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Biden executive order changes foreign investment paradigm

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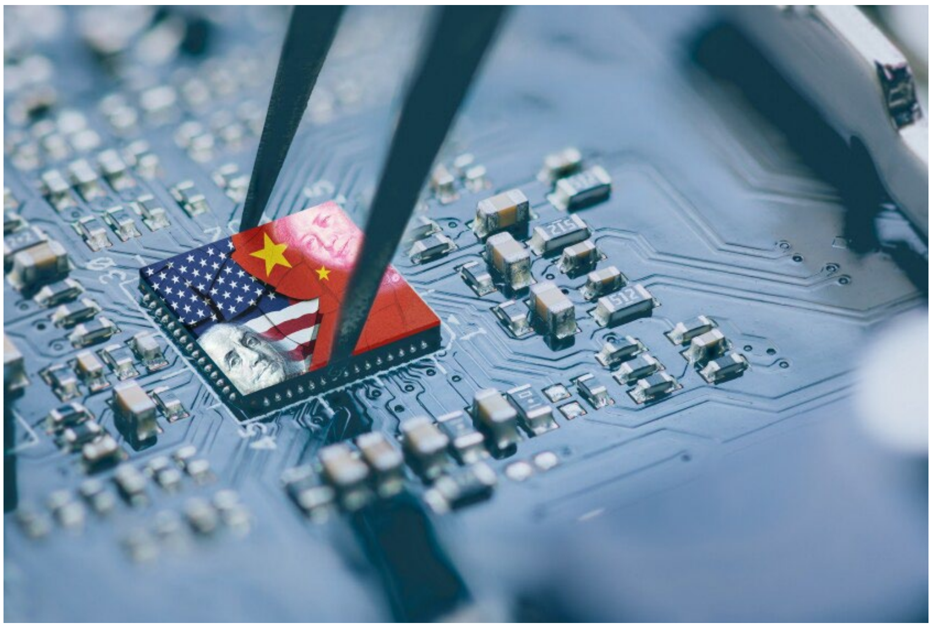

The decision to restrict certain investments is a further step towards decoupling from China, but mutual dependency will put that logic to the test

A recent White House executive order addressing investments in some national security technologies and products in countries of concern has been interpreted as the US's latest attempt to diminish economic ties with China and curtail the country's global influence.

Published earlier this month, the order will ban investments in key technological sectors whose applications could be deviated, including artificial intelligence (AI), quantum computing and advanced semiconductors. The new rules will also require US citizens to notify and disclose certain transactions involving foreign parties.

"The novelty in the new executive order is the imposition of a regime to review outbound rather than inbound investments, which is currently being done through CFIUS [Committee on Foreign Investment in the United States]," said Louis Lehot, partner at Foley & Lardner. "The regime purports to regulate the flow of capital outside the US and into China. The other novelty is that it attempts to regulate both investments and expertise, which will be a challenge to implement."

The advancement by countries of concern in sensitive technologies and products critical for the military, intelligence, surveillance, or cyber-enabled capabilities, constitutes an unusual and extraordinary threat to US national security, US President Joe Biden said in the order. As such, the export of such technologies to those countries should be closely scrutinised.

“The Biden administration’s executive order and the proposed rules it foresees contemplate the first-of-its-kind outbound investment screening regime among the G7 nations to oversee and regulate US domestic firms’ capital transactions in a small number of sectors in China, Hong Kong and Macau,” said Harry Broadman, partner and managing director at Berkeley Research Group. “Given that the rules have yet to be defined, let alone finalised, it is difficult to gauge the scope and intensity of concern on the part of the US business community, including whether the coverage applies only to new deals or to established investments as well.”

Although the new restrictions will apply mostly to private equity and venture capital firms, they could also cover investors involved in joint ventures with Chinese entities. Asset management firms such as BlackRock, State Street, Vanguard and Fidelity have already been identified by the US House Subcommittee on China as among those offering funds investing in Chinese firms listed on its watchlist.

“For those already invested in China, the executive order as publicly announced offers some relief, as it does not purport to regulate prior investments in China nor does it call for divestment,” said Lehot. “Based on what we know, the government of the People’s Republic of China will not respond aggressively to the order. It should also be well-aware that the final proposal is more tepid than previously threatened: prior drafts of the executive order were broader in scope and effect.”

Less is more

Though the new rules complement and expand existing export controls, they have been criticised for being too weak. Some of China’s staunchest critics on Capitol Hill, for instance, have said they wished the Biden administration’s proposals went further.

“The current administration has spent considerable efforts reviving the US-China relationship at the most senior levels in the current year, and this executive order seems to have tied the knot on any further regulation in this area,” said Lehot. “The economic relationship between the US and China has many layers and complexities. While we have seen many signs of ‘decoupling’ of the two economic systems, they remain interdependent, and neither party has an interest in creating a shock so severe that it would be a shot in the foot.”

Other critics suggested the new restrictions should include more mainstream investment products, including mutual funds and index funds. Existing concerns around the transfer of personal identifying information (PII), however, mean that the investment ban could eventually be expanded to cover sectors such as biotechnology and medical science.

“Depending on Capitol Hill’s reaction to the rules ultimately developed and implemented under this executive branch initiative, Congress could attempt to enshrine in law either a similar regime or a more sweeping set of limits on US firms’ investments abroad – including in a wider variety of sectors and larger number of foreign markets,” said Broadman.

A draft legislation currently pending in Congress could also lead to even more expansive measures being implemented within the next year.

“This is one of the few areas where Congress and the executive branch are fully aligned and where there is little substantive difference between the Democratic and Republican parties, so it is reasonable to expect future developments as well as a broadening of the scope of industries and technologies prioritised for review,” said Christopher Swift, partner at Foley & Lardner. “However, even when there are clear executive orders and implemented regulations, the US national security community tends to develop novel interpretations that push the boundaries of what the law appears to require. It’s important for investors to keep this in mind and work with experienced legal counsel rather than just following the headlines.”

For Swift, the executive order represents the third step of a long process that has incrementally and fundamentally changed the US government’s approach to foreign investment issues. That process, he said, started during the global war on terrorism, when reforms to the CFIUS regime began to focuse on critical infrastructure and other homeland security issues.

“During the Trump administration, similar changes in CFIUS authorities focused not just on homeland security but also on so-called ‘industrial’ security – with this new executive order, the US government is turning that industrial security focus outwards," Swift added. "The bottom line is that the US government now has an industrial policy, even though it may look different from those implemented by European and East-Asian allies. While European industrial policies tend to be driven by economics and employment, the US approach is driven by national security, with economics being a secondary objective."

Tit for tat

Another key concern for those covered by the executive order or involved in the discussion is the sort of measures that China could adopt in response.

"It is certainly conceivable that, in retaliation, Beijing could intensify its scrutiny or even limit certain Chinese investments in the US – in certain corridors of Washington, such a move would be welcome," said Broadman. "A more challenging retaliatory action by China would be if Beijing offered sweeteners for inbound investments into China by firms located in other G7 countries that compete head-to-head with US businesses."

Others, however, perceived any potential tit-for-tat measures from China as less of an immediate concern – especially in light of the economic hardship currently faced by the country.

"Economic growth in China has not occurred as anticipated this year, and the government is most likely focused on bolstering growth and preserving access to US markets," said Lehot. "Any response is likely to be for the purposes of saving face rather than revenge. If legislation were to pass Congress and be signed by the president, all bets are off, but this is not expected."

Last month, China's Ministry of Commerce (MOFCOM) restricted exports of gallium and germanium – two metals used in semiconductor manufacturing – to Europe and the US. Some say a likely move from China could be to expand those restrictions to new materials or sectors.

"The Chinese Communist Party tends to take a reciprocal approach in cases like this one, so it would be reasonable to anticipate that MOFCOM or the Chinese Ministry of Justice will implement a similar review process for Chinese investments in the US," said Swift. "The Chinese government could add US companies that comply with the new executive order to various lists of unreliable entities, and in some cases, even target individual US officials with sanctions and travel bans."

A revised version of China's Counter-Espionage Law passed earlier this year banned the transfer of any information related to national security and broadened the definition of "spying". It also enabled Chinese authorities to access data, electronic devices and personal property, as well as to block individuals from leaving the country – all of which has made it increasingly difficult for foreign entities to comply with local requirements, which often differ or even clash with those in their home country.

"There will probably be practical limits to what the government can do: China's economy needs to sustain high economic growth in order to maintain full employment, and the ability to pursue those objectives has been tied to US technology transfers in the past," said Swift. "There is a degree of mutual dependency here, and even if China and the US both intend to go the wrong way, this conscious decoupling is complicated and uncomfortable for both of them."