

US Moves To Narrowly Limit Investment in China

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On August 9, 2023, after more than a year of deliberations, the Biden administration finally released an [executive order](#) (the Order) directing the Department of the Treasury (Treasury) to create a new regulatory program to prohibit or require notification of outbound U.S. investments to China in certain sensitive sectors.

This new outbound foreign direct investment (FDI) review program, which complements existing authority to review **inbound** U.S. FDI conducted by the Committee on Foreign Investment in the United States (CFIUS), will not go into effect immediately. But the contours of the eventual program can be seen in the Order and in an advance notice of proposed rulemaking (ANPRM) also issued by Treasury on August 9, 2023.

The program will be narrowly targeted, at least at the outset, with the greatest impact most likely on U.S. private equity and venture capital investments in China.

Restrictions on Outbound Investment

The Order directs Treasury to create an outbound FDI review program that will require reporting on or (in more narrow circumstances) will prohibit investments by U.S. persons involving “covered national security technologies and products,” which is defined to include “sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI) sectors that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities” of China (to include Hong Kong and Macau).

Thus, the outbound FDI review program will complement other efforts by the Biden administration to limit China’s ability to develop these categories of sensitive technologies, most notably the October 7, 2022, rule issued by the Department of Commerce imposing additional export controls over these technologies. According to data from the Department of Commerce Bureau of Economic Analysis (BEA),¹ while FDI from China into the United States has decreased by almost 30% since 2019, U.S. FDI into China has increased by almost 20% over the same time period.

According to the Order and ANPRM, U.S. investments in companies developing these technologies in China are “not sufficiently addressed by existing tools” because such investments often provide Chinese companies with intangible benefits such as managerial assistance, reputational benefits, further investment and talent networks, and market access not captured by other regulatory regimes.

The outbound FDI review program will affect U.S. person² investments, and certain foreign investment with a U.S. person nexus, in China. Treasury anticipates that transactions covered by the program would include certain acquisitions of equity interests (e.g., mergers and acquisitions, private equity and venture capital), greenfield, joint ventures and certain debt financing transactions by U.S. persons.

Under the Order and ANPRM, a broader range of investments captured by the regime will require notification to Treasury (proposed by Treasury to be due within 30 days after closing a covered transaction), and a more limited set of investments will be outright

¹ See the BEA’s “[U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data](#)” and “[Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data](#),” both as of August 10, 2023.

² “U.S. person” is any U.S. citizen or 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.

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prohibited. Although all prohibited transactions are supposedly to be focused on military, defense and intelligence applications, given the nascent nature of the technologies at issue, drawing a distinction between purely civilian and military technology will prove challenging for investors and the U.S. government.

According to the ANPRM, U.S. investment in semiconductors and AI likely will be divided into “notifiable transactions” and “prohibited transactions,” based on the nature and capability of the technology, and all covered quantum computing transactions will be prohibited. The Order makes clear that the policy objective is to only capture U.S. investment that helps to develop sensitive technologies and products critical for military, intelligence, surveillance and cyber-enabled capabilities.

In the case of artificial intelligence, the ANPRM stated that the Order seeks to “cover U.S. investment into entities that develop AI systems that have applications that pose significant national security risks without broadly capturing entities that develop AI systems intended only for consumer applications or other civilian end uses that do not have national security consequences.” While the ANPRM provides broad descriptions of which transactions will require notification or be prohibited within each sector, the ANPRM solicits public input on the specific contours of each definition.

The ANPRM indicates that the regime will not entail a case-by-case CFIUS-like review through which the U.S. government would examine individual transactions. Instead, parties will be responsible for determining whether:

- a transaction is prohibited,
- subject to notification, or
- permissible without notification.

Civil penalties will attach for:

- failure to timely notify a transaction,
- undertaking a prohibited transaction, or
- making material misstatements in, or material omissions from, information filed with Treasury.

The ANPRM leaves open the question of how Treasury will treat errantly notified transactions that would have been prohibited. As in the CFIUS context, the Order grants Treasury civil administrative subpoena power, the ability to impose civil penalties and the ability to refer potential criminal violations to the attorney general.

Importantly, the Order also provides Treasury broad powers to nullify, void or compel divestiture of any prohibited transaction.

The ANPRM indicates that the program is not proposed to apply to investments made prior to the effective date of the forthcoming regulations. However, Treasury may, after the effective date of

the regulations, request information about covered transactions completed by U.S. persons after the issuance of the Order.

According to the ANPRM, the program likely will also prohibit U.S. persons from “knowingly directing transactions” that are otherwise prohibited by the program. This includes:

- U.S. persons who manage a foreign fund.
- U.S. person officers, senior managers or equivalent senior-level employees at a foreign fund that undertakes a transaction at that U.S. person’s direction.
- U.S. person venture partners who launch a foreign fund.

The program will also impose obligations on U.S. persons who “control” (*i.e.*, own, directly or indirectly, a 50% or greater interest) a foreign entity to notify the U.S. government of notifiable transactions and take “all reasonable steps” to prevent prohibited transactions undertaken by the controlled foreign entity — a potentially hefty compliance burden on U.S. person parents.

While Treasury appears to at least partially borrow jurisdictional hooks from the sanctions toolbox and suggests adopting broad knowledge standards from the Export Administration Regulations, it also recognizes in its inquiries that the information needed to comply with the program may not be readily available to U.S. investors.

The ANPRM makes clear that the program’s eventual regulations will carve out several “excepted transactions” that are expected to include investments in publicly traded securities, exchange-traded fund investments, U.S. person passive limited partnership investments below a to-be-announced *de minimis* threshold, intracompany transfers from a U.S. parent to a Chinese subsidiary, committed but uncalled capital investments and covered foreign person buyouts.

Notably, the contemplated “excepted transactions” concept could permit U.S. persons to passively invest in funds managed by non-U.S. general partners but would capture investments by a fund managed by a U.S.-person general partner. In addition to these limited carve-outs, the definition of “covered transaction” is expected to exclude certain enumerated activities including:

- University-to-university research collaborations.
- Procurement of inputs for covered national security technologies.
- Intellectual property licensing arrangements.
- Certain activities secondary to a covered transaction (*e.g.*, bank lending; the processing, clearing or sending of payments by a bank; underwriting services; prime brokerage).

Treasury’s timeline for creating the outbound FDI review program is not entirely clear, but the program is unlikely to go into effect for at least several months. The ANPRM solicits

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public feedback on 83 distinct questions regarding the eventual implementation of the Order. Public comments must be received within 45 days of the ANPRM's publication in the Federal Register, and we expect — as has occurred in similar situations — significant comment from a variety of interested parties.

Potential for Further Action by US Congress and US Allies

While Congress has considered regulating outbound U.S. investments for several years, legislation has proven to be elusive. In September 2022, several members of Congress who have been key proponents for legislation — led by Sens. Robert Casey, D-Pa., and John Cornyn, R-Texas — [wrote to President Joe Biden](#) to “urge your Administration to move forward with executive action — which can then be bolstered by statutory provisions — to safeguard our national security and supply chain resiliency on outbound investments to foreign adversaries.”

Sen. Casey recently co-led a new outbound investment legislative proposal, an amendment to a pending defense policy bill

in the Senate that would require notification of certain outbound investments. Unlike the Order, it would not prohibit any transactions. Thus, while the Order represents the first step toward regulating outbound U.S. investments in China, congressional action may follow.

Another key area to watch will be the reaction of U.S. partners and allies. Some U.S. allies that have created their own CFIUS-like reviews for inbound FDI have [signaled a willingness to consider outbound FDI review mechanisms](#). Treasury's [fact sheet](#) makes clear the Order and ANPRM were developed following discussions with the G-7 and other ally and partner engagements conducted by the Biden administration.

International initiatives, however, will almost certainly trail U.S. efforts. If the U.S. becomes an island in these efforts, the practical effects of the Order may be more limited as Chinese companies find capital elsewhere — something they have increasingly done over the past several years.

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