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## Export Controls Alert

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### A closer look at the proposed restrictions on outbound US investments

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The Biden administration looks at new outbound investment rules regarding the People's Republic of China, including the Special Administrative Regions of Hong Kong and Macau. Comments due by September 28, 2023. What you need to know!



#### What's the Impact

- / The Executive Order has been issued, but implementing regulations are not due for some time.
- / The proposed regulation terms are only provided for comment and should be seen as starting points for discussion with relevant stakeholders.
- / The rules are developed in collaboration with the public and especially the affected industry.

#### Executive Summary

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On August 9, 2023, President Biden issued an Executive Order (Executive Order) restricting outbound US investments in certain national security technologies and products in countries of concern (the People's Republic of China (PRC), including the Special Administrative Regions of Hong Kong and Macau). At the same time, the Treasury Department released an Advance Notice of Proposed Rulemaking (ANPRM) seeking comments from industry on various proposed definitions and regulations. The ANPRM was published on August 14, 2023.

The good news is that the proposed regulations are not yet effective—comments are due by September 28, 2023, and we would not expect to see formal regulations until next year. The ANPRM indicates that the regulations will be forward looking, and the Executive Order provides that the Treasury will not have the authority to nullify, void, or force divestiture of the transaction until after the effective date of the implementing regulations. However, we note that pursuant to the ANPRM, the Treasury may request information about transactions by US persons that were completed or agreed to after August 9, 2023.

The ANPRM was released under the signature of Paul Rosen, the Assistant Secretary for Investment Security. As Mr. Rosen also heads the Committee on Foreign Investment in the United States (CFIUS) and given the nature of the proposed investment restrictions, the proposed regulations use terms and concepts familiar to CFIUS practitioners.

However, the ANPRM does not define a CFIUS-type process whereby US persons can seek clearance for transactions involving investments in what the ANPRM defines as a "covered foreign person." Instead, the ANPRM defines the term "covered transaction" and provides that some covered transactions are prohibited and others will be notifiable. Akin to export compliance, it will be up to the parties to determine whether the transaction is prohibited, notifiable, or not a "covered transaction."

We note that a "covered transaction" includes not only traditional investments (acquisitions of equity), but also contingent acquisitions of equity (e.g., convertible debt), greenfield investments, and joint ventures that could result in the establishment of a "covered foreign person." The latter two types of transactions are a point of concern because they go beyond traditional investment entities (i.e., PE and VC firms) and directly impact most US businesses seeking to expand their operations in the PRC. A covered foreign person is defined as a legal person (an individual or entity) of a country of concern that is involved in an activity that is further defined elsewhere—typically the development or production of technologies deemed to be a threat to national security (e.g., semiconductors and microelectronics, quantum computing and communication, and artificial intelligence). The degree to which the technology is close to cutting edge will determine whether the covered transaction is prohibited or notifiable.

This will put a significant burden on the parties to assess whether the transaction is or is not prohibited. The Executive Order provides that Treasury can nullify, void, or otherwise compel the divestment of any prohibited transaction and for the application of civil penalties up to the maximum allowed by the International Emergency Economic Powers Act (IEEPA). Given that the transaction would be subject to the laws of a foreign jurisdiction, it is not readily apparent how

the Treasury would be able to nullify or void a transaction that was completed under the laws of a foreign state.

Unlike past ANPRMs, the proposed rules are presented informally—there is no cohesive set of rules that can be reviewed and commented upon. Instead, the rules are presented as a set of issues followed by questions describing topics of interest to the Treasury as a guide for comments. We provide below our assessment of the ANPRM, but we caution that these proposed regulations are likely to change in ways that may be hard to predict until public comment is received.

## More detailed review of the proposed Outbound Investment Restrictions

### Introduction

The Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern directs the Secretary of the Treasury to establish a program to prohibit or require notification concerning certain types of outbound investments by United States persons into certain entities located in, subject to the jurisdiction of, or owned by a person of a country of concern and involved in discrete categories of advanced technologies and products.

On August 14, 2023, the Department of the Treasury (Treasury Department) published an Advance notice of proposed rulemaking (ANPRM), giving a first impression of direction the ordered regulations will go. As of now, the Executive Order has been issued but implementing regulations are not due for some time and, at least based on the ANPRM, will have very limited application to transactions completed or agreed to after the date of the EO but before the effective date of the regulations. The Executive Order expressly states that Treasury's ability to nullify, void, or otherwise compel divestment of a transaction will not be effective until the effective date of the implementing regulations. The proposed regulation terms are only provided for comment and should be seen as starting points for discussion with relevant stakeholders. Yet, they provide a first glimpse on how the Treasury Department may approach the new restrictions on investments into the PRC.

In the following, we provide an overview over the most important information that can be deduced from the ANPRM.

### ANPRM — Proposed Rules

The currently published ANPRM asks stakeholders to submit comments on the proposed terms for the proposed regulations that the Treasury Department intends to implement following the Executive Order. The ANPRM provides proposed drafts of individual elements of the regulations including relevant background information as well as questions to the general public for comments which may eventually be used to revise them.

The topics of interest include the suggested scope of the regulations, especially which persons, transactions, and technologies will be covered and which exceptions and exemptions may be available.

### *General Objective*

The stated objective of the proposed regulations is not intended to impede all US investments into the PRC or impose sector/wide restrictions. The proposed regulations focus on three categories of technologies and products that are enumerated in the Executive Order and the “intangible benefits” that a US investment can provide such as enhanced standing and prominence, managerial assistance, access to investment and talent networks, and market access and enhanced access to additional financing. As discussed below, the proposed regulations also define the term “excepted transaction” to identify a transaction that does not accrue those “intangible benefits” (e.g., passive investments). We would expect the types of transactions that qualify as “excepted transactions” to be subject to much debate in the comments and the internal development of the final rules.

### *Scope of Program*

According to the ANPRM, the Treasury Department seeks to establish a program to implement the goals and objectives of the Executive Order to prohibit certain types of covered transactions and to require submission of a notification for other types of transactions. The ANPRM states that the Treasury Department does not contemplate a case-by-case review of outbound investments and expects the transaction parties will have the obligation to determine whether the transaction is prohibited, subject to notification, or permissible without notification.

To make this determination, three criteria must be evaluated: (1) the actors, a US Person and a Covered Foreign Person (Parties Scope) must engage in a (2) covered transaction (Transaction Scope) where the Covered Foreign Person is (3) engaged in the development or production of certain national security technologies or products (Technology Scope).

### *Parties Scope*

Each covered transaction will involve at least two stakeholders: one, the investor, usually being the party subject to the authority of the US (US Person) and the foreign party (Covered Foreign Person), a (natural or legal) person of the PRC, Hong Kong, or Macau.

The Executive Order defines a US Person as any United States 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 in the United States. The regulations are expected to apply to US persons wherever they are located. This definition is commonly used when a US Person is defined, and we do not expect it to be altered, even though this was put up for discussion by the Treasury Department.

The proposed definition of the Covered Foreign Person is broad, covering (1) a “person of a country of concern” that is engaged in, or a “person of a country of concern” that a US 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.

A "person of a country of concern" is any individual that is not a US citizen or lawful permanent resident of the United States and is a citizen or permanent resident of a country of concern; 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; 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.

These terms are broadly defined, and we would expect them to cover virtually any US activity involving a Chinese person or entity. The definition of a US person is not limited to traditional investment entities, such as VC and PE firms, and includes any US corporation that makes an investment in a Chinese person or entity. As a result, the regulations further define "excepted transactions" to carve out various types of transactions which are less likely to be viewed as investments, for example, routine intercompany transactions between US entities and their Chinese subsidiaries.

### *Transaction Scope*

The Treasury Department anticipates that transactions covered by the program would include certain acquisitions of equity interests, such as mergers and acquisitions, private equity, venture capital, greenfield joint ventures, and certain debt financing transactions.

The proposed rules differentiate between two types of transactions, prohibited and notifiable. This, however, does not affect the anticipated definition for "covered transactions," which applies to both. According to the proposed definition, a "covered transaction" is a US 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.

The ANPRM further suggests that it may expand the definition of a covered transaction to include indirect transactions, where a US person invests in a third-country entity that will use the investment to enter a transaction with a covered foreign person, that would otherwise be subject to the program, to evade the prohibition or notice requirements. Unsurprisingly, like its review of CFIUS covered transactions, the Treasury Department will likely investigate the family tree of the

investors up to its ultimate owners to assess whether a US person is making an indirect investment in a covered foreign person.

Because the proposed definition of a "covered transaction" is very broad (it covers the typical activities of Private Equity and Venture Capital firms as well as activities conducted by much of industry), the proposed regulations define a class of transactions (excepted transactions) that the Treasury Department intends to exclude from the definition of a "covered transaction" certain transactions that present a lower likelihood of concern. The proposed definition of an "excepted transaction" includes investments in publicly traded securities, index funds, mutual funds, exchange-traded funds, and similar instruments. The definition also excludes investments made by a limited partner in a VC or PE fund where the limited partner is contributing solely capital and cannot make managerial decisions or influence decision making or operations. The Treasury Department will also set a de minimis threshold for "excepted transactions."

An investment that gives the US person rights beyond those considered standard minority shareholder protections will not qualify as an "excepted transaction." Thus, where the US person obtains board membership or observer rights, or involvement beyond the voting of shares, such as business, management, or strategy decisions, the transaction will not qualify as an "excepted transaction."

Certain M&A activity, such as a transaction through which a US person acquires all the interests in the equity or assets held by a covered foreign person, will qualify as an "excepted transaction." In addition, intercompany transfers from a US parent to a subsidiary located in a country of concern will qualify as an "excepted transaction." The ANPRM further explained that the Treasury Department does not consider the definition of a "covered transaction" to apply to most routine intercompany actions such as the purchase or sale of inventory or fixed assets, the provision of paid services, the licensing of technology, or the provisions of loans, guarantees, or other obligations. These are defined in the definition of an "excepted transaction." As we noted above, we expect that the definition of an "excepted transaction" to be subject to much debate as the various stakeholders push to broaden the types of transactions that are excluded. We would advise businesses that do business in the PRC to submit comments to make sure the types of transactions they conduct in the PRC qualify as "excepted transactions." You should also consider the impact that the PRC's receding economy may have on your business and the potential need to make investments in the PRC to support your supply chain.

What can be inferred from the explanatory notes accompanying the proposed definition of an "excepted transaction" is that they closely follow the intended purpose of prohibiting US persons from providing intangible benefits that support a covered foreign person while disrupting the US Person's operations as little as possible. This can for example be seen in the examples of "excepted transactions" that include buyouts or intracompany transfers (e.g., the sale or purchase of inventory or fixed assets, licensing of technology, or providing loans or guarantees).

The Executive Order furthermore grants the Treasury Secretary the authority to prohibit US Persons from knowingly directing transactions that would be prohibited if engaged in by a US

person as well as to require US Persons to take all reasonable steps to prohibit and prevent any transaction by a foreign entity controlled (meaning the US Person owns 50 percent or more of the interest) by a US Person.

### *Technology Scope*

The third element of the analysis is the identified activity of the “covered foreign person,” which is understood to relate to “covered national security technologies and products.” The Executive Order defines the term “covered national security technologies and products” to mean 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 determined by the Secretary in consultation with the Secretary of Commerce. These will likely be related or tied to export-controlled technologies.

The ANPRM provides a list of covered technology sectors: (1) semiconductor and microelectronics sector, (2) Quantum Information Technologies sector, and (3) Artificial Intelligence sector. It is under the technology scope that ANPRM proposes to define whether a “covered transaction” involving a covered foreign person develops and/or produces the covered technology is prohibited or notifiable.

In the semiconductor and microelectronics sector, “covered transactions” involving the following technologies would be prohibited: technologies that enable advanced integrated circuits (developing or producing EDA software or IC manufacturing equipment), advanced IC design and production (developing advanced IC designs per ECCN 3A090, advanced IC fabrication—expanded beyond the controls defined in Part 744.23 of the Export Administration Regulations (EAR), and advanced IC packaging), and the installation or sale of supercomputers (using the definition from Part 772 of the EAR).

The Treasury Department has indicated that activities in the IC design, IC fabrication, and IC Packaging sector that are not prohibited (under the appropriate regulation above) would be subject to the notification requirement.

In the quantum information technologies sector, “covered transactions” involving the following quantum technologies would be prohibited: the production of quantum computers and components, the development of quantum sensors designed exclusively (or primarily) for military, government, or mass-surveillance end uses, and the development of quantum networking/communication systems designed exclusively (or primarily) for secure communications.

In the artificial intelligence sector, “covered transactions” involving the following AI technologies would be prohibited: the development of software that incorporates an AI system and is designed exclusively (or primarily) for military, government, or mass-surveillance end uses.

In the artificial intelligence sector, “covered transaction” involving the following AI technologies would require notification: the development of software that incorporates an artificial

intelligence system and is designed to be exclusively (or primarily) 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.

As noted above, most of the “covered transactions” involving advanced semiconductor and microelectronics, quantum information technologies, and AI will be prohibited. It is anticipated that these definitions will be much debated given the subjective nature of the descriptions and the lack of any mechanism to seek clarification.

### *What happens if the rules are applicable?*

If the rules apply because the requirements are fulfilled, the legal consequence depends on which technology or product the transaction is involved with.

There are two possible consequences: 1) the transaction is prohibited (Prohibited Transaction) or 2) the US Person is obliged to notify the Treasury Department about the transaction (Notifiable Transaction).

A Prohibited Transaction will cover transactions where the technology scope involves advanced semiconductor and microelectronic technologies and products, specific and advanced quantum information technologies, and products with respect to end uses and investments into covered foreign persons engaged in the development of software that incorporates an AI system and is designed to be exclusively (or primarily) used for military, government intelligence, or mass-surveillance end uses.

Notifiable Transactions are certain other transactions in (1) semiconductor and microelectronic technologies other than those under the Prohibited Transaction and (2) engaged in 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.

### *What are the implications?*

As of now, there are no immediate implications for US persons resulting from either the Executive Order or the rule since the Executive Order only calls on the Secretary of the Treasury to implement rules on the “investment ban.” As the proposed rules are at a very early stage and accompanied by a set of 83 questions, we expect the final regulations will not become effective until next year.

The only immediate effect for companies in the affected sectors is that, even though the Executive Order and subsequently the rules will not apply retroactively, the Treasury Department



may, after the effective date of the regulations, request information about transactions by US persons that were completed or agreed to after the date of the issuance of the Executive Order, i.e., starting August 9, 2023.

We also note that the covered technologies are defined in terms used in the EAR. For example, Advanced Integrated Circuit Designs are defined in terms of the performance specified in ECCN 3A090. Curiously, the definition of Advanced Integrated Circuit Fabrication uses nearly the same language as the prohibitions in Part 744.23(a)(2)(iii) of the EAR. However, whereas Part 744.23(a)(2)(iii) includes three criteria, the proposed definition includes three new criteria:

- (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.

We understand that the Commerce Department's Bureau of Industry and Security (BIS) is working on an update to the 744.23 prohibitions that were issued in October 2022. We suspect that these new items were taken from those anticipated BIS regulations. We also note that the ANPRM's proposed definition of Advanced Integrated Circuit Packaging may also appear in BIS's upcoming regulations.

## Conclusion

With the restrictions on outbound investments, the US government entered a new regulatory realm which is yet unprecedented. Because of that, it is not surprising that the rules are developed in collaboration with the public and especially the affected industry, as their expertise and input is greatly needed to properly define the scope of application as well as minimizing potentially damaging impacts of the rules on the industry.

For now, affected companies should review their business relations with the PRC, Hong Kong, and Macau to identify any transactions which might be covered by the future rules and keep records of any such transactions to be able to appropriately respond to any request for information by the Treasury Department after the rules come into force.

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