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Biden Administration Issues Executive Order and Proposals Targeting Outbound Investment in China

Daniel P. Brooks, Nova J. Daly, Nazak Nikakhtar, Paul J. Coyle, and
Patrick Griffio*

In this article, the authors discuss an executive order outlining how the U.S. government will begin to regulate U.S. investments in the People's Republic of China.

After much anticipation, the Biden administration has released an executive order (E.O.)¹ outlining how the U.S. government will begin to regulate U.S. investments in the People's Republic of China. This E.O., when implemented, will regulate U.S. investments in certain Chinese companies engaged in activities related to semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI).

The announcement follows months of discussion at both the White House and within Congress regarding whether and how to curb capital flows into Chinese companies that are developing advanced technologies with military and intelligence applications.

Alongside the E.O., the U.S. Department of the Treasury issued an advance notice of proposed rulemaking (ANPRM)² on implementation of the E.O. and the scope of the program.

Background

The new restrictions on outbound investments in Chinese companies will in some ways build on prior initiatives.

In November 2020, then-President Trump issued an E.O. restricting specific types of investments in Communist Chinese Military Companies designated by the U.S. Department of Defense pursuant to the Section 1237 of the 1999 National Defense Authorization Act.

President Biden subsequently replaced Trump's E.O. in June 2021 by issuing another E.O.³ that similarly restricted outbound investments in Chinese military-industrial complex companies.

Both E.O.s prohibited U.S. persons from transacting in the publicly traded securities of Chinese companies that were linked to the China's defense sector.

Since 2021, Senator Cornyn, Senator Casey, and others within Congress have introduced various iterations of the National Critical Capabilities Defense Act,⁴ which would establish a review process for outbound transactions related to the offshoring of certain supply chains and other "national critical capabilities" to "countries of concern." More recently, Cornyn and Casey introduced the Outbound Investment Transparency Act as an amendment⁵ to the National Defense Authorization Act (NDAA), also aiming to regulate a broad range of investments in China and other "countries of concern."

The E.O.

The new E.O., "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern," will build on these prior efforts and add to the financial restrictions. The E.O. directs Treasury, in consultation with the U.S. Secretary of Commerce and other relevant executive agencies and departments, to issue regulations that (1) require U.S. persons to notify the U.S. government of certain transactions involving "covered foreign persons" that "may contribute to the threat to the national security of the United States" (notifiable transactions), and (2) prohibit U.S. persons from engaging in certain other transactions involving covered foreign persons that "pose a particularly acute national security threat because of their potential to significantly advance the military, intelligence, surveillance, or cyber-enabled capabilities of countries of concern" (prohibited transactions).

The E.O. defines a "covered foreign person" as any "person of a country of concern" engaged in activities involving one or more "covered national security technologies and products." The only "country of concern" identified in the E.O. is the People's Republic of China (including the Special Administrative Regions of Hong Kong and Macau), though additional countries could be added in the future. "Covered national security technologies and products"

include “sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and artificial intelligence sectors that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities of a country of concern.” The E.O. contemplates that additional industry sectors could be identified in the future.

The ANPRM outlines how Treasury proposes to implement the E.O.’s objectives and clarifies the intended scope of the program by elaborating on certain definitions included in the E.O. and proposing additional definitions for other key terms, providing details on the proposed notification requirements and timelines, and describing Treasury’s investigatory authority and enforcement mechanisms, among other things.

“United States Person”

The E.O. authorizes Treasury to prohibit or require notification of instances where a U.S. person engages in a transaction with a covered foreign person. In its ANPRM, Treasury proposes adopting the E.O.’s definition of “United States person” as any U.S. citizen, lawful permanent resident, entity organized under the laws of the United States or any jurisdiction in the United States (including any foreign branches of such entity), and any person in the United States.

“Covered Foreign Person” and “Person of a Country of Concern”

The E.O. requires that Treasury prohibit or require notification of certain transactions by a U.S. person with a “covered foreign person.” Treasury proposes defining a covered foreign person as “(1) a person of a country of concern that is engaged in, or a person of a country of concern that a U.S. person knows or should know will be engaged in, an identified activity with respect to a covered national security technology or product; or (2) a person whose direct or indirect subsidiaries or branches are referenced in item (1) and which, individually or in the aggregate, comprise more than 50 percent of that person’s consolidated revenue, net income, capital expenditure, or operating expenses.” This definition is intended to capture parent companies whose subsidiaries and branches engage

in activities related to a covered national security product, as well as the subsidiaries and branches themselves.

Treasury proposes defining “person of a country of concern” as:

1. Any individual that is not a U.S. citizen or lawful permanent resident of the United States and is a citizen or permanent resident of a country of concern;
2. An entity with a principal place of business in, or an entity incorporated in or otherwise organized under the laws of a country of concern;
3. The government of a country of concern, including any political subdivision, political party, agency, or instrumentality thereof, or any person owned, controlled, or directed by, or acting for or on behalf of the government of such country of concern; or
4. Any entity in which a person or persons identified in items (1) through (3) holds individually or in the aggregate, directly or indirectly, an ownership interest equal to or greater than 50 percent. This definition is intended to capture entities located outside of a country of concern that are majority-owned by persons of a country of concern.

“Covered Transactions”

Treasury proposes using a single term, “covered transaction,” to encompass both prohibited transactions and notifiable transactions. “Covered transactions” would include a U.S. person’s direct or indirect:

1. Acquisition of an equity interest or contingent equity interest in a covered foreign person;
2. Provision of debt financing to a covered foreign person where such debt financing is convertible to an equity interest;
3. Greenfield investment that could result in the establishment of a covered foreign person; or
4. Establishment of a joint venture, wherever located, that is formed with a covered foreign person or could result in the establishment of a covered foreign person.

Treasury does not contemplate retroactive application of this definition to cover transactions and the fulfillment of any uncalled, binding capital commitments with cancellation consequences made prior to the issuance of the E.O. However, Treasury may request information regarding covered transactions that were completed or agreed to after the date of issuance of the E.O. “to better inform the development and implementation of the program.”

Treasury proposes including “indirect” transactions within this definition to “close loopholes” and “clarify that attempts to evade prohibitions on certain transactions cannot find safe harbor in the use of intermediary entities that are not ‘U.S. persons’ or ‘covered foreign persons.’” For example, a U.S. person would be prohibited from knowingly investing in a third-country entity that would use the investment to undertake a transaction that would otherwise be subject to the program if engaged in by the U.S. person directly.

Treasury proposes excluding the following “excepted transactions” from the scope of covered transactions subject to the program:

1. Any of the following investments, provided that the investment does not afford the U.S. person rights beyond standard minority shareholder protections:
 - a. Investments in publicly traded securities;
 - b. Investments in index funds, mutual funds, exchange-traded funds, or similar instruments (including associated derivatives) offered by an investment company; and
 - c. Investments made as a limited partner into a venture capital fund, private equity fund, fund of funds, or other pooled investment funds if (i) the limited partner’s contribution is solely capital into a limited partnership structure and the limited partner cannot make managerial decisions, is not responsible for any debts beyond its investment, and does not have the ability (formally or informally) to influence or participate in the fund’s or a covered foreign person’s decision making or operations and (ii) the investment is below a certain de minimis threshold to be determined by Treasury;
2. The acquisition of the equity or other interest owned or held by a covered foreign person in an entity or assets

located outside of a country of concern where the U.S. person is acquiring all interests in the entity or assets held by covered foreign persons; and

3. Intracompany transfers of funds from a U.S. parent company to a subsidiary located in a country of concern.

Additionally, the following activities would generally not be considered covered transactions as long as they are not undertaken with the purpose of evading the regulations: university-to-university research collaborations; contractual arrangements or the procurement of material inputs for any of the covered national security technologies or products (such as raw materials); intellectual property licensing arrangements; bank lending; the processing, clearing, or sending of payments by a bank; underwriting services; debt rating services; prime brokerage; global custody; equity research or analysis; or other services secondary to a transaction.

The ANPRM contemplates prohibiting U.S. persons from “knowingly directing transactions” that would be prohibited if engaged in by a U.S. person. “Knowingly” for purposes of this provision would mean that the U.S. person “had actual knowledge, or should have known, about the conduct, the circumstance, or the result.” However, this prohibition would not extend to “the provision of a secondary, wraparound, or intermediary service or services such as third-party investment advisory services, underwriting, debt rating, prime brokerage, global custody, or the processing, clearing, or sending of payments by a bank, or legal, investigatory, or insurance services.” The ANPRM also contemplates treating as notifiable or prohibited any transaction by a foreign entity controlled by a U.S. person that would be prohibited or notifiable if engaged in by a U.S. person and proposes requiring U.S. persons to “take all reasonable steps” to prohibit and prevent any transaction by a foreign entity controlled by a U.S. person that would be a prohibited transaction if engaged in by a U.S. person.

“Covered National Security Technologies and Products”

Treasury proposes defining specific covered national security technologies or products based on a description of the technology or product and the relevant activities, capabilities, or end uses of such technology or product, as applicable. Transactions would be prohibited or notifiable depending on whether the covered foreign

person is engaged in activities involving the applicable defined technology or product:

- Semiconductors and microelectronics:
 - Prohibited: Transactions with a covered foreign person engaged in activities that involve specific technology, equipment, and capabilities that enable the design and production of advanced integrated circuits or enhance their performance; advanced integrated circuit design, fabrication, and packaging capabilities; or the installation or sale to third-party customers of certain supercomputers, which are enabled by advanced integrated circuits.
 - Notifiable: Transactions with a covered foreign person engaged in activities involving the design, fabrication, or packaging of other integrated circuits.
- Quantum information technologies:
 - Prohibited: Transactions with a covered foreign person engaged in activities involving quantum computers and components (quantum computers, dilution refrigerators, or two-stage pulse tube cryocoolers); quantum sensors (the development of a quantum sensing platform designed to be exclusively used for military end uses, government intelligence, or mass-surveillance end uses); or quantum networking and quantum communication systems designed to be exclusively used for secure communications, such as quantum key distribution.
 - Treasury is not currently considering a notification requirement for quantum information technologies.
- AI systems:
 - Prohibited: Transactions with a covered foreign person engaged in the development of software that incorporates an AI system and is designed to be “exclusively used” for military, government intelligence, or mass-surveillance end uses.
 - Notifiable: Transactions with a covered foreign person engaged in the development of software that incorporates an AI system and is designed to be “exclusively used” for: cybersecurity applications, digital forensics tools, and penetration testing tools; the control of

robotic systems; surreptitious listening devices that can intercept live conversations without the consent of the parties involved; non-cooperative location tracking (including international mobile subscriber identity (IMSI) catchers and automatic license plate readers); or facial recognition.

Treasury is considering conditioning a person's obligations on the person's knowledge of relevant circumstances and adopting a definition of "knowledge" similar to that found in Section 772.1 of the Export Administration Regulations. Under this approach, to be covered by the regulations, "a U.S. person would need to know, or reasonably should know based on publicly available information and other information available through a reasonable and appropriate amount of due diligence, that it is undertaking a transaction involving a covered foreign person and that the transaction is a covered transaction."

Notification Requirements and Timelines

Treasury proposes requiring parties to file any required notifications no later than 30 days following the closing of the transaction. U.S. persons would be required to provide details regarding the persons involved in the transaction (including beneficial ownership), a description of the basis for determining that the transaction is a covered transaction, information regarding any previous investments made by the U.S. person in the covered foreign person as well as any planned or contemplated future investments, transaction documentation, and other information. With certain limited exceptions, information and documentary material submitted with a notification would be afforded confidential treatment and would not be made public unless required by law.

Enforcement

Treasury anticipates that the program will not involve a "case-by-case" review of U.S. outbound investments similar to that maintained by the Committee on Foreign Investment in the United States (CFIUS) for reviewing foreign investments in U.S. businesses and real estate transactions. Instead, transacting parties will be

responsible for determining whether a transaction is a prohibited transaction, a notifiable transaction, or permissible without notification. Parties who fail to lawfully follow the E.O. and implementing regulations will be at risk of civil and criminal penalties.

The E.O. requires Treasury to investigate violations of the E.O. or implementing regulations and pursue available civil penalties, which could be imposed for any material misstatements made in or material omissions from information or documentary material submitted to or filed with Treasury; undertaking a prohibited transaction; or the failure to timely notify a transaction for which notification is required. Consistent with the E.O. and the International Emergency Economic Powers Act, Treasury can “nullify, void, or otherwise compel the divestment of any prohibited transaction entered into after the effective date” of the implementing regulations. The E.O. authorizes Treasury to refer potential criminal violations under the E.O. or implementing regulations to the Attorney General.

Conclusion

The E.O. announcement follows months of discussions regarding whether and how the United States should restrict outbound investment in China while balancing national security and economic concerns. Leaders on Capitol Hill⁶ were closely following the development of the E.O. and requesting information from the Biden administration on details of a final program. The announcement also follows previous efforts by the White House to restrict China’s access to advanced computer and semiconductor technologies; in October 2022, Commerce and the White House announced a series of export control regulations aimed at restricting China’s ability to purchase and manufacture advanced computing chips.

Notes

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