Davis Polk

Biden administration releases initial proposal for outbound foreign investment rules targeting China

August 10, 2023 | Client Update | 17-minute read

The Biden administration has requested public comment on a proposed framework restricting outbound investment by U.S. persons in certain Chinese sectors.

On August 9, the Biden administration released a long-awaited executive order (the Executive Order) and an advanced notice of proposed rulemaking (the ANPRM) providing a conceptual framework for outbound investment controls focused on China, including Hong Kong and Macau (the Outbound Investment Proposal). No detailed rules have yet been proposed, and there are no currently effective restrictions or notification requirements. Feedback on the ANPRM from industry and other stakeholders will be taken into account as Treasury begins to draft proposed rules, which will themselves be subject to notice and comment. Comments on the ANPRM are due by September 28.

At a high level:

- The Outbound Investment Proposal is broadly consistent with expectations established by previous rounds of consultation with practitioners and industry and with prior press reports.
- The new mechanism will be part of the Department of Treasury, housed in the Office of Investment Security (which also manages the CFIUS foreign investment review process). However, unlike CFIUS, there will not be a filing and review mechanism. U.S. investors will be responsible for determining whether an investment is prohibited or triggers a reporting requirement.
- The Outbound Investment Proposal targets investments into "countries of concern," currently only China, and it applies to investments by U.S. persons (including U.S.-controlled persons) in companies based in China, owned by Chinese citizens or companies, or with a majority of their operations in China.
- As the Biden administration has signaled for some time, the Outbound Investment Proposal does not target all or even a large fraction of outbound U.S. investment into China or Chinese-owned companies, instead focusing on investments in companies engaged in activities relating to three sectors: (i) advanced microchips and microelectronics, (ii) quantum computing, and (iii) artificial intelligence designed for military or surveillance applications. Even within those sectors, not all investments will be prohibited or subject to reporting requirements.

However, within the relatively confined universe of the targeted sectors, there are a number of important uncertainties, such as:

- how investors are supposed to assess the (often closely held) technical details of a company's products and their "primary purpose."
- what and how extensive a covered company's activities "relating to" controlled technologies have to be to trigger the rule.
- whether and how investors are meant to assess future product development in companies that may be in the developmental phase.

Although the ANPRM indicates a genuine intent by Treasury to limit unintended consequences and ensure clarity, it appears, based on the conceptual framework proposed to date, that uncertainty and overdeterrence of transactions in the targeted sectors may be an issue.

There may also be an outsized impact on non-U.S. funds and other investment vehicles that are not publicly traded and target U.S. investors. (U.S. and U.S.-controlled funds would be directly bound by the investment restrictions under the ANPRM.) The ANPRM suggests that the final rule will apply to indirect investments as well, and in at least some circumstances it may prohibit at least some U.S. institutional investors from participating in funds that engage in any investment prohibited by the Outbound Investment Proposal. This may require separate vehicles for (or the exclusion of) non-excepted U.S. investors.

The ANPRM also proposes certain important exceptions to the scope of the Outbound Investment Proposal, including that transactions in public securities, index and mutual funds will be exempted and that certain services provided by U.S. person financial intermediaries, including underwriting services and prime brokerage, will not be covered.

We now turn to a more detailed examination of the Outbound Investment Proposal.

Framework and requirements of the Proposal

Structure of the Proposal

The Executive Order provides a general authorizing framework for rules implementing outbound investment restrictions, but it does not itself impose any such restrictions. The Executive Order directs the Secretary of the Treasury, in consultation with the Secretary of Commerce and other agencies as appropriate, to issue regulations subject to public notice and comment that require U.S. persons to provide notification of specified categories of transactions involving "covered national security products and technologies" in "countries of concern" (notifiable transactions) and prohibiting U.S. persons from engaging in specified categories of transactions involving countries of concern (prohibited transactions). The sole country of concern initially identified in the Executive Order is the People's Republic of China (including the Hong Kong and Macau SARs), though additional countries may be named in the future. "Covered national security products and technologies" 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," as defined in the regulations to be issued by the Treasury Department. In other words, the current authority is limited to these three sectors, and the specific technologies and transactions to be covered by reporting requirements or prohibitions are left to be defined by the implementing regulations.

The ANPRM provides high-level guidance on how Treasury intends to approach a number of key points, though in most cases no or limited specific terms are proposed. For each point, Treasury also provides a list of questions soliciting feedback on these proposals during the comment period (though commenters are free to address any issue). After receiving and evaluating the ANPRM comments, Treasury will produce a notice of proposed rulemaking with an actual draft regulation for further review and comment. As noted above, comments on the ANPRM are due by September 28.

Overview of the process

Under the ANPRM approach, "U.S. persons" would be required to evaluate whether "covered transactions" with "covered foreign persons" relating to "covered national security technologies and products" are either Prohibited Transactions or Notifiable Transactions. Unlike CFIUS, there would be no review or clearance of transactions by the U.S. government; the U.S. person investors would be responsible for determining whether a transaction is prohibited or notifiable. (While the ANPRM presently proposes that notifications must be filed no later than 30 days following the closing of a covered transaction, we note that one possibility is that notification would be required in advance, which could effectively impose at least some delay on covered transactions.)

We examine each of the elements below.

"U.S. persons"

The ANPRM would restrict investment by "U.S. persons." The initial definition is reasonably straightforward: any United States citizen, lawful permanent resident, entity organized under the laws of the United States or any jurisdiction within the United States (including its foreign branches), and any person in the United States.

However, the ANPRM would also apply to U.S. person involvement in investments by non-U.S. entities in some circumstances. First, a U.S. person could not knowingly direct a non-U.S. person to engage in a transaction that would be prohibited by a U.S. person. Thus, for example, a U.S. citizen executive of a non-U.S. company could not direct that company to make an investment that would be prohibited if made by a U.S. company (though the ANPRM contemplates that the executive may be able to recuse herself from the investment decision), and a non-U.S. fund managed by a U.S. person general partner could not undertake an investment that would be prohibited for a U.S. person. Second, a U.S. person would have to report any Notifiable Transaction by, and take all reasonable steps to prevent a Prohibited Transaction by, a non-U.S. entity that the U.S. person "controls," which the ANPRM proposes to define as direct or indirect ownership of a 50% or greater stake. The ANPRM does not, however, prohibit U.S. persons from acting in intermediary or other capacities in connection with investments that would be prohibited for U.S. persons (and thus does not go as far as the "facilitation" prohibition under U.S. sanctions); U.S. banks, for example, are not prohibited from processing payments relating to investments in which a U.S. person could not engage.

"Covered foreign person"

These are the entities with which transactions may be notifiable or prohibited. The definition has two elements: the nature of the person and the nature of the person's activities.

The nature of the person is, again, relatively straightforward. To be a "covered foreign person," the person must be a "person of a country of concern," which includes:

- Citizens or permanent residents of a country of concern, but only if they are not also a U.S. citizen or lawful permanent resident (green card holder).
- Any entity that is either organized under the laws of a country of concern or that has its principal place of business in a country of concern.
- Any agency, instrumentality, or person or entity owned, controlled, directed, or acting on behalf of the government of a country of concern.
- Any entity owned 50% or more in the aggregate by any of the foregoing.

The activity-based criteria, however, are far from clear. To be a "covered foreign person," a person must be (1) a "person of a country of concern" "that is engaged in, or…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 (of any nationality) that has branches or subsidiaries described in 1) that constitute more than 50% of the person's consolidated revenue, net income, capital expenditures, or operating expenditures. The definition of "covered national security technology or product" is addressed below, but the remaining elements have significant uncertainties.

Most fundamentally, the ANPRM is silent on the meaning of "identified activity." In various places there are references to "activities involving" the specified technologies, but the relevant activities are not further defined. It is unclear how direct or specialized a company's activities potentially relating to specified technologies have to be to trigger the prohibition or notification requirements, nor is it clear from the definitions themselves.

Furthermore, the "engaged in" and, especially, "knows or should know will be engaged in" standards appear quite difficult to apply in practice, particularly in the context of startup or early-stage companies. Even determining whether a foreign company "is engaged" in specified activities could be quite difficult. First, the technical definitions are in some cases detailed and difficult for even third parties expert in the industry to determine (an issue that has already arisen with the Commerce Department's export control restrictions targeting similar technologies). Second, there is no articulated materiality standard for activities, and it seems possible that relatively small-scale activities or plans (e.g., a single military-related project) may trigger the criterion. Finally, what a U.S. investor "knows or should know" a company will do in the future seems even more problematic; while it appears that post-investment changes in circumstances are, in principle, not covered, as a practical matter they would at least raise potential questions as to whether a U.S. investor "should have known" of the future plans. The proposed knowledge standard is discussed in greater detail below.

As a final note, the criteria for third-country investors that have more than 50% of their revenue or expenditures in a country of concern mean that a company may shift back and forth between being a "covered foreign person" and being outside the scope of the Outbound Investment Proposal. The capital expenditures criterion in particular appears as one that could be unstable and unpredictable; if a company with a center of gravity outside China happens to be building a facility in China in a particular year, that may account for an outsized proportion of its capital expenditure budget for a limited time.

“Covered transaction”

The ANPRM’s definition of “covered transaction” is surprisingly broad, although the definition is subject to some exclusions. The ANPRM proposes to define a “covered transaction” as “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.” Thus, any direct or indirect acquisition of an equity interest or convertible equity interest of any size in a “covered foreign person,” or the establishment of or entry into a joint venture with a “covered foreign person,” is a “covered transaction,” with the exception of the following “excepted transactions”:

- passive investments in publicly traded securities
- passive investments in index funds, mutual funds, ETFs, or similar instruments offered by an investment company or private investment fund
- limited partner investments into a venture fund, private equity fund, fund of funds, or other pooled investment fund, provided that
  - the investment is solely a contribution of capital into the fund with no formal or informal participation in the fund’s (or any covered foreign person’s) decisionmaking or operations, and
  - the investment is below an unspecified *de minimis* threshold, which may separately require both that the investment be below a certain size and that the investor be below a certain size (on the theory that the participation of large U.S. investors may lend prestige and credibility to the covered foreign person)
- a purchase of 100% of a covered foreign entity located outside China (e.g., purchasing the Indian subsidiary of a Chinese company); and
- intracompany funding by a U.S. company of a subsidiary located in a “country of concern.”

The coverage of indirect investments in particular creates substantial ambiguities and internal inconsistencies. For example, if a U.S. entity seeks to purchase a foreign company that is not itself a “covered foreign person” but has a subsidiary that is, is that an “indirect investment” in a “covered foreign person”? The definition of “covered foreign person” excludes the foreign company itself unless more than half of the company’s assets or revenue are in a “country of concern,” but the indirect investment rules contain no such exclusion and appear designed to capture investments in non-exempt funds holding interests in “covered foreign persons” regardless of proportion (and one could imagine circumstances in which a non-Chinese company had a significant operation in an area of concern in China). The interplay between “indirect investment” and the 50% rule for “covered foreign persons” is unclear. Second, what of the typical private equity or venture capital fund in which investment commitments are made before any investment is made? If a U.S. person invests in a non-U.S. fund, and the fund subsequently invests in a covered foreign person, does that render a U.S. person’s commitment to the fund a “covered transaction” if the exemption does not apply (say because the limited partner is a large institutional investor outside the *de minimis* rule)? Treasury has acknowledged some of these issues in its requests for comment, but the intended approach is unclear.

“Covered national security technology or products”

The ANPRM, following the Executive Order, proposes targeting transactions with “covered foreign persons engaged in activities involving” three categories:

- Semiconductor and microelectronic technologies and products (prohibition for advanced products and technologies; notification for less advanced products and technologies)
- Quantum computing technologies and products, based on either particular advanced technologies or intended military, surveillance, or cryptographic end uses (prohibition)
- Artificial intelligence systems, based on intended military, surveillance, cybersecurity, or robotics end uses (notification; potential prohibition)

The proposed definitions provided for each category are set forth in detail in Appendix 1.

In general, these definitions are useful in identifying what is not covered by the Outbound Investment Rules. Within the categories of interest, though, implementation becomes much more difficult. First, it is in many cases not clear exactly

what activities are covered; if a company specializes in a covered technology, that is presumably relatively easy to determine, but particularly in the semiconductor and microelectronics space it may be difficult to determine whether a company's activities are "related to" the development of products with the specified characteristics or how direct the relationship needs to be (e.g., is a mining company that extracts gallium as well as aluminum from bauxite engaged in activities "related to" the production of gallium-based semiconductors?). The "primary end use" of products may be equally unclear, particularly in a pre-commercial stage and where one technology may have multiple applications. For example, a smart camera developed for warehouse applications might be adapted for highway toll collections; would that company then be considered to have a product "primarily" for non-consensual location tracking? What if the product is developmental and has only a single customer, which is not Chinese (say the camera system is developed for a Brazilian toll road)? The universe of activities one must examine to determine what use is "primary," how activities of large or diversified companies are to be evaluated, whether there are any materiality thresholds if a product has law enforcement or military customers, and whether it matters if the government in question is not the government of a company of concern are all unclear.

That leads to a second issue, which is the lack of any time horizon. Information on detailed technical criteria for products under development and on intended target markets is likely to be uncertain and subject to becoming stale very quickly. Moreover, while the technical criteria articulated may be advanced today, it is unclear whether they will be regularly revised to take technological advancements, including more widespread usage of what currently is considered to be advanced technologies, into account.

Knowledge

Many of the restrictions are based on the knowledge of the U.S. investor. The ANPRM proposes to borrow its "knowledge" standard from the export control rules, which includes "not only positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence." That standard appears very difficult to apply objectively in the context of investments in a rapidly evolving industry, particularly in the absence of any time horizon.

The ANPRM goes on to say that what a U.S. investor reasonably should know will be assessed and that what an investor reasonably should know will be "based on publicly available information and other information available through a reasonable and appropriate amount of due diligence."

All in all, it appears that it will be very difficult to assess with certainty how an investment in with any potential connection to a targeted sector will be viewed in hindsight, and this uncertainty would seem to undermine the ANPRM's intent to narrowly target specific activities and products in the sectors of concern rather than discouraging all investment in those sectors.

Retroactivity

In general, the rules are not intended to be retroactive. There are explicit proposed exclusions for investments pursuant to binding capital commitments entered into prior to the date of the Executive Order (though there is no explicit exclusion for commitments entered into from now until the time the rules are finalized), and the ANPRM neither proposes to require divestment of existing investments nor to prohibit continued funding of existing subsidiaries or portfolio companies.

Enforcement

Violations of the final rules under the Outbound Investment Proposal will be subject to the penalties provided in the International Emergency Economic Powers Act (IEEPA) (*i.e.*, civil penalties of up to the greater of approximately $350,000 or twice the value of the underlying transaction or, in the case of willful violations, criminal penalties of up to 20 years' imprisonment and a fine of up to $1 million). The Treasury Department is also given the authority to nullify or force the divestment of any prohibited transaction. Thus, potential penalties are severe, which may amplify the impact of any ambiguity in the final rules.

We also note that while the substantive prohibitions of the Outbound Investment Proposal apply to U.S. persons, IEEPA provides for liability for any person who conspires to violate or causes a violation of the statute or any regulation issued thereunder (which would include these regulations) and could provide a basis for liability for non-U.S. persons involved in a prohibited investment by a U.S. person.

Next steps

The ANPRM is a proposal for discussion and explicitly seeks feedback on many of the issues identified above and on other concerns regarding over- and under-inclusiveness and administrability. This is fully consistent with the approach of the Treasury staff as the ANPRM was developed; they have to date exhibited genuine interest in stakeholder input on impact, workability, and potential unintended consequences. The ANPRM especially solicits comments on potential clarification of definitions and scope and on commercial impact (supported by data to the extent possible). There are over 80 questions from Treasury embedded in the ANPRM, which are worth reviewing and include general invitations to comment on the burdens, benefits, and alternatives to the ANPRM's approach. The comment period is relatively short (45 days, though it can be extended) and the proposals and their potential impact complex, so persons interested in commenting should consider acting rapidly.

Following the closing of comments on the ANPRM, we expect Treasury to digest the comments and work on fleshing out the proposal in light of the information received to draft a notice of proposed rulemaking containing the actual draft regulation. We expect the subsequent notice to be subject to public comment as well, though it may be more difficult as a practical matter to have a significant impact on a more fully formed proposal. The timing of this next stage, and the ultimate effective date of the regulations, remain uncertain, though it would be surprising if there were a final rule before the end of 2023 and the process could easily stretch well into 2024.

Looking ahead, the Executive Order directs the Secretary of the Treasury and the relevant agencies to review the outbound investment rules one year after their eventual effective date and to provide annual reports to the President assessing the effectiveness of the rules, technological developments, and trends in investments and transaction flows and recommending changes to the Executive Order or use or modification of other statutory authorities as appropriate. The notification requirements are also designed to inform potential future regulation, and administration statements have indicated that this proposal is something of a pilot program that may be expanded in the future.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Li He
+852 2533 3306
li.he@davispolk.com

James C. Lin
+852 2533 3368
james.lin@davispolk.com

Paul Marquardt
+1 202 962 7156
paul.marquardt@davispolk.com

Martin Rogers
+852 2533 3307
martin.rogers@davispolk.com

Will Schisa
+1 202 962 7129
will.schisa@davispolk.com

Miranda So
+852 2533 3373
miranda.so@davispolk.com

Charles Marshall Wilson
+1 202 962 7130
charles.wilson@davispolk.com

Kevin Zhang
+852 2533 3384
kevin.zhang@davispolk.com

Appendix 1

Covered national security technologies or products:

Semiconductors and microelectronics

Proposed for prohibition:

Technologies that Enable Advanced Integrated Circuits

- Software for Electronic Design Automation: The development or production of electronic design automation software designed to be exclusively used for integrated circuit design.
- Integrated Circuit Manufacturing Equipment: The development or production of front-end semiconductor fabrication equipment designed to be exclusively used for the volume fabrication of integrated circuits.

Advanced Integrated Circuit Design and Production

- Advanced Integrated Circuit Design: The design of integrated circuits that exceed the thresholds in Export Control Classification Number (ECCN) 3A090 in supplement No. 1 to 15 CFR part 774 of the Export Administration Regulations (EAR), or integrated circuits designed for operation at or below 4.5 Kelvin.
- Advanced Integrated Circuit Fabrication: The fabrication of integrated circuits that meet any of the following criteria: (i) logic integrated circuits using a non-planar transistor architecture or with a technology node of 16/14 nanometers or less, including but not limited to fully depleted silicon-on-insulator (FDSOI) integrated circuits; (ii) NOT-AND (NAND) memory integrated circuits with 128 layers or more; (iii) dynamic random-access memory (DRAM) integrated circuits using a technology node of 18 nanometer half-pitch or less; (iv) integrated circuits manufactured from a gallium-based compound semiconductor; (v) integrated circuits using graphene transistors or carbon nanotubes; or (vi) integrated circuits designed for operation at or below 4.5 Kelvin.
    - "Fabrication of integrated circuits" is defined as the process of forming devices such as transistors, poly capacitors, non-metal resistors, and diodes, on a wafer of semiconductor material.
- Advanced Integrated Circuit Packaging: The packaging of integrated circuits that support the three-dimensional integration of integrated circuits, using silicon vias or through mold vias.
    - "Packaging of integrated circuits" is defined as the assembly of various components, such as the integrated circuit die, lead frames, interconnects, and substrate materials, to form a complete package that safeguards the semiconductor device and provides electrical connections between different parts of the die.

Supercomputers

- Supercomputers: The installation or sale to third-party customers of a supercomputer, which are enabled by advanced integrated circuits, that can provide a theoretical compute capacity of 100 or more double-precision (64-bit) petaflops or 200 or more single-precision (32-bit) petaflops of processing power within a 41,600 cubic foot or smaller envelope.

Proposed for notification

- Integrated Circuit Design: The design of integrated circuits for which transactions involving U.S. persons are not otherwise prohibited.
- Integrated Circuit Fabrication: The fabrication of integrated circuits for which transactions involving U.S. persons are not otherwise prohibited.
- Integrated Circuit Packaging: The packaging of integrated circuits for which transactions involving U.S. persons are not otherwise prohibited.

Quantum Information Technologies

Proposed for prohibition

- Quantum Computers and Components: The production of a quantum computer, dilution refrigerator, or two-stage pulse tube cryocooler.
    - "Quantum computer" is defined as a computer that performs computations that harness the collective properties of quantum states, such as superposition, interference, or entanglement.
- 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.
- Quantum Networking and Quantum Communication Systems: The development of a quantum network or quantum communication system designed to be exclusively used for secure communications, such as quantum key distribution.

Note: The ANPRM indicates that Treasury is considering substituting "primarily" for "exclusively."

Artificial intelligence

Proposed for prohibition:

- Artificial intelligence: 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.

Proposed for notification:

- Artificial intelligence: The development of software that incorporates an artificial intelligence 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.

Note: The ANPRM indicates that Treasury is considering substituting “primarily” for “exclusively.”