

Executive Order 14105 on Outbound Investment in China and Proposed Rule

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On August 9, President Biden issued Executive Order 14105 (“EO 14105”) on *Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern*. EO 14105 significantly reshapes U.S. outbound investment policy towards China. Under the EO 14105, the Biden Administration provides a new framework for restricting investments in “countries of concern” that specifically means the People’s Republic of China and its Special Administrative Regions of Hong Kong and Macau (collectively, “China”). (See our update on EO 14105 [here](#).)

EO 14105 tasks the Secretary of the Treasury, in consultation with the Secretary of Commerce and other Cabinet members, to devise a new two-part program with respect to “covered national security technologies and products.” Currently, that key term is defined to mean: (a) semiconductors and microelectronics; (b) quantum information technologies; and (c) artificial intelligence (“AI”) sectors that are critical for China’s military, intelligence, surveillance, or cyber-enabled capabilities.

On August 14, the U.S. Department of the Treasury (“Treasury”) published an advance notice of proposed rulemaking (“ANPRM”) to implement EO 14105. The Biden Administration released these highly anticipated documents after many months of speculation about how the U.S. Government might curtail certain U.S. investment that could enhance China’s military, intelligence, surveillance, or cyber-enabled capabilities. The ANPRM calls for public comments on the proposed rule due by September 28, 2023, but neither EO 14105 nor the ANPRM specifies an implementation date for the new rule.

The new program will include both notification of covered transactions and prohibition of certain covered transactions. EO 14105 also reinforces the new regulations through additional prohibitions against conspiracy and evasion of the new prohibitions. EO 14105 authorizes the Secretary of the Treasury to prohibit U.S. persons from knowingly directing transactions to other persons that the U.S. person could not lawfully perform and to prohibit and require notification of transactions carried out through U.S. person-controlled foreign entities.

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ANPRM

In the ANPRM, Treasury explains that the program “is not intended to impede all U.S. investments into [China] or impose sector-wide restrictions on United States person activity.” Treasury will not engage in case-by-case review of transactions but will instead place the burden on the transactions parties to determine whether their transactions are subject to applicable notification requirements or prohibition, similar to existing practice under jurisdiction of the Committee on Foreign Investment in the United States (“CFIUS”) over inbound foreign investments and private parties’ compliance with U.S. economic sanctions programs.

The ANPRM defines the key terms in EO 14105 in the following ways:

- “*Covered foreign person*” is refined to mean (1) a person of China that is engaged in, or that a U.S. person knows or should know will be engaged in a covered activity, or (2) a person whose subsidiaries or branches meet the above definition and which comprise more than 50% of that person’s consolidated revenue, net income, capital expenditure, or operating expenses.
- “*Person of a country of concern*” means any Chinese citizen or permanent resident who is not also a U.S. citizen or lawful permanent resident; any entity that is incorporated in or has a principal place of business in China; any Chinese governmental subdivision, political party, agency, or instrumentality; and any entity in which the foregoing persons hold 50% or greater equity ownership.

Treasury also intends to introduce a new term, “*covered transaction*,” to describe the scope of transactions that will be subject to the new rule. This key term will include a U.S. person’s direct and indirect:

- Acquisition of an equity interest or contingent equity interest in a covered foreign person;
- Provision of debt financing to a covered foreign person that is convertible to an equity interest;
- Greenfield investment that could result in the establishment of a covered foreign person; and
- Establishment of a joint venture with a covered foreign person, or that could result in the establishment of a covered foreign person.

Treasury notes that this definition is prospective and will not apply retrospectively to completed transactions. However, Treasury may make information requests to certain transaction parties about their closed transactions to inform the further development of the program.

The ANPRM proposes to exempt the following types of transactions: most investments in publicly traded securities without any special shareholder rights; U.S. person’s purchase of all equity interests held by covered foreign person in assets located outside China; intracompany transfers from U.S. parent company to a subsidiary outside of China; and transactions pursuant to binding, uncalled capital commitments made before the issuance of EO 14105. In addition, the ANPRM contemplates the use of national interest

waivers in limited cases.

The ANPRM also fleshes out the scope of “*covered national security technology or product*” to include the following:

- **Semiconductors and Microelectronics:**
 - *Prohibitions* on transactions with covered foreign persons involving:
 - Technologies that enable advanced integrated circuits (“IC”), including IC manufacturing equipment and software for electronic design automation;
 - Advanced IC design and production, including IC design that exceed the thresholds in Export Control Classification Number (“ECCN”) 3A090 in the Commerce Control List of the Export Administration Regulations; advanced IC fabrication meeting certain parameters; and IC packaging that support three-dimensional integration of ICs; and
 - Supercomputers.
 - *Notification* requirements for transactions involving IC design; IC fabrication; and IC packaging.
- **Quantum Information Technologies:** *prohibitions* on transactions involving quantum computers and components; quantum sensors; and quantum networking and quantum communication systems
- **AI Systems:**
 - *Prohibition* on transactions involving 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;
 - *Notification* requirement for transactions involving the development of software that incorporates an AI system and is designed to be exclusively used for cybersecurity, digital forensics tools, and penetration testing tools; control of robotic systems; surreptitious listening devices; non-cooperative location tracking; and facial recognition.

The ANPRM notes that Treasury intends to enforce the new regulations through the imposition of civil penalties authorized under International Economic Emergency Powers Act (“IEEPA”). These penalty amounts would be the same as those that currently apply under certain major economic sanctions programs administered by the Office of Foreign Assets Control (“OFAC”). Annually adjusted, the current maximum IEEPA civil penalty amount is the greater of twice the transaction value or US\$356,579 for each transaction.

The ANPRM invites public comments on the proposed rule, including specific questions with respect to each point above. In particular, Treasury seeks comments on the new “knowledge” standard that would determine whether a U.S. person is subject to certain prohibitions and notification requirements. Treasury also seeks comments on the circumstances where a U.S. person’s conduct would violate the new prohibition against “knowingly directing transactions” to others that a U.S. person could not perform.

Lastly, Treasury is concerned about certain types of transactions that could become vehicles for evasion, including many commonplace cross-border activities with China:

- University-to-university research collaboration;
- Contractual arrangements and procurement of material inputs for covered national security technologies and products;
- Intellectual property licensing;
- Bank lending;
- Bank payment processing, clearing, and sending;
- Underwriting services;
- Debt rating services;
- Prime brokerage;
- Global custody; and
- Equity research and analysis.

Treasury indicates a willingness to consider options that would not unduly impede these generally innocuous academic and economic activities. However, this receptiveness is tempered by the concern that these activities could allow parties to sidestep the new proposed prohibitions and notification requirements.

Key Takeaways

The new EO 14105 rules should not affect most transactions with China. For now, the new prohibitions and notification requirements target only certain investments involving advanced computing, quantum technology, and AI. However, the precise scope of those affected transactions is still subject to further consideration by Treasury and has not been finalized. In the meantime, the new rules and their uncertainties may cause companies in these high-tech sectors to reconsider any new ventures and investments involving China to mitigate risk.

The ANPRM's focus on routine bank transactions as potential avenues for evasion could also pose serious compliance headaches for financial institutions. Treasury specifically calls out bank lending and payments processing as activities that could become subject to the new rule as "*covered transactions*." Although financial institutions may become involved in cross-border transactions by handling wire transfers and credit facilities, they may not have full visibility into the details of the underlying transactions. Much will depend on how Treasury defines its "knowledge" standard and how it will apply in the context of international banking transactions. To mitigate this risk, financial institutions may take proactive measures that could have unintended consequences on routine international business involving China.

Similarly, Treasury's specific reference to academic research collaborations between U.S. and Chinese universities as another potential avenue for evasion of the new EO 14105 requirements will likely be of grave concern to university administrators and faculty members at U.S. institutions of higher education. Given the vast scale of such collaborations that occur almost daily, it will be essential within the ANPRM process for Treasury to provide additional clarity so as not to chill open scientific and research activities that have long been considered within the realm of fundamental research and that are intended to lead to publication and the expansion of human knowledge.

Because the President invoked his IEEPA authority to issue EO 14105, the new rule could be subject to enforcement through civil penalties as well as criminal penalties. The ANPRM calls for comments on civil monetary penalties in three scenarios: misstatements submitted to Treasury; violation of the new prohibitions; and failure to provide required notification under the new rule. Treasury intends to penalize these violations using the same maximum penalty amounts that currently apply to the Iranian sanctions and many other OFAC sanctions programs. It remains to be seen whether these civil penalties will only apply to violations with knowledge, or whether they will apply as strict liability even when there is no knowledge, which can be the case with OFAC economic sanctions programs under IEEPA.