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Kirkland Alert

President Biden Issues Executive Order on Certain U.S. Investments in National Security Technologies and Products

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Last week, President Biden issued a highly anticipated executive order, Executive Order 14105 (the "EO"), that directs the U.S. Department of the Treasury ("Treasury") to draft regulations that will require disclosure of or prohibit certain outbound foreign investments into mainland China, Hong Kong and Macao (collectively, "China"). The EO will apply to transactions in three identified sectors: **semiconductors and microelectronics**, **quantum information technologies**, and certain **artificial intelligence** technologies. Alongside the EO, Treasury published an Advance Notice of Proposed Rulemaking ("ANPRM") that seeks public comment on, among other things, the scope of key terms to be included in regulations and the procedures that Treasury will establish to administer the new outbound investment program (the "Program"). Comments are due by September 28, 2023, and we currently anticipate that Treasury will issue draft regulations in 2024.

The EO represents a major piece in a broader effort to improve the tools available to address perceived competitive and national security threats to the U.S. emanating from China. When considered in combination with other actions such as the recent aggressive tightening of export controls, passage of the *CHIPS and Science Act of 2022*, and a presidential executive order directing the Committee on Foreign Investment in the United States ("CFIUS") to consider certain risk factors when reviewing transactions, outbound investment controls are part and parcel of the Biden administration's (the "Administration's") larger strategy to address increasing challenges from China by enhancing the U.S. industrial base and addressing perceived risks to critical supply chains and U.S. technological advantages. To date, however, while outbound investment controls have prompted bipartisan discussion in, and garnered significant support from, members of Congress based on potential gaps in

existing investment monitoring and export control regimes, no proposed outbound investment legislation has yet become law.

Importantly, neither the EO nor the ANPRM impose immediate restrictions or requirements on U.S. persons' outbound investment transactions. With that said, they forecast the type and scope of rules that could take effect — potentially even within the next year.

Here are our thoughts on five key aspects of the EO and ANPRM.

1. Restrictions will apply to "United States persons," which will include U.S.-based companies and investors, along with other entities affiliated with such persons and businesses.

The Program will regulate certain transactions engaged in by a "United States person" ("U.S. person") which the EO defines as any U.S. citizen or lawful permanent resident, and any entity organized under U.S. law or the laws of any jurisdiction within the U.S., including any foreign branches of such entities. "Entity" is defined broadly, to include, for example, corporations, joint ventures, and partnerships. The EO also authorizes Treasury to:

> (i) Prohibit U.S. persons from "*knowingly directing*" transactions that would be prohibited if actually engaged in by a U.S. person; and
>
> (ii) Require U.S. persons to "*take all reasonable steps to prohibit and prevent*," or provide notification of, transactions by a foreign entity controlled by such U.S. person, if such transactions would be subject to restrictions if engaged in by a U.S. person.

Treasury is considering defining "*directing*" as encompassing circumstances where a U.S. person, "*orders, decides, approves, or otherwise causes to be performed*" a transaction that would be prohibited or subject to notification requirements if engaged in by a U.S. person. For example, transactions engaged in by a foreign fund (e.g., a Cayman limited partnership) managed by a general partner that is a U.S. person would be subject to the same restrictions as if the transactions were undertaken by a U.S. person. The ANPRM also explains that Treasury is considering deeming any foreign entity in which a U.S. person owns, directly or indirectly, an interest of 50% or more, as one controlled by such U.S. person.

Importantly, these restrictions will apply to individual U.S. persons who serve on investment committees, boards of directors and other governing bodies of non-U.S. funds and companies. In other words, even if the non-U.S. fund or company could undertake a transaction in China that would not be subject to the Program's requirements, an individual U.S. person could still have affirmative legal obligations with respect to the deal.

2. Restrictions will apply to "*covered transactions*," which will include a variety of transaction and investment types, in addition to typical M&A activity.

Treasury expects that, at a minimum, the following types of activities will constitute "*covered transactions*" (i.e., transactions that are subject to regulation) under the Program's final regulations:

- Acquisitions of equity interests or contingent equity interests in a "*covered foreign person,*"[1] which would cover most traditional M&A activity, including most private equity and venture capital transactions;
- Greenfield investments that could result in the creation of a "covered foreign person;"
- Establishment of a joint venture, which either could result in the creation of or is formed with a "covered foreign person;" and
- Other activities that evade, or have the purpose of evading, the Program's jurisdiction.[2]

Notably, the ANPRM contemplates potentially carving out a number of activities from the prohibition and disclosure requirements. These types of "excepted transactions" could include:

> (i) Investments in public companies or collective funds (e.g., index or mutual funds) where the U.S. person investor's rights are limited to standard minority protections;
>
> (ii) Investments made by limited partners in a fund below an as-yet-undefined *de minimis* threshold that do not otherwise grant the limited partner the ability to influence or participate in the fund's decision making or operations;
>
> (iii) Acquisitions of interests held by a "covered foreign person" in an entity or assets located outside of China where the U.S. person is acquiring all of the interest in the entity or assets held; and

(iv) Intracompany transfers of funds from a U.S. parent company to a Chinese subsidiary.[3]

Although the scope of transactions that will trigger notification requirements (as opposed to outright prohibitions) has not yet been determined, the ANPRM suggests that any potential notifications must be made by the U.S. person that is a party to the notifiable transaction no later than 30 days after the deal closes. It is not contemplated that the Program will apply retroactively (i.e., prior to the effective date of the future regulations), but Treasury may, after the effective date of the future regulations, request information about transactions that were completed or agreed to after August 9, 2023.

3. The EO focuses on transactions in certain identified sectors of concern that pose particularly acute national security challenges.

The EO targets transactions that implicate certain technologies or products critical for the military, intelligence, surveillance or cyber-enabled capabilities of a country of concern (i.e., China). While prior legislation had identified additional potential sectors for regulation, the EO sets out three sectors of "covered national security technologies and products":

(i) Semiconductors and microelectronics;

(ii) Quantum information technologies; and

(iii) Artificial intelligence systems.

Treasury may cabin the eventual regulatory definition of "covered national security technologies and products" by reference to certain end-uses of the technologies or products, and the ANPRM explains that the Administration is actively seeking to identify limitations based on end-uses of relevant technologies and products. Consistent with that goal, the ANPRM requests public comment on defining those sectors, excluding uses of products and technologies that are purely commercial, and tailoring the eventual rule to permit investments that provide a strategic benefit to the U.S.

While the EO contemplates prohibiting certain transactions that "*pose a particularly acute national security threat*" — for example, the design of advanced semiconductors,

which aligns with the policy goals of U.S. export controls and other regulatory regimes — it frames notification requirements as potentially more appropriate for other less-sensitive technologies and products — for example, packaging for less advanced chips. Treasury anticipates that the information gathered through the Program's notification process will enable it to better understand how technologies/products contribute to threats to U.S. national security, track investment trends in relevant sectors and inform future policy development.

4. The public will have an opportunity to comment on the proposed rules prior to full implementation.

The ANPRM provides a sense of the intended scope of the Program, while highlighting certain items that Treasury is seeking additional information and public input on.

These topics include:

> (a) The scope of investment targets that will trigger prohibition or notification requirements, and the types of transactions that will be exempt from such requirements;
>
> (b) How, if at all, Treasury should regulate follow-on investments in a "covered foreign person" if the original transaction deals with an investment that would have been a "*covered transaction*" but occurred prior to the regulations becoming effective;
>
> (c) The penalties for failing to comply with the Program, and Treasury's approach to enforcement;
>
> (d) Whether the Program should allow for post-closing notifications, or require pre-closing notifications; and
>
> (e) What changes to key definitions may be warranted to ensure clarity for investors while deterring evasion of the Program's requirements.

5. Congressional input is likely to impact final regulations.

On July 27, 2023, the U.S. Senate passed the OITA as part of its *National Defense Authorization Act for Fiscal Year 2024* ("NDAA"). Like the EO, the OITA would impose a notification requirement on certain outbound investment transactions and other

"covered activities." The OITA passed in a bipartisan vote of 91-6, suggesting that it may be included in the final version of the NDAA in some form. The OITA covers a broader range of countries and technologies than the EO and ANPRM (for example, Russia, Iran and North Korea, as well as hypersonics, satellite-based communications and networked laser scanning systems with dual-use applications). However, it would not empower Treasury to prohibit any outbound investment transactions and covers more sectors than the three identified by the EO.

As several members of Congress have expressed their desire for legislation to supplement any outbound investment EO, we anticipate that there is a good chance that Congress will still take action on outbound investment in the near term.

Takeaways

- The restrictions discussed in the EO and ANPRM are not immediately effective, and their contours will likely be amended prior to full implementation based on Congressional and public input, including through additional review and comment periods. Although it may be a year or longer until the rules become effective, the ANPRM reserves the ability for Treasury to make notification requirements retroactive to transactions that closed as early as August 9, 2023.
- Outbound investment restrictions are likely to apply to a wide range of non-U.S. entities by virtue of their affiliations with U.S. persons and/or entities. U.S. persons will not be able to avoid outbound restrictions by indirectly engaging in transactions through non-U.S. funds, non-U.S. subsidiaries, or other affiliates based outside of the U.S.
- Following the passage of the historic, bipartisan *CHIPS and Science Act of 2022*, the Biden administration is looking to protect the massive investment of capital spurred by that bill using all tools at its disposal. Outbound investment controls are an important part of this effort.
- While outbound investment restrictions will target the three identified sectors at the time of implementation, we anticipate that the number of regulated sectors is likely to expand over time, to potentially include hypersonics, satellite-based communications and/or sensitive personal data collection.

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1. The ANPRM initially defines "covered foreign person" as a "person of a country of concern" but goes on to note that Treasury "is considering elaborating upon" the definition such that it would include the following:

- Persons 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
- Persons whose direct or indirect subsidiaries or branches are referenced in the item above and which, individually or in the aggregate, comprise more than 50% of that person's consolidated revenue, net income, capital expenditure, or operating expenses↩

2. The ANPRM also explicitly names a number of activities that, standing alone and without any other aspects of a "covered transaction" (e.g., the acquisition of governance rights by a U.S. person) will not constitute "covered transactions." These are:

- University-to-university research collaborations;
- Contractual arrangements or the procurement of material inputs (e.g., raw materials) for "covered national security technologies or products;"
- Intellectual property licensing arrangements;
- Bank lending;
- The processing, clearing or sending of payments by a bank;
- Underwriting or debt rating services;
- Prime brokerage;
- Global custody;
- Equity research or analysis; and
- Other services secondary to a transaction.↩

3. While the EO authorizes Treasury to exempt any transaction deemed by Treasury, in consultation with its interagency partners, to be "in the national interest of the United States" from applicable prohibitions or notification requirements, Treasury is not currently considering including a mechanism for case-by-case determinations to be made with respect to a "national interest" exemption in final implementing regulations.↩

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14 August 2023 Kirkland Alert Highlights From CFIUS' Latest Annual Report
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