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Client Insight: Biden Administration Issues Executive Order and Proposed Regulations Restricting Outbound U.S. Investment into China

Insights
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The U.S. is seeking comments from investors and other affected parties on the implementation of a novel regulatory program that would prohibit investments by U.S. persons in PRC companies involved in three technology sectors of national security concern—semiconductors and microelectronics, quantum information technologies and artificial intelligence systems. Here is a detailed look at the proposed rules and their potentially significant impact on the activities of U.S. venture capital funds, corporate venture capital, private equity funds, and other investors.

On August 9, 2023, the Biden Administration issued an Executive Order ("EO")[Fn 1] to regulate U.S. outbound investment in certain technologies and products in the People's Republic of China, including Hong Kong and Macao (collectively, the "PRC"). The EO provides for the establishment of a new and targeted national security program to be implemented and administered by the U.S. Department of the Treasury ("Treasury") in consultation with other agencies, including the U.S. Department of Commerce. Concurrently, Treasury issued an Advance Notice of Proposed Rulemaking ("ANPRM") to provide an overview and solicit comments on the scope of the new program. The program would, pursuant to future implementing regulations, define certain "covered transactions" that would either: (1) require U.S. persons to provide notification to Treasury of the same, or (2) prohibit U.S. persons from undertaking certain transactions, in either case involving certain PRC entities engaged in activities related to subsets of the following three advanced technology

areas: (i) semiconductors and microelectronics, (ii) quantum information technologies and (iii) artificial intelligence systems.

The proposed program is not solely concerned with limiting certain Chinese companies' access to U.S. capital, but is instead principally focused on the intangible benefits that are often provided by U.S. venture capital funds, corporate venture capital, private equity funds, and other investors. As described by Treasury, the proposed program seeks to deny affected PRC companies access to "intangible benefits that often accompany United States investments and that help companies succeed, such as enhanced standing and prominence, managerial assistance, investment and talent networks, market access, and enhanced access to additional financing."

The U.S. already prohibits or restricts the export to the PRC of many of the technologies and products under consideration for the new program. The new program would add technology categories and complement the President's earlier Executive Order from June 3, 2021, as later supplemented, that prohibits investments in approximately one hundred named Chinese companiesdue to their suspected ties to defense or surveillance technology sectors.

According to Treasury, this new program would prevent U.S. investments from helping accelerate the indigenization within the PRC of technologies that threaten U.S. national security. Treasury states that this indigenization undermines the effectiveness of existing U.S. export controls and inbound investment screening programs (i.e., Committee on Foreign Investment in the United States (CFIUS) review), which also seek to protect U.S. national security.

The ANPRM proposals and Treasury questions are open for public comment for a 45 day period after publication, which will close September 28, 2023. As explained below, final rules are expected in early 2024.

Takeaways:

- **No Immediate Effect on Investors or Chinese Companies.** The EO directs Treasury to set up an outbound investment screening program. The ANPRM solicits comments from the public with regard to how the program should be structured and poses over 80 questions about potential implementation. The final program will be implemented by final rules adopted pursuant to an additional notice and comment process that is not expected to conclude until early 2024.

- **No New Filing and Approval Process for Covered Foreign Investments.** To the relief of many, the new program will not set up a "reverse CFIUS" filing process for the review of each proposed "covered investment." In other words, the new program will not create a case-by-case review of individual investments.

- **Certain Investments in PRC Companies Active in Semiconductors and Microelectronics, Quantum Information Technologies, and Artificial Intelligence Systems will be Banned When the Rules Become Effective.** The program will prohibit investment in PRC companies active in certain semiconductors and microelectronics, quantum information technologies, and artificial intelligence systems that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities of the PRC. The proposed regulations will narrowly define the subcategories of these technologies subject to prohibition so that, for example, it is expected that many normal commercial applications of artificial intelligence will remain available for investment.

- **Certain Investments in PRC Companies Active in Semiconductors and Microelectronics and Artificial Intelligence Systems will be Allowed Subject to Post-Closing Notification to Treasury**. The program will allow all investments in semiconductors and microelectronics and artificial intelligence systems that are not otherwise specifically prohibited by the rules, with certain investments subject to a post-closing notice, likely to be required within 30 days of the closing of the investment. This post-closing notification requirement appears to be motivated primarily by the desire of the U.S. government to gather information regarding cross-border investment flows to inform the future development and implementation of the program.

- **Existing PRC Investments are Not Expected to be Subject to Prohibition or Notice.** The program is not expected to have a retroactive effect and, accordingly, all investments made prior to the issuance of the EO should be grandfathered in. In addition, the rules may allow subsequent follow-on investments under circumstances to be considered in the rulemaking process.

- **The Program Will Include Non-Circumvention Rules.** The final rules will include prohibitions on U.S. persons circumventing the investment restrictions through the use or direction of non-U.S. entities.

Which Investors are Covered by the Proposed Rules?

The program anticipates that U.S. persons, wherever they are located, will be responsible for adhering to the investment prohibition and the notification requirement. A U.S. person includes any U.S. citizen, lawful permanent resident,

entity organized under the laws of the U.S. or any jurisdiction within the U.S., "including any foreign branches of any such entity, and any person in the U.S." The ANPRM seeks comment on whether this definition should be amended to enhance clarity. For example, this definition may present ambiguity as to the extent to which the program would apply to a foreign person temporarily present in the U.S. Under the EO, the Secretary 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.

What Types of Transactions are Covered by the Proposed Rules?

The program is anticipated to focus on U.S. persons undertaking certain types of transactions that could convey intangible benefits, specifically: acquisition of equity interests (e.g., via mergers and acquisitions, private equity, venture capital, and other arrangements); greenfield investments; joint ventures; and certain debt financing transactions that are convertible to equity.

In an effort to minimize unintended consequences of the new regulations, Treasury is considering exceptions for certain types of passive and other investments that may pose a lower likelihood of conveying intangible benefits. For example, Treasury is considering excepting from the program's coverage certain U.S. investments into publicly-traded securities, index funds, mutual funds, exchange-traded funds, certain investments made as a limited partner, committed but uncalled capital investments, and intracompany transfers of funds from a U.S. parent company to its subsidiary.

In addition, Treasury does not intend the definition of "covered transaction" to apply to the following activities, so long as they do not involve any of the definitional elements of a "covered transaction" and are not undertaken to evade the rules:

- 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.

Which Companies are Covered by the Proposed Rules?

The EO specifies the rules will apply to companies in named “countries of concern.” However, the EO currently specifies only one country—the PRC (including Hong Kong and Macao)—as a country of concern. It is possible that additional countries may be added in the future. Therefore, initially, the program will apply to investments in companies that are organized under the laws of the PRC, have a principal place of business in the PRC, or are majority-owned by PRC individuals or entities.

Unlike the existing sanctions framework, the new program will identify certain technologies for coverage, rather than banning or blacklisting specific PRC companies. Accordingly, U.S. investors will need to determine whether a company in which they plan to invest develops technology that would constitute a “covered transaction.”

While more specific details and definitions will be included in any final rules, the ANPRM describes the affected technology categories that will be subject to prohibition, and those subject to post-closing notification. A chart listing the affected technologies is provided below:

Technology Category	Prohibited	Allowed Subject to Post-C Notice

Technology Category	Prohibited	Allowed Subject to Post-C Notice
Semiconductors and Microelectronics	PRC entities engaged in 1. the development of electronic design automation software; 2. the development of semiconductor manufacturing equipment; 3. the design, fabrication, or packaging of advanced integrated circuits; and 4. the installation or sale of supercomputers	PRC entities engaged in the design, fabrication, and pac of less advanced integrated
Quantum Information Technology	PRC entities engaged in 1. the production of quantum computers and certain components; 2. the development of certain quantum sensors; and 3. the development of quantum networking and quantum communication systems	None
Artificial Intelligence	PRC entities engaged in a narrow set of activities related to software that incorporates an AI system and is designed for particular end uses with national security implications, e.g., military, government intelligence, or mass-surveillance end uses	PRC entities engaged in act related to software that incorporates an artificial intelligence (AI) system and designed for certain end-use may have military or intellige applications and pose a nati security risk

What is the Impact on Existing Investments?

The program is not expected to provide for retroactive application with respect to transactions and investments completed prior to the issuance of the EO. Treasury may, after the effective date of the regulations, request information about transactions

by U.S. persons that were completed or agreed to after the date of the issuance of the EO to better inform the development and implementation of the program. The ANPRM seeks comments on how Treasury should treat follow-on investments in covered PRC companies that were made prior to the new regulations' effective date. While the ANPRM does not discuss particulars, it is possible Treasury may allow additional pro-rata investment without further restrictions or notification requirements, or additional investment subject to certain percentage or value thresholds or other restrictions.

What is the Potential Impact on New Investments?

Once the program is implemented via final regulations, U.S. investors will need to assess whether a company in which they intend to invest is a PRC company and whether it is engaged in either a prohibited technology or a technology that requires notification. Pursuant to the knowledge standard under consideration, 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." Accordingly, more diligence will be required than simply the willingness of the company receiving the investment to represent that it is not a PRC-controlled company involved in the relevant technologies. U.S. investors will need to conduct their own assessment to meet the knowledge standard.

As with CFIUS, there is no minimum percentage or dollar value of investment threshold required for an investment to be a "covered transaction" under the new program. Thus, U.S. investors will need to assess every transaction potentially affected by the proposed rules, including early investments in seed rounds or early stage funding involving small dollar amounts. U.S. investors will need to assess the present and likely future intentions of the company in order to determine whether the proposed investment will qualify as a "covered transaction" that is prohibited or subject to notice. The budget and time needed for adequate diligence will need to be factored into the investment negotiation process.

If the "covered transaction" is prohibited, then the U.S. investor will not be able to make the investment. If the "covered transaction" is subject to notification, the U.S. investor will be able to make the investment and will be required to make a notification within an expected 30 days of initial closing. (See details below.)

How do the Proposed Rules Affect Venture Capital and Other Fund Investors?

The ANPRM specifically references fund investors in discussion related to exclusions for certain limited partner investments and circumvention rules. Given the concern with respect to "intangible benefits that often accompany United States investments," Treasury is considering how these benefits can be avoided by the elimination of any loopholes and unintended consequences.

Exclusion for Certain Limited Partnership Investments.

The rules will exclude *de minimis* limited partner investments into VC funds, PE funds, or funds of funds that invest in "covered transactions." The exclusion will apply to fund limited partners that do not have the ability to influence or participate in the fund's management, funding of any covered investment, or the applicable portfolio company's decision-making or operations. The *de minimis* level is not described in the ANPRM, and Treasury invites comments on how it should measure and limit such limited partner exclusion. Note that this exclusion is for limited partners and will not extend to the investment fund itself.

In light of the availability of this exclusion and the additional scrutiny of PRC investments overall, we will likely see venture capital, private equity, and other investment fund limited partners requesting representations and warranties from funds and their general partners and managers stating that the fund will refrain from making prohibited covered investments. Such provisions are likely to become common in new fundraises.

Fund-Specific Prohibitions on Avoidance

The ANPRM says that the rules will clarify that attempts by U.S. persons to "knowingly direct" transactions that would be prohibited if made directly by a U.S. person will not be permitted. According to the ANPRM, the proposed rules would define as "directing" one who "orders, decides, approves, or otherwise causes to be performed" a transaction.

Treasury provides examples of fund-specific situations that would be prohibited:

1. U.S. general partner that manages a foreign fund that undertakes a transaction that would be prohibited if made directly by a U.S. person;

2. U.S. person serving as officer or senior level employee of a foreign fund that directs the fund to undertake a transaction that would be prohibited if made directly by a U.S. person; and

3. U.S. person launches a foreign fund focused on making investments that would be prohibited if made directly by a U.S. person.

> The ANPRM says that this definition would exclude from "knowingly directing" those scenarios in which U.S. persons who serve on the management committee of a foreign fund recuse themselves from all investments that would be prohibited if made directly by a U.S. person. On the other hand, the ANPRM provides that a U.S. person who is an officer, senior manager, or equivalent senior-level employee at a foreign fund that undertakes a prohibited transaction "at that U.S. person's direction" will be treated as "knowingly directing" that transaction. Accordingly, it appears that Treasury is currently contemplating that the final rules will allow a U.S. person to be employed at a senior level by a foreign fund that makes a prohibited investment so long as the U.S. person is not personally directing or facilitating such prohibited investment.

In addition, the program will require U.S. persons to take "all reasonable steps" to prevent any transaction by a foreign entity controlled by a U.S. person that would be prohibited if engaged in by a U.S. person. Treasury is considering how to define "all reasonable steps" and whether the standard would require: (i) relevant binding agreements between a U.S. person and the relevant controlled foreign entity or entities; (ii) relevant internal policies, procedures, or guidelines that are periodically reviewed internally; (iii) implementation of periodic training and internal reporting requirements; (iv) implementation of effective internal controls; (v) a testing and auditing function; and (vi) the exercise of governance or shareholder rights, where applicable.

What Would a Post-Closing Notice Require?

Treasury is considering that required notifications be filed via a portal hosted on its website no later than 30 days following the closing of a "covered transaction," and that any information submitted would not be made public other than under limited exceptions required by law.

U.S. persons would be required to furnish information for applicable "covered transactions" in semiconductors and microelectronics and AI systems that includes, but is not limited to:

> (i) the identity of the person(s) engaged in the transaction and nationality (for individuals) or place of incorporation or other legal organization (for entities);
>
> (ii) basic business information about the parties to the transaction, including name, location(s), business identifiers, key personnel, and beneficial ownership;
>
> (iii) the relevant or expected date of the transaction;

(iv) the nature of the transaction, including how it will be effectuated, the value, and a brief statement of business rationale;

(v) a description of the basis for determining that the transaction is a “covered transaction” – including identifying the covered national security technologies and products of the covered foreign person;

(vi) additional transaction information including transaction documents, any agreements or options to undertake future transactions, partnership agreements, integration agreements, or other side agreements relating to the transaction with the covered foreign person and a description of rights or other involvement afforded to the U.S. person(s);

(vii) additional detailed information about the covered foreign person, which could include products, services, research and development, business plans, and commercial and government relationships with a country of concern;

(viii) a description of due diligence conducted regarding the investment;

(ix) information about previous transactions made by the U.S. person into the covered foreign person that is the subject of the notification, as well as planned or contemplated future investments into such covered foreign person; and

(x) additional details and information about the U.S. person, such as its primary business activities and plans for growth.

What are the Penalties for Non-Compliance?

Under the EO, Treasury can “nullify, void, or otherwise compel the divestment of any prohibited transaction entered into after the effective date” of the implementing regulations. The ANPRM seeks comment on the potential divestment process and whether ordering the divestment of a prohibited transaction should be tailored to the size, type, or sophistication of the U.S. person or to the nature of the violation. Treasury notes that it would not use this authority to unwind a transaction that was not prohibited at the time it was completed.

Treasury is also authorized to impose civil penalties up to the maximum allowed under 50 U.S. Code § 1705(b), namely, the greater of $250,000 or twice the value of the transaction, for: (i) material misstatements or omissions from information submitted to Treasury; (ii) the undertaking of a prohibited transaction; or (iii) the failure to timely notify a transaction where required.

What Happens Next?

The proposed rulemaking and the 80+ questions posed by Treasury are open for public comment until September 28, 2023. Interested parties may submit comments throughout that period. After the comment period, Treasury will likely issue proposed final regulations, which in turn will be subject to additional notice and comment procedures. Accordingly, it is not expected that any final rules will be in place until 2024.

How Can GD Help?

If you have questions or concerns regarding the executive order or advance notice of proposed rulemaking, or would like to submit public comments to help shape the final regulations, please contact your Gunderson attorney before September 28, 2023.

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