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August 17, 2023

Executive Order and ANPRM on U.S. Outbound Investment in China: Key Considerations for Funds and Asset Managers

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TO: AML Compliance Working Group
Asia Regulatory and Policy Committee
Chief Risk Officer Committee
Global Markets and Investing Working Group
Operations Committee
SEC Rules Committee RE: Executive Order and ANPRM on U.S. Outbound Investment in China: Key Considerations for Funds and Asset Managers

Introduction

On August 9, 2023, President Biden signed Executive Order 14105, titled Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern^[1] (Executive Order), which directed the US Secretary of the Treasury to develop and establish a US Outbound Investment Program. The stated purpose of the US Outbound Investment Program is to address the national security threat posed by countries of concern using advanced technologies to enhance their military, intelligence, surveillance, or cyber-enabled capabilities.

Concurrent with the publication of the Executive Order, the US Department of the Treasury (Treasury) published an Advanced Notice of Proposed Rulemaking^[2] (the ANPRM) to initiate the accompanying rulemaking process and invites public comments by September 28, 2023. The ANPRM does not implement the US Outbound Investment Program. Rather, the relevant prohibitions and notification obligations will not become effective until the implementing regulations are finalized by Treasury, which likely will not be until mid to late 2024.

The US Outbound Investment Program will:

- Prohibit certain types of investment by US persons into certain entities with a principal place of business in or organized under the laws of a country of concern, and entities

50% or more owned by persons of a country of concern, with capabilities or activities related to defined technologies and products that pose a "particularly acute threat" to US national security; and

- Require notification to Treasury by US persons into certain entities with a principal place of business in or organized under the laws of a country of concern, and entities 50% or more owned by persons of a country of concern, with capabilities or activities related to defined technologies and products that "may contribute to the threat" to US national security.

The Executive Order specified that "countries of concern" currently consists of the People's Republic of China, including the Special Administrative Regions of Hong Kong and Macau. The relevant advanced technologies relate to semiconductors and microelectronics, quantum information technology, and artificial intelligence.

Treasury publicly indicated the program is anticipated to focus on US persons undertaking certain types of transactions that could convey intangible benefits, such as enhanced standing and prominence, managerial assistance, access to investment and talent networks, market access, and enhanced access to additional financing. Treasury also indicated it is considering creating an exception for certain types of passive and other investments that may pose a lower likelihood of conveying intangible benefits, such as certain US investments into publicly-traded securities, index funds, mutual funds, and exchange-traded funds. The scope and nature of each of the potential exceptions is under consideration in the ANPRM. This memorandum provides an overview of the US Outbound Investment Program proposal in the ANPRM and key issues for ICI members to begin to consider in connection with their China investment strategy. ICI will be responding to the ANPRM and will be engaging with relevant ICI Committees in this process.

US Outbound Investment Program Overview

The subsections below explore four key concepts related to the scope of the US Outbound Investment Program: covered transactions, US person, covered foreign person, and national security technologies.

Covered Transaction

The ANPRM proposes that "Covered Transaction" will be defined as a US person's direct or indirect:

- Acquisition of an equity interest or contingent equity interest in a covered foreign person;
- Provision of debt financing to a covered foreign person where such debt financing is convertible to an equity interest;
- Greenfield investment that could result in the establishment of a covered foreign person; or
- 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 proposed definition would not include holding or disposing of an investment. However, the proposed definition of "covered transaction" will also include indirect transactions executed via intermediary entities. For example, a US person would not be able to knowingly invest in a non-US entity that will use the investment to undertake a covered transaction that would be subject to US Outbound Investment Program's restrictions if engaged in by a US person directly.

In contrast, the definition of covered transaction will not include activities such as:

- University to university research collaborations;
- Intellectual property licensing arrangements;
- Bank lending and payment services; and
- Underwriting services.

The ANPRM also outlines important exclusions from the scope of covered transactions, which we discuss in greater detail below. These include certain passive investments (such as passive investments in publicly traded securities and investment funds), equity interest buyouts, intercompany transfers, and transactions involving committed but uncalled capital, will also be exempted from the definition of covered transaction.

US Person

The ANPRM proposes that "US person" be defined to include:

- Any US citizen or lawful permanent resident;
- Any entity organized under the laws of the United States or any jurisdiction within the United States, including any [non-US] branches of any such entity; and
- Any person in the United States.

Similar to the implementing regulations for the US Economic Sanctions Programs, the implementing regulations for the US Outbound Investment Regime will apply to US persons wherever they are located (e.g., a US citizen residing in London will be required to comply even if they are acting on behalf of a non-US investor). It is not clear, based on the ANPRM, how Treasury would interpret the inclusion of persons "in the United States" in the context of entities.

Covered Foreign Person

The ANPRM proposes that "covered foreign person" be defined as:

- 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; and
- A person whose direct or indirect subsidiaries or branches are engaged in the 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.

The proposed "knowledge" standard in the ANPRM includes both actual or constructive knowledge as well as "reason to know" or "reason to believe" (similar to the definition of knowledge in the US Export Administration Regulations). Treasury will also restrict US persons from "knowingly directing" transactions covered by the implementing regulations to the US Outbound Investment Program. The proposed definition of "directing" in the ANPRM includes ordering, deciding, approving, or otherwise causing to be performed a transaction prohibited under the implementing regulations if engaged in by a US person.

National Security Technologies

The proposed definition of "national security technologies" in the ANPRM covers three specific categories of advanced technologies that are deemed to pose a risk to US national security. They are:

- Semiconductors and microelectronics;
- Quantum information technologies; and
- AI systems with specific end uses.

The ANPRM provides that Treasury is seeking to capture only those national security technologies that pose significant US national security risks and not technologies and products intended for consumer/civilian end uses. Please see the Appendix for a high-level overview of the proposed prohibitions and notice requirements for specific technology and products in each category of national security technologies.

Considerations for Registered US Investment Funds and Asset Managers

Described below are certain key issues or areas of uncertainty that we have identified that may be of particular interest or concern to US registered investment funds and asset managers. This list is not exhaustive.

Scope of Exclusions

Certain investments that otherwise would be considered covered transactions are proposed to be excepted from the prohibitions and notification obligations of the US Outbound Investment Program. Importantly, included in the exceptions are certain activities of key importance to US funds, managers, and service providers. However, there are several considerations that must be evaluated (and eventually clarified) when assessing the scope and applicability of such exceptions.

i. Publicly Traded Securities

The definition of "covered transaction" will exclude investments in publicly traded securities.

Certain aspects of this important exclusion remain unclear, however. Specifically, the ANPRM is silent on whether references to "publicly traded" securities cover only listed securities or also securities acquired on a secondary market or securities otherwise acquired in a public transaction. The publicly traded securities exception also contrasts with US economic sanctions measures that prohibit US persons from investing in publicly-traded securities of certain "Chinese Military Industrial Complex Companies" or funds that provide investment exposure to such securities.

ii. Investments in Certain Funds

US persons would be permitted to make passive investments in index funds, mutual funds, or exchange-traded funds that have engaged in covered transactions. However, the scope of this exception isn't fully clear and the proposed language requires clarification. Importantly, to the extent such funds are US entities, however, the funds themselves would be subject to the investment restrictions in the US Outbound Investment Program.

iii. Passive Investments in Venture Capital and Private Equity Funds

The ANPRM would exclude from "covered transactions" limited partnership interests in venture capital and private equity funds. However, these will be excluded only as long as the US limited partner:

- does not have the ability to influence or participate in the decision-making or

operations of one or both of the investment fund and a relevant covered foreign person, and

- invests below a de minimis threshold that has not yet been established in the ANPRM (but could include consideration of the limited partner itself or the size of the limited partner's investment).

iv. **Non-Bank Lending**

Although the ANPRM includes an exception for bank lending, the ANPRM is silent with respect to non-bank lending. This may be an area for further clarification.

Non-US Subsidiaries of US Persons

The proposed definition of US person in the ANPRM does not extend to non-US subsidiaries. However, the ANPRM states that US persons must take "take all reasonable steps to prohibit and prevent any transaction by a foreign entity controlled by such US person that would be a prohibited transaction if engaged by a US person" creating an obligation for US parents that control non-US entities. The proposed definition of "controlled" non-US entity in the ANPRM is a non-US entity in which a US person owns, directly or indirectly, a 50 percent or greater interest.

The proposed definition on "all reasonable steps" in the ANPRM is broad, and is defined to include implementing relevant policies, procedures, training, and internal controls (including a testing and audit function) to govern a US person's compliance with the US Outbound Investment Program in respect of its controlled non-US entities. The ANPRM further provides that US persons will be subject to the US Outbound Investment Program's prohibition and notification requirements if they "knowingly direct" restricted activities by a non-US person that are covered by the US Outbound Investment Program.

US Persons "Knowingly Directing Transactions"

As stated above, the ANPRM will restrict US persons from "knowingly directing transactions" covered by the implementing regulations to the US Outbound Investment Program. The ANPRM provides several examples where the outbound program would apply to US persons involved with non-US investment funds:

- Example 1: A US person General Partner manages a non-US investment fund that undertakes a transaction that would be prohibited if performed by a US person.
- Example 2: A US person is an officer, senior manager, or equivalent senior-level employee at a non-US investment fund that undertakes a transaction at that US person's direction when the transaction would be prohibited if performed by a US person.
- Example 3: Several US person venture partners launch a non-US investment fund focused on undertaking transactions that would be prohibited if performed by a US person.

Consideration will need to be given to whether a broader exception or additional guidance may be needed for US asset managers acting on behalf of non-US person investment funds or other clients.

Appendix

PROPOSED COVERED NATIONAL SECURITY TECHNOLOGIES AND PRODUCTS

CATEGORY

PROHIBITION

NOTICE REQUIREMENT

Semiconductors and Microelectronics

The US Government is concerned with the development of semiconductor and microelectronic technology, equipment, and capabilities that will underpin military innovations that improve the speed and accuracy of military decision-making, planning, and logistics

- Specific technology, equipment, and capabilities that enable the design and production of advanced integrated circuits or enhance their performance;
- Advanced integrated circuit design, fabrication, and packaging capabilities; and
- The installation or sale to third-party customers of certain supercomputers, which are enabled by advanced integrated circuits
- Design, fabrication, and packaging of other integrated circuits

Quantum Information Technologies

The US Government is concerned with the development and production of quantum information technologies and products that enable capabilities that could compromise encryption and other cybersecurity controls and jeopardize military communications

- Specific and advanced quantum information technologies and products, or with respect to end uses
- Not contemplated at this time

AI Systems

The US Government is concerned with the development of AI systems that enable the military modernization of countries of concern – including weapons, intelligence, and surveillance capabilities – and that have applications in areas such as cybersecurity and robotics

- 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
- The development of software that incorporates an AI 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 catchers and automatic license plate readers); or facial recognition

Notes

[1] Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern, August 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/>.

[2] Treasury Seeks Public Comment on Implementation of Executive Order Addressing U.S. Investments in Certain National Security Technologies and Products in Countries of Concern, August 9, 2023, available at <https://home.treasury.gov/news/press-releases/jy1686>.

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