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Executive Order and Draft Regulations Restrict U.S. Investments in China for the First Time

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The interplay of Chinese and United States investments has been one of particular interest and subject to significant legal changes in the last few years. Normally, reviews of inbound investments of Chinese capital into the United States are handled by CFIUS. Numerous client alerts have addressed the background on the CFIUS process and subsequent developments. However, now for the first time, this administration seeks to implement a "reverse CFIUS" outbound review mechanism for certain U.S. investments in China.

On August 9, 2023, President Biden issued an executive order entitled "Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" (the "Order") with the goal of reviewing U.S. investments in advanced technology industries in China to protect national security. This Order has been widely expected for months and serves as the first-ever outbound investment review mechanism in the United Staes. On August 14, 2023, the Department of Treasury, Office of Investment Security formally published an Advanced Notice of Proposed Rule 88 FR 54961 (the "Proposed Rule") to implement the Order.

Together the Order and the Proposed Rule put together an outline of what the eventual program's scope could entail including: (1) a notification requirement; and (2) a prohibition requirement. The initial rules currently only apply to three sectors in China:

(1) Certain artificial intelligence ("AI") systems;
(2) Semiconductors and microelectronics; and
(3) Quantum information technologies and certain artificial intelligence ("AI") systems.

The Proposed Rule notes that the aim of the outbound investment program is not solely on restricting the investment of capital in Chinese companies. A White House senior administration official acknowledged "China doesn't need our money. . . The thing they don't have is the know-how. And the know-how [we] have seen is often very connected to specific types of investments." Thus, the broader range of the Order is to restrict the "intangible benefits" that accompany U.S. investments, including "enhanced standing and prominence, managerial assistance, access to investment and talent networks, market access, and enhanced access to additional financing." Below, we provide greater details about what is in the Executive Order and the Proposed Rule.

Summary of the Executive Order

According to the Order, certain "countries of concern" are currently engaged in strategies to advance sensitive technologies and products critical for military, intelligence, surveillance, and cyber-enabled capabilities. The Order states that the development of these technologies poses a threat to the United States and that certain U.S. investments "may accelerate and increase the success of the development" of those technologies. The Order however defines only one "country of concern"—China (including Hong

Kong and Macau).

To address this threat to national security, the Order authorizes the Treasury Department to issue regulations that require either:

(1) Notification Requirements: requiring U.S. persons to provide information to the U.S. Government regarding certain types of transactions with specified foreign persons; or

(2) Prohibition Requirement: prohibiting U.S. persons from engaging in other types of transactions involving specified foreign persons.

The details regarding the scope of the Notification Requirement and Prohibition Requirement, including the types of products and technologies of concern are found in the Proposed Rule but still need to be finalized through the regulatory process in the coming months.

Summary of the Proposed Rule

In the fact sheet to the Proposed Rule, the Office of Investment Security details the regulatory framework it will ultimately issue to implement the Order. It provides for the following:

Specific Notification and Prohibition Rules. The Proposed Rule targets a specific subset of investments and provides a general list of notification and prohibition requirements:

- Semiconductors and Microelectronics
  - Notification: Chinese companies engaged in activities related to the design, fabrication, and packaging of less advanced integrated circuits.
  - Prohibition: Chinese companies engaged in activities related to: (i) technologies that enable advanced integrated circuits; (ii) advanced integrated circuit design and production; and (iii) supercomputers.
- Quantum Computers and Components
  - Notification: Proposed Rule does not currently contemplate a notification requirement in the quantum computing sector.
  - Prohibition: Chinese companies engaged in activities related to: (i) quantum computers and components (the production of a quantum computer, dilution refrigerator, or two-stage pulse tube cryocooler); (ii) quantum sensors (quantum sensing platforms designed to be exclusively used for military end uses, government intelligence, or mass surveillance end uses); and (iii) quantum networking and quantum communication systems (a quantum network or quantum communication system designed to be exclusively used for secure communications, such as quantum key distribution).
- Artificial Intelligence
  - Notification: Chinese companies engaged in development of software incorporating AI exclusively for use for cybersecurity, digital forensics, penetration testing, control of robotic systems, surreptitious listening, non-cooperative location tracking and facial recognition.
  - Prohibition: Chinese companies engaged in the development of software that incorporates an AI system and is designed to be primarily used for military, government intelligence, or mass-surveillance end uses.

Expansive Definition of "U.S. Persons." The program anticipates that U.S. persons, wherever they are located, will be responsible for adhering to the prohibition and the notification requirements. It is important to note that under the Order, the Treasury may also place certain obligations on U.S. persons with respect to foreign entities that they control and in certain situations where U.S. persons knowingly direct transactions by non-U.S. persons.

Various Types of Covered Transactions. The program anticipates including transactions that could convey "intangible benefits," specifically: the acquisition of equity interests, greenfield investments, joint ventures, and certain debt financing transactions that are convertible to equity.

Implication

Neither the Order nor the Proposed Rule has any immediate effect—the Proposed Rule seeks comments from U.S. industry within 45 days of its publication in the Federal Register, after which Treasury will issue a notice of proposed rulemaking, to be followed by another notice and comment period, after which Treasury will ultimately issue a final rule. As a result, most media outlets say it will not be implemented till late 2024, depending on the volume of comments received.

Regardless, the Order and Proposed Rule represent an extraordinary expansion of the ability of the U.S. government to review outbound investment from the United States and should be carefully reviewed by U.S. fund managers as well as companies considering investments in Chinese companies in or near the fields of quantum computing, semiconductor, or artificial intelligence.