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Navigating the new China regulatory consensus

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A rare bipartisan consensus has emerged in Washington to aggressively counter China's exploitation of U.S. technology, capital markets, and open investment environment to advance Chinese priorities viewed as contrary to U.S. interests, particularly its military modernization, extraterritorial claims, and threats to Hong Kong. This fall, the U.S. Congress and Executive Branch will consider new far-reaching legislation and enforcement tools that would implement this consensus and accelerate the so-called "decoupling" of the U.S. and Chinese economies.

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Indeed, during this author's experience at the State Department over the last four years, new coordination mechanisms were critical, as China policy now permeates every functional and regional bureau across the department. The same is true across the U.S. government: even agencies focused principally on domestic affairs now must take account of new China-related requirements. This recalibration in U.S.-China relations has, in turn, left U.S. and global industries — from semiconductors and private equity to media and higher education — to confront novel compliance and risk management decisions.

In particular, five key regulatory trends are shaping the vast U.S.-China economic relationship that generates hundreds of billions of dollars of exports and cross-border investment year after year.

(1) Restricting U.S. private investment in securities benefiting the Chinese national security complex. Executive Order (EO) 13959, issued in late 2020, prohibited U.S. persons from investing in securities issued by certain Chinese companies designated due to ties to the Chinese military. In June 2021, President Biden amended the EO but maintained or strengthened key provisions. It is not yet clear whether the EO will be extended to prohibit investments undertaken by subsidiaries or affiliates of U.S. companies in Asia or elsewhere. The Biden Administration may also expand the list of blacklisted Chinese companies that are part of China's "military-civil fusion" strategy, the effort to harness civilian and commercial enterprise to advance military development.

The Holding Foreign Companies Accountable Act, enacted in 2020, also prohibits U.S. securities listings of any company that fails U.S. audit requirements, a common shortcoming among China-based firms. Investors should carefully monitor these changes and take account of investments that could be covered by an expanded EO or other legislative measures.

(2) Heightened scrutiny of inbound Chinese investment and — potentially — outbound investments into China. Following the 2018 Foreign Investment Risk Review Modernization Act, which expanded authority of the Committee on Foreign Investment in the United States (CFIUS) to vet foreign investment in U.S. firms, businesses must take account of CFIUS risk prior to nearly every transaction with a foreign investor.

A pending rule granting the U.S. Commerce Department authority to prohibit certain information and communications technology and services (ICTS) transactions with foreign adversaries may create an overlapping review regime. Increasingly, U.S. policymakers are viewing both inbound and *outbound* investment involving China as a zero-sum proposition, especially as it relates to critical technology.

There are signs of bipartisan support in Congress for a new U.S. government review process for outbound U.S. investment and offshoring of critical capacities to China and other competitors. This may foreshadow a new "reverse" CFIUS review regime (or a pilot project) that could be considered by Congress this fall.

(3) Countering foreign transactions — with little or no U.S. nexus — that bolster Chinese military capacity. It is not just U.S. companies that need to consider new risks. After reports of a potential Chinese acquisition of an advanced aerospace company in a U.S. partner nation in Eastern Europe in 2021, the U.S. Commerce Department placed the acquirer on a new restricted party list, effectively scuttling the deal.

Although non-U.S. businesses have for years contended with U.S. "secondary" sanctions targeting Iranian ties, the United States may now turn such sanctions against foreign deals involving China's military industry — even where no U.S. business or technology is involved — and enlist partner jurisdictions in this effort.

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(4) Prioritization of supply chain integrity for both government contracting and commercial transactions. The U.S. government is promoting integrity of supply chains and discouraging foreign control of critical commercial technologies. Sweeping "Section 889" procurement restrictions (named for the section of the 2019 National Defense Authorization Act (NDAA) with several new China-related provisions) not only prohibit federal agencies and federal funding recipients from acquiring telecommunications equipment and services from several Chinese companies, but also bar federal contracts to entities that merely *use* such equipment or services in their business, regardless of any nexus to federal government work.

The 2020 CARES Act included financial incentives for U.S. businesses to "onshore" strategic capacities, and the CHIPS Act created new subsidies for domestic semiconductor manufacturing. In 2020, a series of EOs sought to limit the availability of two popular Chinese communication applications (WeChat and TikTok) and, through the CFIUS process, to force a Chinese parent to divest U.S. assets.

In a February 2021 EO, the U.S. government also mandated a sector-by-sector supply chain review by U.S. agencies. Moreover, U.S. Customs and Border Protection has ordered the detention of products produced by Chinese slave labor. Companies that fail to take account of supply chain vulnerabilities and foreign ownership face regulatory exposure and competitive risk: Rivals may market their own "clean" supply chains and ownership structures – and expose others' supply chain vulnerabilities.

(5) Heightened transparency, disclosure, and know-your-customer requirements. The U.S. government has significantly enhanced due diligence and disclosure requirements for Chinese and foreign counterparties. The Commerce Department has imposed restrictions on exports to certain Chinese persons whose activities support military end uses, even if a particular export is unrelated to those activities.

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Following legal actions against U.S. government research grantees failing to disclose Chinese funding, a recent Senate-passed bill would mandate higher education institutions to disclose contracts and funding through a CFIUS-type review. In addition, the 2021 NDAA requires unprecedented disclosure of ultimate beneficial owners (UBO) of U.S. businesses, and enforcement of the Foreign Agents Registration Act has increased to unprecedented levels. Designed to thwart potential "front" companies and persons directed by China and other adversaries, these requirements present heightened compliance and reputational risk for companies that do not take account of possible Chinese contacts or influence.

Unprecedented time: The revamping of regulatory requirements governing the U.S.-China economic relationship is affecting U.S. and global industry in unprecedented ways and demands new approaches toward corporate compliance and risk management. But these developments also present competitive opportunities for nimble companies that are attuned to regulatory change and adapt accordingly.

About the author

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