

Treasury Revises Proposed Limits on China Tech Investments

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Treasury Revises Proposed Limits on China Tech Investments

By Paul B. Edelberg, Esq.¹

Revised regulations restricting investments in Chinese companies developing semiconductors and microelectronics, quantum information technologies, and artificial intelligence systems are taking shape and could soon be in effect.

While the regulations cover only a few specific technologies that the U.S. Government has identified as key to the nation's future technological superiority, they still create transaction risk and uncertainty.

Companies and private equity funds will need to implement procedures, policies and safeguards if they intend to invest in these covered technologies. They will also need to revise their investment documents.

This article outlines what potential investors need to know.

Background

In August 2023, President Biden issued an Executive Order creating the first U.S. outbound foreign direct investment regime regulating investment by "United States Persons" into certain technologies in certain countries. Immediately after the Executive Order, the U.S. Department of Treasury issued proposed regulations in an Advanced Notice of Proposed Rulemaking (the ANPRM) and requested comment on those proposed regulations.

On July 5, 2024, the U.S. Department of Treasury published revised proposed regulations in response to those comments in a Notice of Proposed Rulemaking (the NPRM) and requested comments by August 4, 2024. It is anticipated that Treasury will now finalize the regulations within a brief period, now that the comment deadline has passed.

The Order

The Executive Order (No. 14105) would prohibit or restrict investment by "U.S. Persons" in "Covered Foreign Persons" engaged in activities involving certain technologies (Covered Activities), which have been identified by the U.S. Government as sensitive areas that are key to future technological competitive superiority, thereby having national security importance. These sensitive areas are semiconductors and microelectronics, quantum information technologies, and artificial intelligence systems, as described in more detail below.

Certain investments would be prohibited under the Executive Order, while others would be allowed but would require a notification filing with the U.S. Department of Treasury following completion of the transaction. It is important to note that there is no review or approval process by the U.S. Department of Treasury, unlike export control approvals or inbound investment review by CFIUS. While the absence of a review and approval process makes an investment decision and transaction less cumbersome, it presents a host of other issues, as discussed below, including compliance uncertainty.

Who Is a Covered Foreign Person?

When compared to the original proposed regulations, the new proposed regulations amplify on and modify who constitutes a "Covered Foreign Person." A Covered Foreign Person is defined as one of the following:

- any individual who is a citizen or permanent resident of China, Macao or Hong Kong (called a Country of Concern), and is not a U.S. citizen or a permanent resident of the U.S.

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- an entity with a principal place of business in, headquartered in or organized under the laws of a Country of Concern.
- an individual or entity who or which holds a voting interest in or has decision-making authority over any such entity.
- any entity in which one or more persons above, individually or in the aggregate or any entity described in this clause, directly or indirectly holds at least 50 percent of any of the following interests of such entity: outstanding voting interest, voting power of the board, or equity interest.
- an individual or entity who or which derives more than one half of its revenue or net income from such entity or incurs more than 50% of its capital expenditures or operating expenses through a Person of a Country of Concern.
- a government of a Country of Concern or any agency, instrumentality or political party of any such government, including state owned enterprises (a Governmental Unit).
- any entity with respect to which such Governmental Unit holds individually or in the aggregate, directly or indirectly, 50 percent or more of the entity's outstanding voting interest, voting power of the board, or equity interest, or otherwise possesses the power to direct or cause the direction of the management and policies of such entity.

The definition of "Covered Foreign Person" is sufficiently broad to cover direct and indirect subsidiaries of Chinese companies, wherever located, and to cover Chinese subsidiaries of non-Chinese foreign companies, with either direct or indirect Chinese subsidiaries or with joint ventures or other operations in China that derive substantial revenues to any such foreign company.

Who Is Covered?

The restrictions apply to "U.S. Persons." A "U.S. Person" is defined as any U.S. citizen, any lawful permanent resident, any entity organized under the laws of the United States or any jurisdiction within the United States, including any foreign branch of any such entity, or any person *in* the United States.

This definition would apply to a U.S. subsidiary of a non-U.S. foreign company and the parent foreign company's employees working at the U.S. subsidiary, since they would be in the United States. However, the foreign parent company and its foreign employees would not be considered a "U.S. Person" and would not be restricted in its Chinese investments.

Nor would the definition apply to a "controlled foreign entity," with one significant and important exception, as discussed below under the section "Other Prohibited Activities."

Technologies Covered

The proposed revised regulations set forth those investments in Covered Foreign Persons that would be prohibited (called Prohibited Transactions).

In the semiconductor and microelectronics sector, the following investments would be prohibited if the Covered Foreign Person:

- Develops or produces any electronic design automation software for the design of integrated circuits or advanced packaging.
- Develops or produces any front-end semiconductor fabrication equipment designed for performing the volume fabrication of integrated circuits.
- Develops or produces equipment for performing volume advanced packaging.
- Develops or produces commodity, material, software, or technology designed exclusively for

use in or with extreme ultraviolet lithography fabrication equipment.

- Designs any advanced integrated circuit above prescribed parameters.
- Fabricates any advanced integrated circuit above prescribed parameters.
- Packages any integrated circuit using advanced packaging techniques.
- Develops, installs, sells, or produces any supercomputer enabled by advanced integrated circuits above prescribed parameters.

In the quantum computing sector, the following investments would be prohibited if the Covered Foreign Person:

- Develops a quantum computer or produces any of the critical components required to produce a quantum computer such, as a dilution refrigerator or two-stage pulse tube cryocooler.
- Develops or produces any quantum sensing platform designed for, or which the relevant Covered Foreign Person intends to be used for, any military, government intelligence, or mass-surveillance end use.
- Develops or produces any quantum network or quantum communication system designed for, or which the relevant Covered Foreign Person intends to be used for certain networking purposes, secure communications or any other application that has any military, government intelligence, or mass-surveillance end use.

In the artificial intelligence sector, the following investments would be prohibited if the Covered Foreign Person:

- Develops any AI system that is designed to be exclusively used for, or which the relevant Covered Foreign Person intends to be used for, any military end use or government intelligence or mass surveillance end use.

- Develops any AI system that is trained using a quantity of computing power greater than prescribed parameters.

Certain investments within these technology sectors are allowed, but require notification to the Department of Treasury within 30 days after consummation of the transaction. These “Notifiable Transactions” include investments in a Covered Foreign Person which:

- Designs any integrated circuit that is not a prohibited transaction.
- Fabricates any integrated circuit that is not a prohibited transaction.
- Packages any integrated circuit that is not a prohibited transaction.or
- Develops any AI system that is not a prohibited transaction and that is designed to be used for any government intelligence or mass-surveillance end use or military end use or intended to be used for cybersecurity applications, digital forensics tools, and penetration testing tools, or the control of robotic systems or trained using a prescribed threshold of computing power.²

Certain investments that would otherwise be Notifiable Transactions are prohibited and constitute “Prohibited Transactions” if the Covered Foreign Person is named on certain government lists. These lists include a Covered Foreign Person:

- which is included on the Entity List or the Military End User List published by the Bureau of Industry and Security of the U.S. Department of Commerce (BIS).
- which meets BIS’ definition of “Military Intelligence End-User.”
- which is included on Treasury’s Specially Designated Nationals and Blocked Persons (SDN List) or its list of Non-SDN Chinese Military-Industrial Complex Companies (NS–CMIC List). or

² The NPRM proposed for comment three alternative levels of computing power for public comment.

- which is designated as a foreign terrorist by the U.S. Secretary of State.

Engagement by a Covered Foreign Person in any of the technologies comprising Prohibited Transactions and Notifiable Transactions is deemed in the proposed regulations to be a “Covered Activity.”

For U.S. Persons contemplating investments in a Covered Foreign Person in the technology sector, one should conduct thorough due diligence to determine if he proposed investment will involve one of these covered technologies.

Other Prohibited Activities

Controlled Foreign Entity Prohibition

A U.S. Person must take all “reasonable steps” to prohibit and prevent any transaction by its controlled foreign entity that would be a prohibited transaction if engaged in by a U.S. Person. If a controlled foreign entity engages in a Prohibited Transaction, the factors to be considered in determining whether reasonable steps have been taken include:

- the execution of agreements between the U.S. Person and the controlled foreign entity with respect to compliance with these regulations.
- the existence and exercise of governance or shareholder rights by the U.S. Person with respect to the controlled foreign entity.
- the existence and implementation of periodic training and internal reporting requirements by the U.S. Person and its controlled foreign entity with respect to compliance.
- the implementation of appropriate and documented internal controls.
- the implementation of a documented testing and/or auditing process of internal policies, procedures or guidelines.

A “controlled foreign entity” is defined as a non-U.S. entity whose parent is a U.S. Person. To constitute a “parent”, as a general rule,” the U.S. Person must directly or indirectly own greater than 50% of the ownership interest or voting power in the non-U.S. entity or be the general partner, managing member or equivalent of the non-U.S. entity or, if the non-U.S. entity is a pooled investment fund, the investment advisor to that fund. If there is a tiered ownership structure to the non-U.S. entity, the regulations set forth a “bright-line” mathematical test to determine control by the U.S. Person, whereby a downstream entity would be deemed controlled by the U.S. Person if the intervening entity meets the “parent” test (e.g., greater than 50%) and, if not a parent (e.g., 50% or less), indirect downstream holdings are aggregated on a proportionate basis for purposes of calculating the 50% ownership or voting threshold.

Therefore, as mentioned above in discussing who is covered, a controlled foreign entity is not subject to the outbound investment restrictions, but the U.S. Person in control of or working at the controlled foreign entity must take all “reasonable steps” to prevent the controlled foreign entity and its downstream entities from entering into a Prohibited Transaction.

The “Knowingly Directing a Transaction” Prohibition

The proposed regulations also prohibit a U.S. Person from knowingly directing a transaction by a non-U.S. Person that the U.S. Person knows at the time of the transaction would be a Prohibited Transaction if engaged in by a U.S. Person from the investment decision. A U.S. Person “knowingly directs” a transaction when the U.S. Person has authority, individually or as part of a group, to make or substantially participate in decisions on behalf of a non-U.S. Person, and exercises that authority to direct, order, decide upon, or approve a transaction. The regulations state a presumption

that a U.S. Person who is an officer, director, or senior advisor, or otherwise possesses senior-level authority at a non-U.S. Person has such authority. A U.S. Person who has such authority will not be deemed to violate this prohibition if he or she recuses himself or herself from the investment.

Officers, managers and investment committee members who are U.S. Persons and who work at foreign private equity and other funds will need to conduct sufficient due diligence to be sure that no segment of an investment will be used to invest in a Covered Foreign Person engaged in or intending to be engaged in a Prohibited Transactions. If after such diligence they determine that funds will be so used, they should recuse themselves.

Types of Transactions Covered

The new proposed regulations add a few wrinkles to the types of transactions that are covered. In addition to the originally proposed types of transactions, such as acquisition of an equity interest, convertible debt transactions and debt financings that would afford the U.S. Person active management and decision-making authority or the right to appoint board members, and greenfield and brownfield investments, it makes clear that joint ventures formed with a Person of a Country of Concern are covered if the U.S. Person knows at the time of entering into the joint venture that the JV will engage or intends to engage in a Covered Activity. Limited partnership investments in a non-U.S. fund are also covered if and as stated below. Furthermore, the actual conversion of a contingent equity or debt interest is an independent Covered Transaction in addition to the investment in the original contingent interest.

For greenfield and brownfield investments, it covers investments in a Country of Concern which the U.S. Person knows will result in or intends to result in not only the establishment of a Covered Foreign Person, but also the engagement of a Person of a Country of Concern in a Covered

Activity where it was not previously engaged in such Covered Activity. The NPRM gives as an example of the first instance an acquisition of land in a Country of Concern with the intent to convert it into a facility that engages in a Covered Activity, and gives as an example of the second instance the acquisition of a factory in a Country of Concern for the purpose of pivoting its existing operations into a new Covered Activity. It is sufficient for the U.S. Person to intend to result in the Covered Activity, even if the Covered Activity never materializes, in order for a transaction to be covered.

A similar analysis applies to joint ventures. Note that, while covered, joint ventures are not defined in the proposed regulations.

Limited partner investments in foreign pooled investment funds, such as private equity funds and venture capital funds, are Covered Transactions if both of two conditions are met. First, the U.S. Person must know at the time of the investment that the fund will likely invest in a person of a Country of Concern that is in the semiconductors and microelectronics, quantum information technologies, or artificial intelligence sectors. Secondly, the fund must undertake a transaction that would be a Covered Transaction if undertaken by a U.S. Person. If the U.S. Person does not know, through due diligence, that the fund will likely invest in a Covered Foreign Person, but at some point the fund does make such an investment, then the U.S. Person has complied with the regulations. Furthermore, even if the U.S. Person has such knowledge at the time of the investment, but the fund never undertakes such a transaction, the U.S. Person has complied with the regulations. But if both conditions are met, then the U.S. Person must file a notification with Treasury if it is a Notifiable Transaction. If it is a Prohibited Transaction, then the U.S. Person is in violation of the regulations, despite its lack of control over the fund's investment. There

is a provision proposed for limited partnership investments, by which a U.S. Person can withdraw its investment within 30 days after a prohibited fund investment, but the fund may not allow withdrawals at that time or a withdraw may not be practicable.

Furthermore, if the U.S. Person who made the limited partnership investment had come to the conclusion that it “knew” at the time of the investment that the fund would not likely invest in a Covered Transaction, but the fund at some point does make such an investment, the U.S. Person would have to establish to the Department of Treasury in hindsight that it conducted sufficient due diligence at the time of the investment. As discussed below in the section captioned “*Knowledge Standard*,” the lack of sufficient guidance in the regulation as to what constitutes “knowledge” could inadvertently cause noncompliance.

Excepted Transactions

The NPRM proposes certain exceptions and exemptions from the scope of Covered Transactions, as follows:

- Investments in public securities and registered investment company securities (with certain exceptions).
- Acquisition of the entire equity of an entity held by persons of a Country of Concern, provided that after the acquisition the entity does not constitute a Covered Foreign Person.
- An intracompany transaction that supports ongoing operations or other activities that are not Covered Activities, but otherwise would be a Covered Transaction, with certain exceptions.
- A transaction pursuant to a binding uncalled capital commitment that existed prior to August 9, 2023 (the date of the President’s Executive Order).

- The acquisition of a voting interest in a Covered Foreign Person by a U.S. Person upon default or other condition involving a debt financing arrangement, where the loan was made by a syndicate of banks in a loan participation where the U.S. Person lender participates passively in the syndicate.; and
- A transaction involving a person of a country exempted by the Secretary of Treasury or of a type in which the Secretary determines the national security concerns are likely to be adequately addressed.

The above exceptions would not apply if the U.S. Person were to obtain certain investor rights beyond standard minority rights.

Also, Treasury is proposing an exception for passive limited partner investments in pooled funds. The NPRM provides for two alternatives being considered. The first alternative would provide an exception if the investment is solely a passive capital contribution (as defined in the proposed regulation) and either is not more than 50% of the fund’s total aggregated assets under management or in which the limited partner has secured a binding contractual assurance that its capital will not be used to engage in a transaction that would cause the limited partner to have made an indirect prohibited transaction. The second alternative would provide an exception for limited partner investments of not more than \$1,000,000 on an aggregated basis.

Knowledge Standard

Most of the Covered Transactions require “knowledge” on the part of the U.S. Person as an element. In determining whether the U.S. Person meets the “knowledge” standard, the proposed regulations have proposed a knowledge standard and asked for a comment on it. The proposed regulations define “knowledge” as one of the three following standards:

- actual knowledge that a fact or circumstance exists or is substantially certain to occur.
- an awareness at the time of a transaction of a high probability of a fact or circumstance of a future occurrence., or
- reason to know of a fact or circumstance's existence.

This is based on information a U.S. Person had or could have had through a reasonable and diligent inquiry and will take into account the U.S. Person's due diligence efforts, contractual representations and warranties, its efforts to obtain available non-public information about whether or not it is a covered transaction, and whether the relevant counterparty is a Covered Foreign Person.

The general definition of "knowledge" provides an appropriate balance between protecting national security and not imposing unduly restrictive restrictions on investments by U.S. Persons. However, the proposed rule lacks adequate guidance and certainty to investors on the "reason to know" standard.

The U.S. Person is expected to review available public information and use public and commercial databases. Were there warning signs, such as evasive responses? This determination of knowledge will be made in hindsight by Treasury, and the U.S. Person is left to make its own determination of whether it had "knowledge." The regulations do not create a safe harbor and give no guidance beyond the above standards.

The various references to a U.S. investor's "knowledge" that a Person of a Country of Concern "engages in" Covered Activities pose particular problems in the context of technology companies that may not yet have a fully defined product, much less a defined customer base. It also poses problems in large groups of related companies (for example, it is relatively common for Chinese

groups to permit outside investment in particular subsidiaries of a group rather than the parent entity). How is a U.S. person to assess whether an affiliate in which they have not invested directly — which may not even be in the same industry in which the U.S. person intends to invest — may engage in Covered Activities?

Added to this complication is the fact that a number of these determinations need to be made not only at the time of original investment, but at a later date, including upon conversion of a convertible debt or upon investment by a fund in a Covered Foreign Person involved in a Covered Activity.

With respect to changes in technology and focus, it is extremely common for early-stage companies to focus on a technology for which the performance characteristics and uses are not yet known. A typical investment memorandum might, for example, describe a technology that has no current national security concerns and would not be a Covered Activity. If years later that technology is incorporated in weaponry or surveillance equipment in a Country of Concern, should a U.S. investor have known that such a development was likely? Can that question be fairly judged in hindsight?

As mentioned, there is no federal approval or review process other than the ability of the U.S. Department of Treasury to review transactions subsequent to the transaction, whether based on the filed notification or based upon outside sources. Without further guidance in the proposed regulation, the U.S. Person must make its evaluation at its own peril, particularly in assessing whether a transaction is prohibited. If Treasury later investigates the transaction, it can compel disclosure and information and can hold hearings on any act or transaction within the scope of the regulations. The regulations propose civil and

criminal penalties. The regulations do propose a voluntary self-disclosure process to ameliorate any consequences.

Notification Requirement

A U.S. Person that undertakes a Notifiable Transaction must file an electronic notification of that transaction with the Department of Treasury within 30 days after the “Completion Date,” which is the earliest date on which an interest is conveyed or transferred to the U.S. Person or its controlled foreign entity or, in the case of a limited partner investment, the earliest date on which an interest in the relevant Covered Foreign Person is conveyed or transferred to the fund.

A U.S. Person must file a Notifiable Transaction with respect to any transaction by a controlled foreign entity of that U.S. Person that would be a Notifiable Transaction if engaged in by a U.S. Person.

A U.S. Person that acquires actual knowledge after the completion date of a transaction of a fact or circumstance such that the transaction would have been a Covered Transaction if such knowledge had been possessed by the relevant U.S. Person at the time of the transaction must promptly file a notification within 30 days after acquiring such knowledge, whether the transaction was a Notifiable Transaction or a Prohibited Transaction.

Administrative Provisions

Violations of the regulations would be subject to both civil and criminal violations. The Treasury Secretary would also be authorized to order divestiture.

The NPRM provides for a voluntary self-disclosure process for persons who have committed a violation whereby Treasury will consider whether and to what extent to impose penalties, based on the timeliness of the submission and the facts surrounding such violation.

Materials and information submitted to the Department of Treasury are afforded confidential treatment except to the extent required by law, and except that disclosure is permitted in any judicial or administrative legal proceeding, or if provided to Congress, or if provided to any governmental entity. Also, disclosure may be made if the person filing the information consents.

Conclusion

With the NPRM, the U.S. Department of Treasury has fine-tuned the proposed regulations that were originally announced in the ANPRM. It is clear Treasury is attempting to find the right balance between protecting national security and not imposing unduly restrictive restrictions on investments by U.S. Persons.

The underlying framework in the NPRM is designed not to unduly restrict investments in China by U.S. Persons. Of note, the covered technologies have been limited to those that have been identified by the U.S. Government as sensitive areas that are key to future technological competitive superiority.

The regulations are designed to restrict U.S. Persons from funding the development of these technologies in China, Hong Kong and Macao and providing U.S. know-how and other intangible benefits to Covered Foreign Persons. The proposed regulations appear to accomplish these goals. Moreover, the Executive Order avoided creating a cumbersome governmental approval process. It requires simply a post-transaction electronic notification process for Notifiable Transactions.

However, the absence of an approval process creates transaction risk and uncertainty. The U.S. Person must make a determination of whether the investment under consideration is a Prohibited Transaction or a Notifiable Transaction at its own peril. In particular, the knowledge standard leaves room for interpretation on whether sufficient due

diligence was conducted and whether a U.S. Person had the prerequisite “knowledge.” The regulations do not provide any “safe harbors” by which the U.S. Person can safely “know” whether it complies with the regulations. From a practicing lawyer’s perspective, it will be difficult in many instances to advise a client whether it has satisfied the knowledge standard when making the investment.

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