



President Biden issued a long-awaited executive order, "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" (the Executive Order or E.O.), on August 9, 2023, highlighting the risks these technologies and products pose to U.S. national security and marking the latest round in the ever-increasing competition between the United States and China.

The E.O. directs the promulgation of regulations restricting U.S. investment in the Chinese technology sector, which are expected to be effectuated swiftly. The Executive Order also directs the U.S. secretaries of state and commerce to work "with allies and partners regarding the national security risks posed by countries of concern advancing covered national security technologies and products."

This Update provides an overview of the Executive Order and potential regulations, with a particular focus on: (1) the kinds of national security technologies and products that may be subject to the proposed new program; (2) who, or which entities, may be required to comply; and (3) what kinds of transactions may—and may not—be covered. This Update also provides key takeaways as to the implications and potential further actions pursuant to this new regulatory framework.

Background

The Executive Order concludes that countries of concern—limited at this time to the People's Republic of China (including Hong Kong and Macau)—are exploiting U.S. outbound investment to develop sensitive technologies and products critical for military, intelligence, surveillance, and cyber-enabled capabilities, including by exploiting intangible benefits that often accompany such investments (e.g., enhanced standing and prominence, managerial assistance, investment and talent networks, market access, and enhanced access to additional financing). The Executive Order concerns three critical and rapidly growing technologies: semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI).

The Executive Order directs the U.S. Department of the Treasury (Treasury) to establish a new regulatory program. As part of forming that new program, Treasury has issued an Advanced Notice of Proposed Rulemaking (ANPRM) soliciting public comments on key aspects of the proposed program. Broadly, the new regulations required by the E.O. would prohibit U.S. persons from making (or directing) certain transactions involving designated sectors of the Chinese economy and, with regard to other transactions, U.S. persons would be required to report key details to Treasury.

The ANPRM published by Treasury's Office of Investment Security (OIS) on August 9, 2023, contemplates the creation of a new regulatory framework focused on outbound foreign investments. This new program will coexist with current inbound U.S. investment processes currently regulated by the Committee on Foreign Investment in the United States (CFIUS), which is chaired by the OIS, and existing sanctions/export control processes currently regulated through the Office of Foreign Assets Control (OFAC), the U.S. Department of Commerce, and the U.S. Department of State. The ANPRM solicits public comment on 83 distinct questions regarding implementation of the E.O. **Comments are due by September 28, 2023.**

Who May Be Required To Comply?

Under the ANPRM, a "U.S. person" may be required to notify Treasury or be prohibited from undertaking covered transactions (discussed below) with a "covered foreign person," currently limited to entities and individuals in China based on the designation under the Executive Order.

U.S. Person

The ANPRM proposes to adopt the E.O.'s definition of a "U.S. person," wherever located, defined as 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 located in the United States.

Consistent with Treasury regulations as to economic sanctions, these rules are likely to be applied broadly, covering not only direct investments by U.S. persons, but also indirect investments and transactions controlled or directed by U.S. persons. The ANPRM suggests Treasury may require U.S. persons to "take all reasonable steps to prohibit and prevent any transaction by a foreign entity controlled by such United States person that would be a prohibited transaction if engaged in by a United States person" and to notify Treasury of "any transaction by a

foreign entity controlled by such United States person that would be a notifiable transaction if engaged in by a United States person." Treasury may also "prohibit U.S. persons from 'knowingly directing transactions' that would be prohibited transactions pursuant to the Order if engaged in by a U.S. person." Moreover, the ANPRM suggests the regulations will explicitly cover direct and indirect investment, confirming the intention to prohibit "a U.S. person knowingly investing in a third-country entity that will use the investment to undertake a transaction with a covered foreign person that would be subject to the program if engaged in by a U.S. person directly."

Covered Foreign Person

In defining the targets of these rules, Treasury appears intent on piercing corporate structures to prevent investment through Chinese parent entities deriving significant revenue from subsidiaries that would themselves be restricted investment targets under the new rules. The ANPRM proposes to define "covered foreign person" to 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."

The rules would also track the well-known "50% rule" applied in other contexts by Treasury, whereunder an entity that is 50% or more in the aggregate owned by "covered persons" would be considered a restricted investment target under the rules. The ANPRM elaborates that the definition of "person of a country of concern" is either "(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."

What Types of Transactions May (or May Not) Be Covered?

In General

The program is anticipated to focus on U.S. persons undertaking certain types of transactions that could convey intangible ownership benefits, specifically: (1) acquisition of equity interests (e.g., via mergers and acquisitions, private equity, venture capital, and other arrangements); (2) greenfield investments; (3) joint ventures; and (4) certain debt financing transactions that are convertible to equity.

Importantly, the definition of a "covered transaction" would apply to both prohibited and notifiable transactions and would be forward-looking. Additionally, the definition of a "covered transaction" would cover "indirect" transactions. For example, as noted above, an indirect transaction would include where a U.S. person knowingly invests in a third-country entity that will use the investment to undertake a transaction with a covered foreign person that would be subject to the program if engaged in by a U.S. person directly. For retroactive transactions, Treasury indicated that, after the effective date of the regulations, it may request information about transactions by U.S. persons that were completed or agreed to after the date of the issuance of the E.O. to better inform the development and implementation of the program.

Under the ANPRM, certain activities are unlikely to be restricted by the new rules, so long as they are not undertaken as part of an effort to evade the proposed rules. Such activities include, but are not limited to:

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.

Exceptions

The ANPRM proposes, in an effort to minimize unintended consequences, to create an exception for certain types of passive investments and other investments that may pose a lower likelihood of jeopardizing national security.

For example, Treasury is considering excepting certain U.S. investments in 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. Treasury is also considering excepting transactions involving equity or other interest owned or held by a covered foreign person in an entity or assets located outside of China and intracompany transfer of funds from a U.S. parent company to a subsidiary located in China.

Banking organizations are generally outside the scope of the types of investments contemplated under the ANPRM. Treasury specifies a number of banking activities that it does not intend to include within the definition of a "covered transaction," such as bank lending, processing, clearing and sending of payments by a bank, and global custody. However, Treasury is seeking comments on whether and how these banking activities could fall within the definition of a "covered transaction" such that "additional clarity would be beneficial given the policy intent of this program is not to implicate these activities unless undertaken as part of an effort to evade."

The scope and nature of each of these potential exceptions under consideration will likely be the subject of intense commentary in response to the ANPRM.

What Types of Technologies and Products May Be Covered?

The Executive Order and ANPRM concern three sectors of technologies and products to be covered by the new rules: semiconductors and microelectronics, quantum information technologies, and AI. Any U.S. person undertaking a covered transaction with a covered foreign person would be subject to the rules.

Semiconductors and Microelectronics

The ANPRM proposes prohibiting U.S. investments in Chinese entities engaged in the development of electronic design automation software or semiconductor manufacturing equipment; the design, fabrication, or packaging of advanced integrated circuits; and the installation or sale of supercomputers.

For those transactions involving integrated circuit design, fabrication, or packaging which are not otherwise prohibited pursuant to the above, the ANPRM proposes a notification requirement.

Treasury is seeking public comment on several questions including empirical data about trends in U.S. investment into country of concern entities engaged in these activities, and whether there are emerging trends with respect to U.S. outbound investments in semiconductors and microelectronics in countries of concern that would not be captured by the proposed definitions.

Quantum Information Technologies

The ANPRM proposes prohibiting U.S. investments in Chinese entities engaged in the production of quantum computers and certain components; the development of certain quantum sensors; and the development of quantum networking and quantum communication systems. Treasury is not currently considering a separate notification requirement for quantum information technologies.

Importantly, the proposed prohibitions on quantum sensors are limited to those designed to be exclusively used for military end uses, government intelligence, or mass surveillance. The proposal seeks to distinguish these use cases from use cases in civilian fields such as medicine and geology.

Similarly, quantum networking and quantum communication systems proposed to be prohibited are limited to those designed to be exclusively used for secure communications, such as quantum key distribution, so as to avoid capturing quantum systems with no relevance to secure communications or classical encryption.

Treasury is seeking public comment on several questions including whether limitations on quantum sensors and quantum networking and communication systems should be limited to those "designed to be exclusively used" or "designed to be primarily used" for the above purposes.

Artificial Intelligence Systems

For AI systems, the ANPRM includes an approach that would focus on U.S. investments in Chinese entities engaged in 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.

The ANPRM also proposes that notification be required if undertaking a transaction with a covered foreign person engaged in the development of software that incorporates an AI system and is designed to be "exclusively used" for certain specific applications (e.g., cybersecurity, digital forensic tools, the control of robotic systems, listening devices, location tracking, or facial recognition, among others). Treasury is similarly seeking public comment on several questions including on whether to adopt a "primarily used" standard in place of the proposed "exclusively used" language when pertaining to AI systems use.

Key Takeaways

The Executive Order creates a new U.S. regulatory framework, as previewed by the ANPRM, focused on restricting outbound foreign investments. This framework will coexist with current U.S. CFIUS and sanctions/export control programs that specifically target perceived Chinese national security threats, illustrating yet another effort to restrict China's access to sensitive technology and products.

While the scope of the ANPRM appears limited to the three identified technologies, the details of what types of transactions are prohibited and what types of notifications are required for U.S. persons remain uncertain. For example, the new outbound investment regime may require U.S. persons to notify Treasury "regarding particular transactions involving certain entities located in or subject to the jurisdiction of a country of concern, and certain other entities owned by persons of a country of concern, engaged in activities related to other defined technologies and products." Moreover, certain technology businesses that may satisfy an exemption or otherwise fall outside the scope of the ANPRM should stay vigilant, given that they may use covered national security technologies or products, such as the use of AI systems in the life sciences sector.

Notably, the ANPRM does not create a "reverse CFIUS regime." Although the ANPRM uses some terms common to the CFIUS regulations, such as "covered transactions," and both sets of regulations are executed through Treasury, there are critical differences between the two. For example, unlike CFIUS, the ANPRM notes that Treasury does not intend to conduct a case-by-case review of U.S. outbound investments. Rather, the

ANPRM places the burden on the U.S. investor and the parties to covered transactions to determine whether a given transaction is prohibited, subject to notification, or permissible without notification. Thus, this will be a regime governed by enforcement rather than approvals, more akin to U.S. economic sanctions and export controls. Like those regimes, noncompliance may result in stiff penalties, unwinding of transactions, and criminal referrals.

Thus, as interested parties engaged in cross-border investments adapt to these new rules, it will be critical to develop a sophisticated vetting program to ensure that the regulations Treasury ultimately adopts are applied carefully to China-related investments. Given the intense focus on these issues under current U.S. policy, we expect robust and aggressive enforcement of these requirements where missteps lead to investments in China that may be viewed as jeopardizing U.S. national security.

For matters related to foreign direct investment and other foreign trade-related compliance matters, companies and individuals should consult with experienced counsel.

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