

CLIENT ALERT

New Executive Order Sets the Stage to Regulate Outbound Investment, With a Focus on China

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The Biden administration has taken the first concrete steps towards establishing the long anticipated outbound investment review mechanism, releasing an Executive Order creating a framework to prohibit or require notifications of certain investment activity involving certain countries of concern. On August 9, 2023, the President signed the [Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern](#) (the “E.O.”), charging the Secretary of the Treasury with promulgating regulations that: (1) require “United States persons” to provide notification of specified types of transactions involving covered foreign persons (“**notifiable transactions**”); and (2) prohibit U.S. persons from engaging in specified types of transactions involving covered foreign persons (“**prohibited transactions**”).¹

In concert with the release of the E.O., the U.S. Department of the Treasury’s Office of Investment Security (“**OIS**”) issued an [Advance Notice of Proposed Rulemaking](#) (the “**ANPRM**”), providing the outline of the regulations to come.

I. KEY TAKEAWAYS

Although many important questions remain to be answered by the forthcoming regulations, key takeaways at this stage include the following:

¹ The E.O. Section 1, Aug. 9, 2023, available at <https://www.whitehouse.gov/briefing-room/presidential-actions/2023/08/09/executive-order-on-addressing-united-states-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern/>.

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- **Limited Scope:** As expected, the E.O. initially limits its restrictions to investments by U.S. persons in the People's Republic of China (including Hong Kong and Macau), related to three key sectors: (1) semi-conductors and microelectronics, (2) quantum information technologies, and (3) artificial intelligence (“AI”). Moreover, not all investments within these sectors will be prohibited or notifiable transactions. The current limits, however, should not detract from the sea change represented by the introduction of this mechanism to the universe of U.S. investment and trade controls.
- **No Immediate Impact:** Neither the E.O. nor the ANPRM issued by OIS have an immediate impact on businesses. In fact, we do not expect the resulting regulations to enter into force until, at the earliest, the first half of 2024. Moreover, the restrictions are not expected to be retroactive, meaning they will not impact deals that close beforehand.
- **Opportunity for Private Sector Feedback:** The ANPRM provides the private sector with a valuable opportunity to help shape the regulations that will govern the outbound investment review mechanism, including addressing ambiguities in the definitions and identifying requirements that would make compliance more burdensome. Accordingly, we believe it is important for potential investors to take the opportunity to issue written comments to the ANPRM before the **September 28, 2023** deadline. Once the Notice of Proposed Rulemaking is issued by OIS (which is the next step in the rulemaking process), it will largely be too late to meaningfully affect the final version of the regulations.

II. FRAMEWORK OF THE PROPOSED OUTBOUND INVESTMENT REVIEW MECHANISM

As described above, the ANPRM proposes a mechanism whereby certain investments by U.S. persons² in three identified sectors are either prohibited or subject to a notification requirement. The nascent outbound investment review mechanism, as described in the ANPRM, shares many similarities with the Committee on Foreign Investment in the United States (“CFIUS”) review mechanism, most notably that the effort is spearheaded by OIS. Additionally, the ANPRM states that OIS is not proposing a case-by-case review of all outbound investments made by U.S. persons. Instead, as with CFIUS, parties to a transaction are obligated to determine whether the transaction falls within OIS's jurisdiction (either by being prohibited or subject to the notice requirement).

However, there are also key differences to the CFIUS process. For instance, there is no provision for voluntary notifications (as there is with CFIUS)—transactions are prohibited, subject to a mandatory notice requirement, or not within the purview

² As discussed further below, the ANPRM defines a “U.S. 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.”

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of the proposed regulations. Furthermore, unlike the CFIUS process wherein a transaction is reviewed for national security concerns, the current proposal only contemplates notifying OIS that a covered transaction has occurred.

The general scheme is provided below in *Figure 1*.

Figure 1: Outbound Investment Review Mechanism

Categories of Technologies and Products	Notes on the ANPRM Definitions	Prohibited Transactions	Notifiable Transactions ³
Semiconductors and Microelectronics	<ul style="list-style-type: none"> • Most developed definition of the three sectors • Largely co-extensive with the October 7, 2022 export controls • Goal appears to be to limit U.S. persons from supporting China's circumvention efforts 	<ul style="list-style-type: none"> • The development or production of electronic design automation software or front-end semiconductor fabrication equipment designed to be exclusively used for the volume fabrication of integrated circuits • The design, fabrication, or packaging of advanced integrated circuits that meet or exceed specified criteria • The installation or sale to third-party customers of a supercomputer 	<ul style="list-style-type: none"> • The design, fabrication, or packaging of integrated circuits for which transactions involving U.S. persons are not otherwise prohibited
Quantum Information Technologies	<ul style="list-style-type: none"> • Largely novel proposed definitions/technologies • OIS seeking significant feedback • The identification of Quantum Information Technologies in the E.O. and ANPRM may preview forthcoming Quantum-related export controls 	<ul style="list-style-type: none"> • The production of quantum computers, dilution refrigerators, or two-stage pulse tube cryocoolers • The development of quantum sensors designed to be exclusively used for military end uses, government intelligence, or 	<i>NONE</i>

³ Under the proposed rule, parties to a Notifiable Transaction must submit a notification to OIS no later than 30 days after the covered transaction.

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		<p>mass-surveillance end uses</p> <ul style="list-style-type: none"> • The development of quantum network or quantum communication systems designed to be exclusively used for secure communications, such as quantum key distribution 	
<p>Artificial Intelligence Systems</p>	<ul style="list-style-type: none"> • Very broad proposed definition • OIS seeking significant feedback • Characterization of the end use of a particular AI system (particularly one in development) may prove difficult to verify, and it would be unsurprising for these controls to be tightened in the future 	<ul style="list-style-type: none"> • The development of software that incorporates an AI system and is designed to be exclusively used (or primarily used) for military, government intelligence, or mass-surveillance end uses 	<ul style="list-style-type: none"> • The development of software that incorporates an AI system and is designed to be exclusively used (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; noncooperative location tracking;⁴ or facial recognition

Beyond these basics, however, there are a number of proposed definitions and questions posed by OIS that we believe may be of interest to potential investors who will be affected by these regulations. We highlight several below.

a. Extraterritorial Reach

As noted above, both the investment prohibition and the notification requirement extend to certain investments by “U.S. persons.” The ANPRM proposes adopting the definition of U.S. persons used by the E.O.: “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.”⁵ However, there are nuances in the ANPRM’s proposals that potentially extend the mechanism’s reach.

Notably, the proposed investment prohibition extends to U.S. persons “knowingly directing transactions” that would be prohibited if engaged in by a U.S. person, meaning offshore funds managed by U.S. persons would be subject to the restrictions. Furthermore, both the prohibition and notification requirements also extend to transactions by any foreign entity

⁴ This includes international mobile subscriber identity (IMSI) Catchers and automatic license plate readers.

⁵ The E.O. Section 9(h).

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controlled by a U.S. person that would trigger the prohibition or notification requirement if engaged in by a U.S. person. Moreover, the ANPRM notes that Treasury has been authorized to take “all reasonable steps” to prohibit and prevent transactions by any foreign entity controlled by a U.S. person that would be prohibited if engaged in by a U.S. person.⁶ The ANPRM proposes limiting the scope of such “direction” to exclude secondary, wraparound, or intermediary services, confirming that U.S. persons can still advise on, finance, and underwrite transactions that would either be prohibited or require a notice.

b. Expansive Coverage of Chinese Entities

To be considered either prohibited or notifiable, a transaction must include an investment into a “covered foreign person.” The E.O. defines a covered foreign person as a person of a country of concern, which is currently limited to China, that the U.S. person knows or should know is engaged in specified activities involving covered national security technologies and products. As with the “covered foreign person” definition, the ANPRM’s recommended definition of a person of a country of concern is more expansive than the definition given in the E.O. The ANPRM proposes defining the term as:

- (1) any citizen or permanent resident of China, who is not a citizen or permanent resident of the United States;
- (2) an entity with a principal place of business in, or an entity incorporated in or otherwise organized under the laws of, China;
- (3) the Chinese government, 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; or
- (4) any entity in which a person identified above holds, individually or in the aggregate, directly or indirectly, 50 percent or more ownership.⁷

The ANPRM also includes direct or indirect subsidiaries or branches of such entities that, individually or in the aggregate, comprise more than 50% of that person’s revenue, net income, or operating expenses. Note also that the definition appears to require the aggregation of ownership interests held by *multiple unrelated* covered foreign persons.

⁶ OIS has indicated that it is still considering how to define “all reasonable steps.” According to the ANPRM, a wide array of mitigation measures are being contemplated, including binding agreements, requirements related to internal policies, procedures, or guidelines, training and internal reporting requirements, and the exercise of governance or shareholder rights. See ANPRM Section III(M).

⁷ ANPRM Section III(C).

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c. **Broad “Knowledge” Qualifier Provides Both a Reprieve and Additional Responsibilities**

The ANPRM’s treatment of both “covered foreign persons”⁸ and, as noted above, knowingly directed transactions incorporates a knowledge qualifier. This qualifier may provide a slight reprieve to impacted entities. However, the knowledge qualification also places an additional onus on U.S. persons entering into potentially covered transactions to conduct sufficient due diligence on the foreign person to the transaction. The ANPRM proposes using the quite broad definition of “knowledge” used in the Export Administration Regulations at 15 C.F.R. § 772.1:

Knowledge of a circumstance (the term may be a variant, such as ‘know,’ ‘reason to know,’ or ‘reason to believe’) includes not only positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence. Such awareness is inferred from evidence of the conscious disregard of facts known to a person and is also inferred from a person’s willful avoidance of facts.⁹

In addition to questions regarding the scope and clarity of the relevant primary definitions, the ANPRM solicits feedback on how the use of the knowledge qualifier (and the accompanying definition) might impact the behavior of impacted businesses.¹⁰

d. **Covered Transactions Generally Track CFIUS’s Jurisdiction**

The type of transactions covered by the proposed outbound investment review mechanism is wide, though no wider than CFIUS’s jurisdiction. The ANPRM defines a covered transaction as a U.S. 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.¹¹

⁸ The ANPRM’s proposed definition of covered foreign person includes “a person of a country of concern that a U.S. person knows or should know will be engaged in, and identified activity with respect to a covered national security technology or product.” ANPRM Section III(C).

⁹ 15 C.F.R. § 772.1.

¹⁰ See, ANPRM Questions 7, 50, and 51.

¹¹ ANPRM Section III(D).

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Note that while this definition is potentially expansive (e.g., how might OIS identify a “greenfield investment that *could* result in the establishment of a covered foreign person?”), the ANPRM excludes certain transactions from the definition, such as university-to-university research collaborations, procurement contracts related to material inputs for any of the covered national security technologies or products (such as raw materials), and intellectual property licensing agreements, so long as they are not undertaken as part of an effort to evade the regulations.

e. Limited Investments Will Be Exempt from the Requirements

The ANPRM also identifies a broad range of excepted transactions, affording U.S. businesses opportunities to continue engaging in investments with persons of a country of concern involving covered national security technologies and products. These include:

- Investments into publicly traded securities, index funds, mutual funds, exchange traded funds, or similar instruments;
- Passive investments made by a limited partner into a venture capital fund, private equity fund, fund of funds, or other pooled investment fund below a *de minimis* threshold to be determined by OIS;
- The acquisition of all interests held by a covered foreign person in an entity or assets located outside of China;
- Intracompany transfers of funds from a U.S. parent to a sub located in China; and
- Transactions made pursuant to a binding, uncalled capital commitment entered into before the publication of the E.O.

f. Enforcement and Penalties

The E.O. authorizes Treasury to nullify, void, or otherwise compel the divestment of any prohibited transactions. This authorization is not retroactive and only applies if an investment would have been prohibited at the time it was made. Notably, the E.O.’s authorization of such extreme measures does not apply to investments that require notification, regardless of whether or not the required notification was submitted.

Because covered transactions that trigger the notification requirement are not subject to a specific review process, as is the case for a transaction subject to CFIUS’s jurisdiction, the 30-day post-transaction notice requirement does not immediately raise concerns about forced divestment. OIS appears to still be considering how to address notified transactions that it determines should have been captured by the prohibited transactions regulations.¹²

¹² See ANPRM Question 59.

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While the E.O. authorizes both criminal and civil penalties related to violations of the final rules, noting that criminal violations should be referred to the Attorney General of the United States, the ANPRM primarily focuses on civil penalties. OIS is considering civil penalties up to the maximum allowed under the International Emergency Economic Powers Act (IEEPA), *i.e.* the greater of \$356,579 or twice the value of the transaction. The ANPRM does not describe how OIS might identify transactions that required notification but were not notified. However, we expect that OIS Monitoring & Enforcement will monitor outbound investments using publicly available information in a manner similar to its role in the CFIUS process.

III. FINAL CONSIDERATIONS

While oft-discussed and slow to materialize, the E.O. and the ANPRM make clear the Biden administration's commitment to address a perceived gap in U.S. national security. Now it is a matter of when, not if, these regulations will become effective and establish an outbound investment review mechanism. As noted above, we do not expect that to occur until at least 2024 as OIS collects and reviews comments to the ANPRM.

While the narrow focus of the current proposal should limit the present impact on U.S. investors, it remains to be seen if and how future administrations will seek to use and expand the proposed mechanism. We view it as likely that outbound investment control will become another tool in the United States' foreign policy arsenal, akin to sanctions, export controls, and CFIUS, given the authorization to entirely prohibit covered transactions in certain technologies. Accordingly, while there may not be an immediate impact to U.S. persons seeking to invest in foreign entities and the proposed focus of the mechanism is fairly narrow, businesses should take the opportunity to comment on the ANPRM and highlight the potential impacts of the proposed outbound investment review mechanism, including on other technologies and other countries. We expect that these processes and definitions will likely be applied to a broader range of transactions in the future.

Finally, in light of the Senate's recent 91-6 vote to include the Outbound Investment Transparency Act (the "**OITA**") in the 2024 National Defense Authorization Act, Congressional action on an outbound investment review scheme remains a possibility. The Senate-approved version of the OITA includes additional categories of technology (hypersonics, satellite-based communications, and networked laser scanning systems with dual-use applications) that would trigger a notification requirement, and the requirement would be operative at 14 days *prior* to the conclusion of a covered transaction, but the OITA would not prohibit any transactions. The House has yet to consider a similar provision, and the OITA's prospects in conference are unclear in light of the E.O. Regardless, any Congressional legislation in this area will now likely build upon the foundation laid by President Biden's E.O. and the accompanying ANPRM.

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