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# U.S. Issues Unprecedented Order Restricting Investment in China

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*"We now know China as the single largest national security threat of our time, and it's clear that United States entities are helping bankroll its rise."*

– John Cornyn, US Senator from Texas<sup>1</sup>

Senator Cornyn made the above statement on the Senate floor on November 14, 2023, while advocating for his colleagues to pass the Outbound Investment Transparency Act as part of the 2024 National Defense Authorization Act ("NDAA").<sup>2</sup> However, Senator Cornyn could just as easily have made the statement in 2018 when he unsuccessfully advocated for subjecting certain outbound investments to government review as part of the Foreign Investment Risk Review Modernization Act ("FIRRMA"), which expanded the jurisdiction over foreign inbound investment for the Committee on Foreign Investment in the United States ("CFIUS").<sup>3</sup> More on the Outbound Investment Transparency Act later, but independent of Congressional action the United States has already begun setting up an outbound investment screening mechanism – one that gives the executive branch the ability to either prohibit or compel notification of certain investment transactions involving critical technologies in China.

On August 9, 2023, President Biden



issued Executive Order ("EO") 14105, Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern, which requires the Department of the Treasury ("Treasury") to create rules for the screening of investments made by U.S. persons in critical technologies in China. But the EO goes beyond merely screening; Treasury is required to promulgate rules that will in some instances prohibit investment in China related to certain technologies.<sup>4</sup> Treasury has not yet finalized the rules implementing EO 14105, but investment firms, venture capitalists, and even parties to M&A transactions must proceed with caution regarding activities

involving China or Chinese persons.

This article will provide a brief overview of EO 14105 and proposed implementing rules, as well as related legislative developments focused on outbound investment screening, and the outlook for outbound investment screening procedures.

## EO 14105 and Proposed Regulations

President Biden ordered EO 14105 under the authority of the International Emergency Economic Powers Act ("IEEPA"), among other relevant statutory authority.<sup>5</sup> To facilitate the creation of the outbound investment screening



mechanism, President Biden declared a national emergency to deal with the “unusual and extraordinary threat to the national security of the United States” created by the “advancement of countries of concern in sensitive technologies and products critical for the military, intelligence, surveillance, or cyber-enabled capabilities of such countries.” The “countries of concern” are identified in an annex to the EO and currently include only the People’s Republic of China and its Special Administrative Regions of Hong Kong and Macau.

EO 14105 directs Treasury to issue regulations that require U.S. persons to provide information related to certain transactions (“notifiable transactions”) and that prohibit United States persons from engaging in certain other transactions (“prohibited transactions”). The “covered national security technologies and products” identified in EO 14105 include semiconductors and microelectronics, quantum information technologies, and artificial intelligence sectors. Relevant definitions, proposed jurisdictional scope, and possible exceptions were described in more detail, and subjected to public comment, in the concurrently issued Advanced Notice of Public Rulemaking (“ANPRM”).<sup>6</sup>

The ANPRM does the heavy lifting of describing the outbound investment screening mechanism in greater detail, but it quite literally creates more questions than it answers. The ANPRM included 83 numbered questions from Treasury directed at interested parties to assist Treasury in refining the scope of the final outbound investment regulations. Because the regulations may not be finalized for some months, Treasury’s outbound investment ANPRM gives interested parties a general idea of the types of transactions that may be notifiable transactions or prohibited transactions and the parties that may be covered by or excepted from the

forthcoming final regulations.

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

Treasury’s proposed definition of “covered foreign person” includes (1) a person of a country of concern, i.e., China, that is engaged in an activity defined in the regulations involving a covered national security technology or product, and (2) a person whose direct or indirect subsidiaries are a covered foreign person where those subsidiaries comprise more than 50% of the person’s consolidated revenue, net income, capital expenditure, or operating expenses. Under EO 14105, the notification or prohibition requirements are triggered by the involvement of “covered foreign persons,” so the final form of the above definition will be a critical component of future analyses of outbound investment in China.

Similarly, Treasury proposes to define “person of a country of concern” as (1) citizens or permanent residents of a country of concern; (2) an entity incorporated in, organized under the laws of, or having a principal place of business in a country of concern; (3) the government of a country of concern, including political subdivisions and agencies, and any person owned, controlled, or directed by, or acting for or on behalf of the government of a country of concern; and (4) any entity in which a person or persons of a country of concern have individually or in the aggregate, directly or indirectly, an ownership interest of 50% or more.

### Identified “Covered National Security Technologies and Products”

Though subject to change during the rulemaking process, the ANPRM proposes the following types of technologies and products be defined as “covered national security technologies and products,” organized based on

Treasury’s initial identification under either prohibited transactions or notifiable transactions:

#### Prohibited Transactions

- Technologies that Enable Advanced Integrated Circuits
  - Software for Electronic Design Automation
  - Integrated Circuit Manufacturing Equipment
- Advanced Integrated Circuit Design and Production
  - Advanced Integrated Circuit Design
  - Advanced Integrated Circuit Fabrication
  - Advanced Integrated Circuit Packaging
- Supercomputers
- Quantum Information Technologies
  - Quantum Computers and Components
  - Quantum Sensors
  - Quantum Networking and Quantum Communication Systems
- Military, Government Intelligence, or Mass Surveillance AI Systems

#### Notifiable Transactions

- Integrated Circuit Design, Fabrication, or packaging that do not meet the requirements of prohibited transactions involving such products or technologies.
- AI Systems for Cybersecurity, Robotics Control, Surreptitious Listening, Location Tracking, and Facial Recognition

### Covered and Excepted Transactions

Transactions involving the above technologies or products will only be subject to prohibition or notification requirements, respectively, if the

transactions are "covered transactions" that are not "excepted transactions." Treasury has proposed the definition of a "covered transaction" to be the following actions of a U.S. person:

- (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.

The lengthy definition of "excepted transaction" under consideration by Treasury includes exceptions for investments in a publicly traded security; an investment in a mutual fund, index fund, exchange-traded fund ("ETF"), or a similar instrument; or investments made as a limited partner into a venture capital fund, private equity fund, fund of funds, or other pooled investment funds, subject to certain limitations. An excepted investment also prospectively includes complete acquisitions by U.S. persons of an entity or assets held by covered foreign persons, intracompany transfers of funds from a U.S. parent to a subsidiary in China, and a transaction made pursuant to a binding, uncalled capital commitment entered into before August 9, 2023.

## Notification Requirements

For notifiable transactions, the proposed regulations contemplate that the notification be provided "no later than 30 days following the closing of a covered transaction." Examples

of the type of information Treasury has proposed to collect for notifiable transactions include identity and nationality (for individuals) of persons involved in the transaction, beneficial ownership and key personnel of parties to the transaction, transaction documents, and description of due diligence conducted regarding the transaction. The proposed information to be collected has many similarities with information required in voluntary or mandatory filings with CFIUS. Also like CFIUS, the notifiable transaction information will be filed through an electronic portal on Treasury's website.

## Penalties

Failure to notify Treasury of a notifiable transaction, entering into a prohibited transaction, or making material misstatements or omissions to Treasury could lead to up to \$356,579 in civil penalties per violation. Like the CFIUS regulations, the biggest risk for companies entering into transactions prohibited by the outbound investment regulations may be Treasury's power, as granted by EO 14105, to "nullify, void, or otherwise compel the divestment of any prohibited transaction entered into after the effective date" of the implementing regulations. Criminal violations may be referred to the Department of Justice for criminal prosecution.

Treasury received comments on the ANPRM until September 28, 2023, and will next issue a Notice of Proposed Rulemaking, triggering a further public comment period. After review and possible revision, the final regulations will be implemented.

## Proposed Outbound Investment Legislation

As referenced in the introduction, Senator Cornyn, along with several other legislators, is still advocating for the

passage of some form of legislation to review outbound investments despite the implementation of EO 14105. Senator Cornyn's Outbound Investment Transparency Act was ultimately not included in the 2024 NDAA, but its provisions demonstrate the possible effects of Congressional passage of an outbound screening mechanism, namely codifying requirements and providing Congress with greater oversight of the regulatory process.

Congress may still codify the EO with modified language or pass other outbound screening legislation. For example, a bill titled the Preventing Adversaries from Developing Critical Capabilities Act was introduced in the House of Representatives in November 2023 by Representative Michael McCaul of Texas and Representative Gregory Meeks of New York (the "McCaul-Meeks Bill").<sup>7</sup> This bill tracks closely with EO 14105 by requiring the identification of certain categories of technologies and products of specific industries that may pose a threat to U.S. national security when developed or acquired by a country of concern. This list of categories of technologies and products would then be published in the Federal Register and reviewed annually to provide necessary updates. The McCaul-Meeks Bill imposes notification requirements for U.S. investments in covered technology sectors including hypersonics and supercomputing. Like EO 14105, the McCaul-Meeks Bill includes prohibitions on certain transactions.

It is also possible that EO 14105 remains the primary method for the United States to monitor or prohibit outbound investment in certain technologies. But the "covered national security technologies and products" could expand to include additional technologies contemplated by the proposed legislation discussed above or other technologies that have not yet been declared as part of the EO.

Additionally, US allies in G7 countries have provided commitments to also restricting certain investments in critical technologies in China.<sup>8</sup>

## Impacts on Investors

Regardless of the various forms of outbound notification and restriction requirements, investors and practitioners should stay abreast of the forthcoming regulations and any relevant legislation. Under the proposed regulations, the responsibility for determining whether an outbound investment is prohibited or subject to a mandatory notification requirement will be borne by the parties to the transaction. Specifically, the ANPRM contemplates the outbound investment screening mechanism having a knowledge standard that will “condition a person’s obligations on that person’s knowledge of relevant circumstances.” Under this standard, U.S. firms could be responsible for complying with the outbound investment rules when they know or have reason to know or believe that a covered foreign person is engaged in, or will foreseeably be engaged in, activities related to relevant sensitive technologies. The contemplated knowledge standard in the ANPRM does not allow those that willfully disregard relevant facts to escape liability. As a result, U.S. firms will need to adjust due diligence procedures related to outbound investments in China to ensure compliance with the final regulations once they are promulgated.

Investors will also need to be mindful of corporate structure details when determining whether and how the new outbound investment rules apply to a prospective transaction. For example, foreign branches of U.S. businesses will be regarded as U.S. persons under the proposed rules and will be responsible for compliance with the regulations. In addition, certain

entities may be included under the definition of a covered foreign person based on the status of the parent entity. Subsidiary companies located in the U.S. may be subject to restrictions under the outbound investment rules when they are owned by a Chinese parent. Similar to analyses under the CFIUS regulations, compliance with the outbound investment rules may require investors to obtain detailed information on an entity’s ownership structure and corporate family.

The rules governing outbound investments will be an addition to the already complex regulatory environment for international transactions. Investors will not only need to address new compliance risks associated with the outbound investment regime but also be aware of how these rules may overlap with other regulations governing transactions that involve certain actors and countries (e.g., China or Russia) that are of particular concern to the U.S. While a transaction may not always be caught under Treasury’s outbound investment rules, it is possible that dealings with certain parties are subject to other U.S. compliance obligations, including economic sanctions and export controls.

## Conclusion

The outbound investment review program as described in EO 14105 and the ANPRM constitutes an unprecedented move by the United States to address national security concerns. While the new rules on outbound investments in certain Chinese technology sectors could take several months to come into force, the rules will impact many classes of investors and present new compliance concerns for U.S. firms. Companies and investors that may be affected by these rules should begin taking steps now to ensure they have adequate internal

compliance mechanisms in place.



*Torres Trade Law is an international trade and national security law firm that assists clients with the import and export of goods, technology, and services. We have extensive experience with the various regimes and agencies governing national security and trade such as U.S. Customs and Border Protection, the Department of Commerce Bureau of Industry and Security, the Department of State Directorate of Defense Trade Controls, the Department of Treasury Office of Foreign Assets Control, the Committee on Foreign Investment in the United States, the Defense Counterintelligence and Security Agency, and others. Our firm provides clients with full support for all trade and national security law issues, including U.S. export control and economic sanctions laws, industrial security, and trade strategy and policy.*

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## Endnotes

- 1 Senator John Cornyn, Discussing Outbound Investment Transparency Ahead of Biden-Xi Meeting, YouTube.com (Nov. 14, 2023), available at <https://www.youtube.com/watch?v=HFmCbL4Kr48>.
- 2 Outbound Investment Transparency Act, S. 2678, 118th Cong. (2023).
- 3 See *CFIUS Reform: Examining the Essential Elements: Hearing Before the S. Comm. On Banking, Housing, & Urban Affairs*, 115th Cong. 2 (2018), available at <https://www.govinfo.gov/content/pkg/CHRG-115shrg29914/pdf/CHRG-115shrg29914.pdf>.
- 4 Exec. Order No. 14,105, 88 Fed. Reg. 54867 (9 August 2023), available at <https://www.govinfo.gov/content/pkg/FR-2023-08-11/pdf/2023-17449.pdf>.
- 5 International Emergency Economic Powers Act, 50 U.S.C. § 1701.
- 6 Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern, 56 Fed. Reg. 54961 (proposed 9 August 2023), available at <https://home.treasury.gov/system/files/206/Provisions%20Pertaining%20to%20U.S.%20Investments%20in%20Certain%20National%20Security%20Technologies%20and%20Products%20in%20Countries%20of%20Concern.pdf>.
- 7 Preventing Adversaries from Developing Critical Capabilities Act, H.R. 6349, 118th Cong. (2023).
- 8 See Joint Communication to European Parliament, European Council, & the Council on "European Economic Security Strategy," European Commission (June 20, 2023), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023JC0020>; See also Emily Benson, et. al., Transatlantic Approaches to Outbound Investment Screening, Ctr. for Strategic & Int'l Stud. (Jan. 17, 2023), available at <https://www.csis.org/analysis/transatlantic-approaches-outbound-investment-screening>.



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