



Strategic Security Analysis

US Outbound Investment Screening Programme Targeting Investments in Chinese Tech Companies

Ali Ahmadi





The Geneva Centre for Security Policy

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Strategic Security Analyses

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Key points

- The United States has issued new proposed rules governing US investments in technological firms in the People's Republic of China specifically focused on artificial intelligence, quantum computing and semiconductors.
- The measures are fairly limited in scope and are unlikely to have a major effect on the Chinese technological landscape, especially considering the withdrawal of US investors from Chinese technology firms due to geopolitical tension in recent years.
- The final rules have not yet been published, but the proposed rules provide insight into Washington's strategy and approach.
- While the rules are more significant and restricting than the limited regulations some had originally recommended, they also feature measures that seem to be designed to further investigate the technological entrepreneurial landscape in China that could in turn set the stage for further expansions of outbound investment screening.
- The measure comes amid an expanding technological export restriction regime being imposed by the United States and many of its allies on China that seeks to maintain a technological edge for both economic and military purposes.



After over a year of speculation and interagency discussion, the Biden administration has officially unveiled its Outbound Investment Screening Mechanism (OISM).

Introduction

After over a year of speculation and interagency discussion, the Biden administration has officially unveiled its Outbound Investment Screening Mechanism (OISM). The United States has long regulated and monitored inbound investment into the country that may have national security implications, including through the Committee on Foreign Investment in the United States, but this recent development creates new regulations to monitor and restrict investments emanating from the United States in a defined set of Chinese enterprises.

On 9 August 2023 President Biden issued an executive order¹ directing the Treasury Department to create an outbound screening mechanism to address US investments in several foundational technologies and their potential military, espionage, and surveillance applications. A Treasury Department press release² immediately followed, as did an advanced notice of proposed rule-making (ANPRM)³ and a fact sheet⁴ outlining in some detail the department's approach to converting this executive order into regulation.

According to many in Washington, the policy has been “imminent” since October 2022, but debate on the topic goes back even further. Concerns about China's development of technologies that would be critical to Beijing's military and geopolitical ambitions were at the heart of what led to the 2018 reforms of the US inbound investment screening and export-control authorities through the Foreign Investment Risk Review Modernization Act. During those debates, discourse began about US investors providing investment for Chinese companies working in key high-tech fields, together with the managerial expertise that often accompanies it.⁵

But the furore caused by the major semiconductor-focused export controls issued in October 2022⁶ seems to have worried Washington about escalating investment controls too quickly, and hence the publication of new rules was delayed. This provided an opportunity for those favouring a narrower screening format to argue for a more limited approach. Among those advocating such an approach was Secretary of the Treasury Janet Yellen, who is often seen as favouring a softer approach to economic statecraft targeting China, and the Semiconductor Industry Association, which represents US chipmakers in Washington.

This Strategic Security Analysis will seek to explain why the Biden administration has taken this approach, what the proposed mechanism entails, what specifically the administration is trying to accomplish, and what the future of outbound screening of investment in China is likely to hold.



The approach

Emerging technologies and, by extension, export controls have taken centre stage in great-power competition. China has a far larger economy that is more deeply intertwined with the global economy than other targets of US sanctions over the last two decades like Iran or Venezuela. Trying to maintain technological superiority and deny Beijing and its military access to technologies that may have a determinative effect on the future of Sino-US security competition has become central to the US strategy for managing China's rise.

The US approach to this issue has been forming over recent years, but has broadly been defined by an approach colloquially referred to as “small yard, high fence”,⁷ in which the United States seeks to deny access (“high fence”) to a small number of key technologies (“small yard”). The questions of which technologies fit into the yard and how high the fence should be have been constant subjects of debate and causes of discord in recent years. US policymakers and the Washington foreign policy community are also very cognisant of the importance of not denying US and allied nations' firms much-needed revenue for future research and development.

This strategy became somewhat more aggressive when, during a marque address at the Summit of the Special Competitive Studies Project, US National Security Advisor Jake Sullivan publicly rejected the notion that the United States should try to stay just a few years ahead of China in favour of a strategy of building as large a technological lead as possible.⁸ This address should be seen in light of the subsequent 7 October regulatory filing by the Commerce Department's Bureau of Industry and Security (BIS), which imposed a broad set of restrictions, including those with significant extraterritorial effect, on China's semiconductor industry.⁹ This technology was identified as critical because it is used in commercial products ranging from cars to consumer electronics, while the most advanced chips are critical to weapons systems and cutting-edge technologies like cloud computing and artificial intelligence (AI).

Both the United States and China see AI as a key part of the “informationised” or “intelligencised” future of warfare where the balance of power will be dictated above all by the ability to network military assets and use AI to streamline a variety of military imperatives, ranging from improved missile precision to enhanced surveillance capacities and more efficient equipment maintenance.¹⁰ Jake Sullivan has referred to AI as one of the “force multiplier” technologies. In 2017 China mapped out a national AI strategy, the “New-Generation AI Development Plan”,¹¹ that aimed for parity with global AI leaders by 2020 and a decisive edge in the field by 2030. In a 2018 speech China's president, Xi Jinping, argued that accelerating the development of AI is an important strategic starting point for the country to “gain the initiative in global scientific and technological competition”.¹²

Unlike most of today's military technologies, the most cutting-edge AI technology is in the hands of the private sector, not the military. In order to see the most cutting-edge stealth fighter jets or main battle tanks under development, one may have to travel to a classified government research facility, but cutting-edge AI technology is being developed in private sector technology firms, often with commercial applications in mind. These breakthroughs include systems and algorithms with substantial computational and predictive capacities.

Additionally, while tech majors like Amazon, Google and Microsoft play a key role in developing AI, smaller startups also play a crucial role. In its many incarnations, AI technology has been around for over a quarter century.

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With technological evolution and new tools like machine learning, a small team of AI veterans and ambitious upstarts may outperform tech majors in critical niches of AI technology that may prove to be essential to, among other things, national security.

The Biden administration has formally opposed any broad decoupling of the US and Chinese economies in favour of a more limited “de-risking” strategy.¹³ De-risking – the approach favoured by Europe – means that the West should diversify away from the Chinese economy and both reverse any excessive reliance on China and pursue technological security vis-à-vis China. Decoupling, which Washington initially favoured, demanded a far more comprehensive economic divorce from China. Whether this is consistent with the full scope of US technological export restrictions imposed on China is debatable at best. The abovementioned 7 October 2022 BIS regulations imposed on investment in China’s semiconductor industry and Jake Sullivan’s address seem to reflect a much more ambitious and aggressive strategy. But this outbound investment screening regime, as constituted by the executive order and accompanying ANPRM, is fairly limited. Unlike the BIS regulations, this is a more gradual initial effort that can be expanded over time.

The parameters of many emerging technologies like AI have not yet been defined, do not as a result fall within existing export control classification schemes and may therefore cause problems at the enforcement stage.

The OISM

President Biden issued Executive Order 14105 on 9 August 2023, which instructs the Treasury Department to prohibit certain categories of investments in “countries of concern” (China) and requires government notification on other investments. The technologies specifically targeted are “semiconductors and microelectronics; quantum information technologies” and “certain” AI systems.

According to the executive order, the Secretary of the Treasury is the primary official tasked with determining how to implement these new actions, but she is to consult the Secretary of Commerce and other stakeholders in the interagency process, including the Secretaries of Defense, State and Energy, the Director of National Intelligence, and other relevant agencies. The primary division of the Treasury Department developing this mechanism is the Office of the Assistant Secretary for Investment Security.

The ANPRM is not a formal law, but a first draft of regulations meant to solicit further input from industry and other parties of concern in the United States. The public comment period is 45 days, but no deadline has been set for when the final rules will be published.

The ANPRM provides some clear definitions of how the technologies in semiconductors, AI and quantum computing “that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities” of China will be defined. For example, “advanced” semiconductors with certain defined levels of performance, or the technology or software to design them, would be considered prohibited transactions, while investment in trailing-end chips would require notification. Quantum computing limitations are designed to cover applications that could have military end uses, including in communication and encryption. The AI limitations would apply to those AI applications that are “exclusively used” (but this could be changed to “primarily used”) for military and surveillance purposes.

The parameters of many emerging technologies like AI have not yet been defined, do not as a result fall within existing export control classification schemes and may therefore cause problems at the enforcement stage. This will likely be a key issue for debate during the comment period and a dilemma when the ANPRM is converted into implementable regulations.



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Transactions covered by these regulations would include all acquisitions of equity interest, greenfield investments, joint ventures and debt financing that may result in an acquisition of equity. The rules will apply to a broad interpretation of the term "US persons", which includes firms that US persons have a majority stake in, including foreign subsidiaries of a US firm or a firm owned by US persons. It would also extend to their not just investing as such, but also performing investment facilitation services of any kind. Such "persons" would be required to declare any such investments or activities with "covered foreign persons" to the US government. These rules will not apply to investments that have already been completed, but there is ambiguity as to how to handle investments that have been planned, but not yet finalised.

Foreign persons covered by the regulations include an expansive definition of Chinese-owned businesses and businesses majority-owned by Chinese entities and individuals in foreign jurisdictions. This would include foreign subsidiaries of Chinese firms or firms established by Chinese persons but siloed offshore in places like Singapore. In the context of this rule-making process, Macau and Hong Kong Specially Administered Regions are considered part of China.

The Treasury Department does not foresee a formalised screening process for individual cases. Investors will have to determine whether a specific investment is legal or not, or whether it requires notification to the US government. The department is also contemplating civil fines in case of violation, but is seeking further comment on whether firms that have completed transactions in contravention of these rules should be forced to divest.

Critically, the ANPRM's proposed regulations seem to provide an exception for some entities associated with China that derive less than "50 percent of that person's consolidated revenue, net income, capital expenditure, or operating expenses" from activity pursuant to the technology in question. This provides some ambiguity, and observers have raised the argument that this would provide a substantial exception for larger and more diversified Chinese companies and mostly just affect startups.¹⁴

What the OISM seeks to accomplish

Before the OISM was introduced, US semiconductor manufacturers and those operating with US semiconductor design and manufacturing software and equipment could not sell advanced semiconductors to China,¹⁵ but US investors could invest in Chinese startups trying to replicate these capacities as part of Beijing's indigenisation campaign. This is in part what the new actions seek to address. Treasury also touched on this issue when it noted that this "narrowly targeted action will complement our existing export control and inbound investment screening tools".¹⁶

The fact that the Treasury does not foresee that it will be required to review cases in which there may be ambiguity about whether the transaction is allowed or requires notification will mean that US investors will have to be far more thorough in understanding the end uses and potential partners or customers of the technology they are investing in. This is almost certainly a feature, not a bug of the programme. A better understanding of US investments in China's critical technology field and the top firms in that field will be key to future steps as the United States escalates its efforts to control outbound investment that could benefit Beijing. US investment firms have already begun employing national security experts to vet their investments with significant China exposure due to geopolitical and regulatory risks.¹⁷ The ANPRM does make clear that the notification requirements that are to be issued will provide US officials with much more information about the



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flow of US capital into sensitive technology firms in China and will guide future decision-making.

This action seems most targeted at small but promising Chinese startup firms in key technology sectors that could benefit from US venture and equity capital at key stages of their early growth. But US involvement in this area is not crucial for China.

According to research from the Center for Science and Emerging Technology (CSET) at Georgetown University,¹⁸ China has the second largest AI ecosystem behind the United States, with 1,600 AI startups. This research further estimates that from 2015 to 2021, 1,239 Chinese AI companies raised US\$110 billion through 2,299 investment transactions from 36 countries. During this period, 401 transactions involved US investors, accounting for US\$40.2 billion invested in 251 Chinese AI companies. However, data limitations make it difficult to discern how much of each transaction originated from US firms, since such investments often involve several firms acting in concert to take an equity stake in an AI firm.

That being said, while US firms' involvement in investing in China's AI industry is significant, it does not represent a major portion of overall transactions and funds. During the period examined, the CSET researchers found that 83% of transactions and 63% of the transaction value raised by Chinese AI companies had no US investor involvement at all.

The Biden administration is also very concerned about the transfer of know-how and technologies through investment. US venture capitalists who wish to see their investments in Chinese firms perform well would generally be interested in taking board seats in the companies they have invested in and advising them on how to succeed. This is a typical approach that venture capitalists take with their investments in the United States, which helps pass on management and technological progress, but their doing the same with Chinese high-tech firms is viewed as a threat to US national security. Some US firms have even started or helped to facilitate accelerator and incubator programmes for Chinese startups, including AI startups.

The executive order touched on this issue when it mentioned that US investment can bring with it "intangible benefits", including, among other things, managerial and investment assistance, enhanced standing, and market access. This was also referred to in the ANPRM. While Chinese venture capital and equity funds are often financially backed by so-called government guidance funds, they lack the long-standing expertise and maturity of their US counterparts in management and technology scaling.

The OISM's narrow parameters are consistent with the administration's claims that it is not seeking through this action to undermine the Chinese economy or address a wide set of Chinese policies that Washington has declared problematic, like the Belt and Road Initiative. The White House has classified 19 different technologies as emerging and critical technologies, including advanced gas turbine engine, direct energy, and financial technologies.¹⁹ But this proposed action only addresses the three limited fields of semiconductors, AI and quantum computing.

The action also has limits as to how it can affect foreign firms. While it does cover the foreign subsidiaries of a US person, it has little relevance to foreign investors, even ones with some US capital or involvement – unless a US person is specifically using a foreign investment vehicle to skirt the new rules. The ANPRM also seems to be trying not to disrupt the relationship between US firms and their Chinese subsidiaries by establishing a clear difference between ongoing business activities that would require transactions between parent and subsidiary and new capital investments. The latter would fall under this new action. Therefore, overall, there is some extraterritoriality to



this action, but nowhere near that of common US extraterritorial measures like secondary sanctions or foreign direct product rules.

The most important impact of the OISM is how it signals future restrictions on investments in China by both the United States and its allies. US venture capital investments in China have already markedly declined from their high in 2018 as geopolitical tensions rose, altering the risk calculations of private actors, especially in terms of medium- to long-term risk.²⁰ The proposed action will likely serve to exacerbate these trends.

What comes next?

There was much discussion about a pilot programme being rolled out before establishing an OISM. Such a programme requiring notification for outbound investment into China would help develop knowledge of the investment landscape regarding Chinese firms developing emerging technologies. It would also be important to take an incremental approach because of the backlash Washington received from allies in Europe and East Asia over its abrupt rollout of aggressive semiconductor export controls (see the 7 October BIS filing) without consulting its allies. The incremental approach would also help the administration to consult with the industry to fine tune the OISM's practical implementation. While the current policy certainly goes beyond a theoretical pilot programme and imposes actual bans instead of just demanding disclosure, it is probably best to see it as an experimental first phase of a larger scheme to be built over time.

The issue is now likely to shift to the US Congress. After the announcement of the OISM, some members of Congress expressed dissatisfaction with its scope and severity. Senator Marco Rubio, a Republican from Florida, denounced the action as “almost laughable” and “riddled with loopholes”, and promised new legislation to drastically expand outbound investment screening.²¹ One of his fellow Republicans, House Foreign Affairs Committee Chair Michael McCaul of Texas, called it a “half measure” and accused the administration of “appeasing industry at the cost of national security”.²²

After Congress failed to impose an outbound investment review regime in the 2018 Foreign Investment Risk Review Modernization Act, the issue was raised again in the 2021 and 2022 versions of the National Critical Capabilities Defense Act, colloquially referred to as the Cornyn-Casey bill. This bill was introduced again in 2023 and covers a much broader range of transactions and a more diverse array of industries and technologies, including electric vehicles and critical minerals and materials.

An Outbound Investment Transparency Act is also being considered as an amendment to this year's National Defense Authorization Act (a scaled-back version of Cornyn-Casey), which is currently in conference between the two chambers of Congress.²³ At this time it is unclear how the competing visions for outbound investment screening will be addressed or whether they will be made compatible. Advocates of the Cornyn-Casey bill face competition from a bipartisan group of legislators who favour a list-based approach rather than a sectoral approach,²⁴ i.e. by forbidding investment in specific firms rather than technological sectors.

Washington officials are concerned that while Europe has indicated an interest in matching US outbound screening systems, no robust discussions are taking place in European capitals and Brussels on the European version and what shape it would take. The Treasury Department Factsheet stated that the executive order and ANPRM reflect deliberations with US allies and the technology industry and specifically makes reference to discussions with

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the G7.²⁵ This limited action seems to be designed to invite allied cooperation and create a precedent for outbound investment screening.

The Biden administration feels that more progress will be made by pushing the G7 to take action on the matter and thus force greater European engagement on the issue. The G7 recently released a communiqué that endorsed outbound investment screening in narrowly defined situations.²⁶ The European Commission and the High Representative for Foreign Affairs also published a Joint Communication on a European Economic Security Strategy that included a call for the tabling of an outbound investment screening proposal by year's end.²⁷ Considering the complexity of the topic and the length of time this matter had to be negotiated in Washington before the recent executive order, it is hard to imagine that action by all of the parties mentioned above is around the corner. The United States' East Asian allies have a much longer history of outbound investment screening, but it is often antiquated and focused exclusively on military technology.

The Biden administration is conscious of the fact that Beijing is retaliating more aggressively against new US policy measures due to the fear that not doing so would embolden the United States to go even further. Examples of this are increased Chinese scrutiny of Western accounting and political risk firms and the measures taken against Micron technologies.²⁸ But the administration feels reasonably confident that China is concerned about technology decoupling not going much further. It also believes that the current softness in the Chinese economy would discourage China from retaliating aggressively.

Ultimately, the effect of this particular measure is likely to be limited. Chinese firms affected by the OISM will have to replace and backfill significant venture capital and private equity resources when US investment is lost, but this should not be particularly disruptive.²⁹ Other losses, such as the potential for being deprived of the know-how of US venture capitalists, are harder to measure, but are also likely to be manageable.

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Washington is increasingly keen on placing technological export controls and related investment restrictions at the centre of both its short-term and long-term strategy regarding great-power competition with China.

Conclusion

This new effort to restrict US investment in Chinese firms active in the development of key technologies is part of an ongoing escalation of technological export controls targeting China that have come to be a key feature of the Sino-US great-power rivalry as it is manifesting in the current decade. Washington is keen to restrict the development of frontier technologies such as AI, quantum computing, and semiconductors as part of a larger campaign to maintain its edge in global technological supply chains and prevent the Chinese military and intelligence agencies from accessing these technologies.

While this action is more limited than previous US decisions, it is a step in the direction of erecting a larger series of obstructions that would limit the flow of capital from the United States – and eventually from other financial centres – to Chinese technology enterprises. Its direction is consistent with Washington's aim of slowing down Chinese advances in key technologies, and it seeks to close loopholes that may otherwise undermine other key restrictions such as those on the sale of semiconductors and their associated manufacturing software and equipment. While the action's requirements affect US investors more than some initial proposals regarding outbound screening had called for, it also includes a variety of measures meant to gather information and map out the Chinese technological landscape that may set the stage for future action broadening the level of restrictions.

What the sum of these actions makes clear is that Washington is increasingly keen on placing technological export controls and related investment restrictions at the centre of both its short-term and long-term strategy regarding great-power competition with China. Sino-US relations have clearly been heading in the direction of conflict in recent years. But even in this context they have ebbed and flowed from heading toward uncontrolled escalation to periods of engagement and de-escalation. Regardless, Washington's determination to restrict Chinese access to critical technologies remains unchanged.

The United States is also clearly insisting on taking the lead by implementing major actions against firms and then calling for its allies in Europe and East Asia, which with the United States account for the vast majority of global technological supply chains, to follow. Under the Biden administration, Washington has been more accommodating of its European allies. However, it has been inconsistent with regard to coordinating its policies on technology and China with its partners across the Atlantic. While the administration did adopt the European de-risking approach toward China, the abovementioned 7 October restrictions on semiconductors were issued without input from European nations and firms that were significantly affected by it. It would seem that when Europe has a clear framework or policy preference, there is greater balance in its relationship with the United States. But in its absence, Washington takes the lead and Europe is faced with the decision to either follow the US lead or create Western disunity with regard to China.



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