

## Practice Update

# New Outbound Investment Controls Create New Investor Risks

August 28, 2023

On August 9, 2023, President Biden signed the much-anticipated Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern (the Order).

The Order was issued under the authority of the International Emergency Economic Powers Act (IEEPA) and directs the Treasury Department to issue regulations that (1) prohibit U.S. persons from engaging in certain transactions involving foreign persons connected to a country of concern that engage in activities with respect to a covered national security technology or product, and that (2) require U.S. persons to notify the government of certain other transactions.

The People's Republic of China (China), to include Hong Kong and Macau, is identified as the only country of concern in an annex to the Order. The President can add other countries of concern in the future by updating the annex.

Concurrently with the President's Order, the Treasury Department issued an Advance Notice of Proposed Rulemaking (ANPRM) to kick off a 45-day period in which interested parties may provide feedback on various definitions, elements, exceptions, penalties and general parameters of the future regulatory text, particularly with regard to 83

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specific questions presented by the Treasury Department for comment. Written comments must be submitted by **September 28, 2023**.

We do not expect the Treasury Department to issue final rules implementing the new controls until mid-to late-2024. However, investment managers, companies with operations in China, and other persons impacted by the new controls should consider responding to the ANPRM. Those impacted should also assess current compliance practices and identify updates for implementation following issuance of the final rule.

## The U.S. Government Focus on Outbound Investments

Over the last decade, members of Congress, U.S. intelligence agencies and policy makers have become increasingly alarmed by threats posed by U.S. outbound investments in China, which can be exploited to develop sensitive technologies and products critical for military, intelligence, surveillance, and cybersecurity end uses. The primary government concerns with these types of investments are in the transfer of U.S. capital and intangible benefits provided by U.S. investors, such as management assistance, investment networks, talent acquisition, and go-to market expertise.

## The New Outbound Investment Controls

The new controls will prohibit certain investments and require notices for others, which must be filed no later than 30 days following closing of a covered transaction. Either a prohibition or a notice requirement may apply to a **covered transaction** by a **U.S. person** into a **covered foreign person** engaged in an activity involving a **covered national security technology or product**.

In its ANPRM, the Treasury Department proposes the following core definitions:

- **“Covered transaction”** will mean (1) acquisition of an equity interest (e.g., via merger and acquisition, private equity, venture capital, or other arrangement) or contingent equity interest; (2) the provision of debt financing where such debt financing is convertible into an equity interest; (3) a greenfield investment that could result in establishment of a covered foreign person; or (4) a joint venture.
- **“Excepted transactions”** may include passive investments in publicly-traded securities, index funds, mutual funds, exchange-traded funds, certain passive investments made as a limited partner, certain intracompany transfers of funds from a U.S. parent to a subsidiary, and binding but uncalled capital commitments.
- **“U.S. person”** will mean any U.S. citizen, lawful permanent resident, entity organized under the laws of the United States or any jurisdiction within the United States, including any foreign branches of any such entity, and any person in the United States.
- **“Covered foreign person”** will mean:
  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.
- **“Person of a country of concern”** will mean:
  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.

## Covered National Security Technology or Product

The Order defines “**covered national security technology or product**” as 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, as determined by the Treasury Department in consultation with the Commerce Department and other agencies. The ANPRM further indicates that, where applicable, “covered national security technologies and products” may be narrowed by reference to certain end uses of the technologies or products.

### *Advanced Semiconductors and Microelectronics*

- The Treasury Department is considering a prohibition on U.S. persons undertaking a transaction with a covered foreign person engaged in activities involving technologies that enable advanced integrated circuits, such as

electronic design automation software and semiconductor manufacturing equipment; the design, fabrication, or packaging of advanced integrated circuits; and the installation or sale of supercomputers.

- The Treasury Department is also considering a requirement for U.S. persons to notify the Treasury Department if undertaking a transaction with a covered foreign person engaged in activities involving integrated circuit design, fabrication, and packaging of less advanced integrated circuits, that is not otherwise prohibited.

### *Quantum Information Technologies*

- The Treasury Department is considering a prohibition on U.S. persons undertaking a transaction with a covered foreign person engaged in activities involving quantum computers and certain components, quantum sensors, or quantum networking and quantum communication systems.
- At present, the Treasury Department is not considering a separate notification requirement for quantum information technologies.

### *AI Systems*

- The Treasury Department is considering broadly defining “**AI system**” to mean “an engineered or machine-based system that can, for a given set of objectives, generate outputs such as predictions, recommendations, or decisions influencing real or virtual environments.”
- It is also considering a prohibition on U.S. persons undertaking a transaction with a covered foreign person engaged in activities involving software that incorporates an AI system and is designed to be exclusively used for military, government intelligence, or mass surveillance end uses.

- The Treasury Department is further considering a requirement for U.S. persons to notify the Treasury Department if undertaking a transaction with a covered foreign person engaged in activities involving the development of software that incorporates an AI system and is designed to be exclusively used for cybersecurity applications, digital forensics and penetration testing tools, control of robotic systems, certain surreptitious listening devices, non-cooperative location tracking, or facial recognition.

## Penalties for Violations

The Order prohibits any conspiracy formed to violate the Order or implementing regulations and prohibits any action that evades, has the purpose of evading, causes a violation of, or attempts to violate the Order or its implementing regulations. The Treasury Department may refer potential criminal violations of the Order or regulations to the Attorney General for prosecution.

The Order also authorizes the Treasury Department to issue regulations that prohibit persons from knowingly “directing” transactions if such transactions would be prohibited under the Order.

The Treasury Department intends to impose fines up to the maximum allowed under IEEPA (currently \$356,579) for civil violations involving the undertaking of a prohibited transaction, failure to timely file a notice when required, or material misstatements or omissions in documents submitted or filed with the Treasury Department.

The Treasury Department also has the power under the Order to force divestment of any prohibited transaction entered into after the effective date of the final rule. The ANPRM states that the Treasury Department will not use this authority to unwind a transaction that was not prohibited at the time it was completed.

## Congressional Action on the Horizon

We previously discussed the history of Congressional action leading up to the new outbound investment controls [here](#).

More recently, the [Senate version](#) the National Defense Authorization Act (NDAA) for FY2024 incorporates the [Outbound Investment Transparency Act](#) (OITA). OITA would require the Biden Administration to establish a notification process but would not prohibit any transaction. The notification requirement would apply to multiple countries of concern (i.e., China, Russia, Iran, and North Korea) and many industry sectors, some of which overlap with the scope of the Order and ANPRM.

In addition to OITA, bipartisan support exists for passage of the National Critical Capabilities Defense Act (NCCDA), proposed legislation that would substantially broaden the new outbound investment controls. Introduced in 2021, the NCCDA was the subject of a series of Congressional hearings. It was revised in 2022, and then again in 2023. [As recently reintroduced](#) in the House of Representatives, the measure seeks to establish the “Committee on National Critical Capabilities” as an interagency committee to review a broad scope of outbound investment activities in certain industry sectors that involve a country of concern or a covered foreign entity.

The list of NCCDA “national critical capability sectors” includes semiconductor manufacturing, artificial intelligence, large capacity batteries, critical minerals and materials, quantum information science and technology, active pharmaceutical ingredients, automobile manufacturing, and any other sector determined by the President through implementing regulations.

## Conclusion

The new outbound investment controls have finally arrived. U.S. investment firms, fund managers, companies with Chinese subsidiaries or other foreign investments should read the Order and ANPRM, assess likely impacts on existing and future business plans, and consider whether to file comments before the September 28, 2023, deadline. Those impacted should also assess subsidiary and partner activities and prepare updates to relevant internal policies, procedures, and guidelines to ensure timely implementation of suitable due diligence measures.

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