "Defense Trade: Identifying Foreign Acquisitions Affecting National Security Can Be Improved."

I have read the draft Report and believe some additional background would assist its readers in assessing its conclusions and recommendations. Provided below is a brief explanation of the Exon-Florio provision in recognition of its relationship to other U.S. laws and regulations that protect national security and in the context in which the Committee on Foreign Investment in the United States ("CFIUS") implements the provision. I have also provided several comments on the draft Report, as well as a brief description of what Treasury, as chair of CFIUS, is doing to implement the Report's recommendations.

Exon-Florio

When Exon-Florio was enacted, one of the major assumptions behind the legislation was that the President already had at his disposal a number of laws and regulations designed to protect the national security. These range from laws that restrict foreign ownership of U.S. air carriers to laws that regulate the export of sensitive technology or that restrict access to classified information. In recognition of these other laws and regulations, the authority in Exon-Florio was circumscribed, reflecting a presumption that it would be necessary in very few situations, i.e., when no other law, other than the International Emergency Economic Powers Act ("IEEPA") or Exon-Florio itself, is deemed adequate and appropriate to protect the national security.

Since CFIUS's implementation of Exon-Florio began in 1988, there have been more than 1,250 transactions subject to review. Several of these reviews were initiated by the CFIUS chair in response to requests from member agencies. While the President has taken adverse action under the provision on only one occasion, a number of transactions have been withdrawn during the course of review and the parties have either terminated their negotiations, restructured the transaction or, in one case, agreed to voluntarily divest a U.S. company already acquired. Since CFIUS must by law give confidential treatment to the information it receives from the parties to

transactions, there is no public information on specific actions taken in individual cases, including information as to whether CFIUS has undertaken a particular review. Nevertheless, the CFIUS process over the last twelve years has established a record of implementation of Exon-Florio that has been the subject of various reviews and evaluations by GAO and others. These assessments have not provided credible evidence that the implementation of Exon-Florio in conjunction with other laws that protect the national security is inadequate to protect the national security of the United States. In fact, the prevailing judgment is that the existence of Exon-Florio has raised the awareness of foreign investors contemplating acquisitions of U.S. companies to the importance of national security considerations and helped to ensure that foreign investments are structured in ways to avoid national security problems.

The Exon-Florio regulations do not define "national security" and do not specifically define the important threshold concept of "foreign control" in the context of an acquisition. CFIUS concluded more than a decade ago that it is necessary to take this approach in order to give the President the necessary latitude to address problematic transactions that may harm the national security. Deciding the national security impact of a transaction necessarily requires the exercise of judgment.

U.S. Open Investment Policy

The United States has traditionally maintained an open investment policy. This means that foreign investors are accorded national treatment (i.e., permitted to invest in U.S. companies on the same basis as domestic investors) in nearly all sectors of the U.S. economy. Therefore, as a general rule, governmental review and approval of foreign direct investments (FDI) are not required, except in certain sectors related to national security. The United States adheres to this policy because it is in our interest to do so. An open investment policy promotes more open investment regimes in other countries, which benefits U.S. investors seeking investment opportunities abroad. More investment flows abroad from the United States than from any other country. The United States also receives a larger share of the world's FDI than does any other country. This provides numerous benefits to our economy, including introducing new capital, technology, managerial expertise, and jobs. Some of these benefits accrue to sectors of the economy that enhance the U.S. defense industrial base. The Exon-Florio provision was designed to protect the national security in a manner that would avoid unnecessary limitations on the overall U.S. policy support of FDI inflows.

In its 1995 Report on CFIUS, GAO stated that, "The CFIUS review process serves both to protect national security and to minimize any potential adverse effect of the Exon-Florio legislation on foreign investment in the United States."

Voluntary Notices to CFIUS

The Exon-Florio implementing regulations provide for a voluntary system of notification of foreign acquisitions of U.S. companies in recognition of two essential realities: (1) a mandatory

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system of notification was neither necessary, given the broader national security protection provided by other laws and the relatively small number of foreign acquisitions of U.S. companies with national security implications, nor desirable, given the potential risk that screening foreign acquisitions of U.S. companies could give rise to reciprocal actions in foreign countries for U.S. investors; and, (2) Exon-Florio was designed to supplement other laws and was never intended to be the sole or principle legal vehicle for the United States to protect the national security.

CFIUS believes that the voluntary system of notice is the overwhelming choice for implementing Exon-Florio, even though, such a system does hold the risk that a foreign acquisition that should be notified will not be. However, there are very powerful legal incentives for companies to file when there is a possible link to national security.

Now on pp. 7 and 8.
See comment 1.

The discussion on page 7 and the table on page 8 of the draft Report could be misinterpreted to lead to the unwarranted conclusion that there are a significant number of foreign acquisitions of U.S. companies with implications for national security that have not been notified to CFIUS. We are not aware of any statistics that would support the conclusion that there is systematic under-reporting to CFIUS of national security related foreign acquisitions of U.S. companies. The draft Report notes that, since the enactment of Exon-Florio in 1988, about 17 percent of the nearly 7,400 foreign acquisitions of U.S. companies reported to Commerce Department's Bureau of Economic Analysis (BEA) have been voluntarily filed under Exon-Florio with CFIUS. In retrospect, this can be considered a high ratio, especially in view of the conclusion of the draft Report that many of the acquisitions notified to BEA for statistical purposes *have no effect on U.S. national security*. Certainly, there is no evidence in this record that would support the inference that there are a substantial number of national security-related transactions not notified to CFIUS. While GAO referred to three acquisitions with potential national security implications in the draft Report, this does not constitute evidence of substantial under-reporting.

Also, the draft Report does not emphasize that CFIUS has safeguards to help assure that transactions that affect the national security are notified. CFIUS member agencies are involved in many activities (i.e., contracting, export licensing, industry analysis, government-industry consortiums, etc.) with the private sector which expose them to information about foreign mergers with and acquisitions of U. S. companies. There is a procedure in place to uncover non-notified transactions with national security implications, which includes, as provided in the Exon-Florio regulations, that any CFIUS member agency may notify a transaction that has not been notified by the parties to a foreign acquisition. CFIUS has identified non-notified transactions and, where appropriate, has requested that a notice of the transaction be filed. However, no regime can ensure fully that there will be a review of every transaction on a timely basis. To suggest otherwise ignores the basic reality that companies may seek to evade or abuse such a regime.

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Implementation of the Recommendations

The central conclusion of the draft Report is that there could be better use of the information available to the Executive Branch to assist in strengthening confidence that CFIUS is reviewing all the transactions that should be reviewed. The draft Report identifies two concrete recommendations which we support.

We have informed CFIUS agencies of the recommendations and we have begun the process of putting them in place. In early May, CFIUS met at the staff level to review the availability of databases in member agencies that might assist in identifying foreign acquisitions with potential national security implications that were not notified. As part of this review, the staff chair discussed with the agencies: (1) the efforts being taken to develop procedures intra-agency to help identify such non-notified transactions; and, (2) a procedure for the chair to use information in any such databases effectively in the CFIUS process.

Once this review is complete, the staff chair will prepare a report on these activities. I will then circulate the report and recommendations to CFIUS and request that they undertake efforts to implement the recommendations of the Report.

Sincerely,

Timothy F. Geithner
Under Secretary
(International Affairs)

The following GAO comment addresses the Department of the Treasury's comments on our report.

GAO Comment

1. Treasury states that there are only a relatively small number of foreign acquisitions with national security implications and noted that our report could lead to the conclusion that there are a significant number of foreign acquisitions of U.S. companies with implications for national security. We added language to the report explaining that we did not gauge the extent of unreported foreign acquisitions with national security implications.

   However, since the Committee does not know the extent of foreign acquisitions with national security implications that are not reported, there is no documented basis for the Treasury Department's statement that the number of foreign acquisitions with national security implications are relatively small. Further, according to a February 2000 address by the Deputy Secretary of Defense, the Department plans to depend more heavily on commercial firms to meet military requirements, and is pursuing a number of initiatives to encourage cross-border defense industry cooperation and teaming, which may include increased opportunities for acquisitions of U.S. companies by foreign firms. Therefore, an effective Committee process will become increasingly important as the number of foreign acquisitions grow.

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