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How Governmental Carrots and Sticks Impact Private Investment in Defense Tech and the Security Ecosystem

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In response to rising geopolitical tensions – from the Middle East to the Taiwan Strait to the ongoing conflict in Ukraine –the Biden Administration is increasingly using economic incentives and sanctions to assist the United States' foreign policy objectives or mitigate the risk of increased conflict.

Geopolitical risks primarily create financial instability by two paths:

- *First*, governmental tools such as sanctions, asset freezing and controls on capital create financial uncertainty and risk. This path focuses on denying financial resources to a country or near state actor deemed hostile to U.S. or allied interests.
- *Second*, the threat of conflict itself can disrupt supply chains as companies seek to protect themselves and their assets from becoming casualties of conflict. This can impact parties agnostic to, and unaligned in, a particular geopolitical conflict. Current examples include the diversion of 90% of shipping previously passing through the Red Sea and Suez Canal, the recent decision by numerous airlines to temporarily suspend service to multiple locations across the Middle East, and the impact on commercial fishing activity and related supply chains in the South China Sea as tensions simmer between China and the Philippines.

Because none of these conflicts are likely to end soon, asset managers should be on the look-out for how related governmental actions may affect investment decisions and increase regulatory risk. A review of recent actions, both in terms of carrots and sticks, is helpful to understand where future efforts may lie.

The Stick

With increased geopolitical instability, asset managers must be aware of potential government regulation and legislation as they make investment decisions. The Biden Administration's current efforts are focused on China – specifically, limiting the transfer of technology to China that could be used by the Chinese military against the U.S. and its allies while ensuring the United States has a reliable supply chain of goods, especially semiconductors, should China make good on its threats to unify with Taiwan through force.

The CHIPS Act, a prominent example, funds US$52 billion into U.S. manufacturing of semiconductors. It is estimated that 90% of advanced chips designed by Apple, Broadcom and NVIDIA are manufactured by TSMC in Taiwan. A potential conflict between China and Taiwan, at a minimum, would disrupt the supply of those chips, and at worst, result in the outright destruction of the TSMC manufacturing facilities in such a conflict. According to Secretary of Commerce Raimondo, as a result of the CHIPS Act, the U.S. will manufacture 20% of the world's most advanced logic chips in 2030 (up from 0% today).

Secretary Raimondo has spoken about the importance of "*deny[ing] China our most sophisticated technology."* The CHIPS Act forbids U.S. companies from selling certain semiconductor chips and equipment, and artificial intelligence technology to China. The Administration considers it "*crystal clear*" that such chips would be used to advance the Chinese military.

Increasingly focused on China, bipartisan Congressional efforts have focused on Tik Tok and its storage of Americans' sensitive financial and personal data on servers in China. In addition, Treasury Secretary Yellen recently opened the door to higher U.S. tariffs on Chinese imports, especially those related to the Chinese overcapacities in green energy infrastructure, as well as potential sanctions on Chinese banks and companies if they aid Russian's military in its ongoing invasion of Ukraine.

The Carrot

Equally important is for asset managers to be aware of where the government will *incentivize* innovation moving forward to mitigate geopolitical risk. Some of this innovation is logically in the defense space, but some touches on cybersecurity and societal goods more broadly.

In 2015, the Department of Defense launched an organization, the Defense Innovation Unit (DIU), focused on "*accelerating the adoption of commercial and dual-use technology to solve operational challenges at speed and scale*." Headquartered in Mountain View, California, DIU (with additional offices in Austin, Boston, Chicago and in Northern Virginia) creates incentives to universities and private companies to create solutions in a plethora of areas, including artificial intelligence, cyber, energy, and machine learning.

Similarly, the Defense Manufacturing Community Support Program (DMCSP) makes long-term investments in facilities, workplace development, R&D and supports small businesses to strengthen the national security innovation ecosystem. Meanwhile, the Accelerate the Procurement and Fielding of Innovative Technologies (APFIT) program established by the National Defense Authorization Act of 2022 provided US$150 million in funding last year to small businesses and non-traditional defense contractors fielding technologies in designated criteria.

These are just three examples of the types of incentives the U.S. is using to encourage the development of technologies that might make a difference in future conflicts. Asset managers who are involved in defense, artificial intelligence, cybersecurity or energy should be aware of what government programs might be applicable to their investments and how to best leverage those programs.

We will continue to monitor developments as they relate to possible sanctions, regulations, and incentives from the government and their potential impact on asset managers. Given the number and nature of threatened or actual conflicts across the globe and given the actors involved in those challenges, there is no question that these developments on the world stage will impact managers' investments decisions for the foreseeable future.

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