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Congress Takes a Step Forward on Outbound Investment

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The U.S. government continues to move closer to establishing a regulatory program related to outbound investment—and potentially a range of other transactions—in sensitive technology sectors involving China, Russia and other "countries of concern."

- On July 25, 2023, the Senate voted 91-6 to add a provision to the 2024 National Defense Authorization Act (NDAA) that would require U.S. persons to notify the government of certain transactions in countries of concern related to advanced semiconductors and microelectronics, artificial intelligence and quantum, among other advanced technologies.
- The Senate's strong support for this provision suggests that it has a good chance of being included in the final version of the NDAA, which will likely be adopted late in the year. However, key members of the House of Representatives have raised concerns about the provision and may look for alternatives to address the issue.
- In the meantime, the Biden administration continues to consider an Executive Order (EO) to address its concerns about U.S. investment in certain advanced technology sectors in countries of concern. The Biden administration has been reportedly targeting August for the EO, but that timing remains fluid.
- Key differences between the NDAA provision and the expected EO are (1) the amendment would include passive investment and certain contractual arrangements, in addition to active investment; and (2) the provision would require only notification and does not explicitly prohibit or limit any particular transactions. The NDAA provision and expected EO are likely to cover similar technologies and countries.

Background

The U.S. government has been considering regulating outbound investment for several years. During the debate concerning reform of inbound foreign investment review and export controls in 2017 and 2018, Congress considered adding provisions for the review of certain outbound investments. These provisions were dropped in the final versions of the legislation (the Foreign Investment Risk Review Modernization Act of 2018 and the Export Control Reform Act), which strengthened the authority of the Committee on Foreign Investment in the United States (CFIUS) and authorized enhanced export controls to address concerns relating to U.S. companies aiding China in the development of strategically significant technologies, including "emerging and foundational technologies." Subsequently, through Executive Orders, the **Trump** and **Biden** administrations prohibited investment in publicly traded securities of certain identified Chinese Military Industrial Complex (CMIC) companies.

More recently, as discussed in our **prior client alert**, there has been a growing consensus that the U.S. government should address national security risks associated with outbound investment—in particular, the risk of supporting China in developing sensitive technology with military applications. Some members of Congress also have wanted to address economic competitiveness and supply chain issues in a broad range of sectors, as reflected in last year's National Critical Capabilities Defense Act (NCCDA), which would have established an interagency committee with authority to recommend that the President block transactions or to require mitigation conditions (a “reverse CFIUS”). Action in Congress had been hindered by differences of opinion regarding the risks that should be addressed and the type of program that should be established.

Proposals for an outbound investment program have included (1) a notification requirement, which would allow the government to collect additional information before taking more targeted action; (2) a reverse CFIUS that would involve a case-by-case review of transactions; and/or (3) prohibitions on certain outbound investment.

Overview of Legislation

Key elements of the Senate NDAA provision include the following:

Type of Program: The NDAA provision would require U.S. persons to notify the government 14 days in advance of closing (and for secured transactions, 14 days after closing) of a range of transactions in countries of concern in specified sectors. This reflects a move away from a reverse CFIUS mechanism as proposed in the NCCDA. Notably, the provision does not prohibit or limit any transactions.

Types of Transactions: Subject to regulations, transactions requiring notification would include the following:

1) Active and passive investment in a covered foreign entity.
2) Debt transactions that afford rights characteristic of equity in a covered foreign entity.
3) Establishment of a wholly owned subsidiary in a country of concern for the purpose of production, design, testing, manufacturing, fabrication or development.
4) The establishment of a joint venture in a country of concern or with a covered foreign entity for the same purposes as in (3) or for research, as well as contractual relationships for research and development.
5) Acquisition with a covered foreign entity of operation cooperation (such as supply or support), the right to board representation or an executive role in a covered foreign entity, governance representation in operating affiliates, and new relationships to share or provide business services (such as financial services, marketing, maintenance or assembly functions) related to a covered sector.

Sectors: Subject to regulations, “covered sectors” include (1) advanced semiconductors and microelectronics; (2) artificial intelligence; (3) quantum information science and technology; (4) hypersonics; (5) satellite-based communications; and (6) networked laser scanning systems with dual-use applications.

Regulations and Exceptions: The Secretary of the Treasury would have authority to issue regulations to further define relevant terms and to provide exceptions from the notification process for de minimis transactions, “ordinary or administrative” business transactions and any category of transactions that the Secretary determines is in the national interest. The Treasury would be required to finalize regulations within 360 days.

Definition of “U.S. Person”: U.S. persons include U.S. citizens and entities organized under the laws of the United States, which on its face would not cover offshore funds controlled by U.S. managers and potentially could exclude U.S. subsidiaries in third countries.

Definition of “Covered Foreign Entities”: Covered foreign entities include (1) entities incorporated in or with a principal place of business in a country of concern, (2) entities with securities primarily traded on an exchange in such a country (which presumably would include Hong Kong) and (3) entities in which one of these entities holds interests of greater than 50%. Thus, subsidiaries in third countries would be covered. The term does not include any entity that can demonstrate that a majority of its equity is owned by U.S. nationals or nationals of such third countries as identified in regulations. Therefore, existing subsidiaries of U.S. companies in China, for example, would be excepted.

Other Items of Note: Notified information would not be disclosed publicly. The Secretary of State, in coordination with other agencies, is directed to lead multilateral engagement to coordinate actions and encourage establishment of similar mechanisms. The Treasury, Commerce and State would have reporting obligations to Congress.

Overview of Potential Executive Order

Key expected elements include the following:

- *Type of Program*: Notification requirement with some prohibitions on investments in specific sectors.
- *Types of Transactions*: Focus on more active capital, including private equity, joint ventures and greenfield transactions. Divestment requirements are not expected.
- *Sectors*: Advanced technology including (1) semiconductors, (2) quantum computing and (3) artificial intelligence.
- *Definition of U.S. Person*: Expected to cover U.S. nationals and companies incorporated in the United States. Application to funds incorporated abroad but with U.S. managers, as well as subsidiaries of U.S. companies, is an open issue.
- *Definition of Covered Foreign Entities*: Expected to cover companies incorporated (or to be incorporated) in countries of concern. Coverage through subsidiaries in third countries is an open issue.

Prospects

The Senate's overwhelming bipartisan support for the NDAA provision that it has a good prospect of being included in the NDAA conference report, which is likely to be adopted late in the year. In particular, the lead Senate cosponsors—Senators Casey (D-PA) and Cornyn (R-TX)—modified their proposal significantly from earlier versions in order to address concerns from industry and thereby reduce objections from key Senate opponents. However, key opponents may still exist in the House of Representatives that could cloud the path forward. For example, following the Senate vote, House Financial Services Chairman Patrick McHenry released a statement noting that "[i]nstead of pursuing weaker outbound investment screening proposals, Congress should build on the reliable existing sanctions infrastructure. This is the stronger approach that Xi truly fears." This statement is particularly significant because the Financial Services Committee has jurisdiction over this issue in the House. It suggests that the Chairman would prefer an alternative approach to addressing concerns about investment in China that focuses on strengthening existing sanctions regimes, such as the prohibitions under the CMIC executive order, instead of creating a new program.

The administration's decision on whether or not to proceed with their outbound investment EO could also substantially alter the prospects ahead. The administration has reportedly been aiming toward mid-August to early September for the EO, although the expected release has been pushed back several times previously and the Senate provision vote could provide justification for a further delay. On the other hand, proponents of the EO within the administration will be able to point to the overwhelming support for the provision as justification to move forward. If the Biden administration ultimately decides to release the EO in late summer, this could influence the conference on the NDAA and could lead to modifications to the provision so that it codifies the EO instead of providing a competing policy.

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