

Congress Should Strengthen Treasury’s Investment Restrictions for China

Bryan Burack

KEY TAKEAWAYS

Ending outbound investment in China is a matter of protecting the nation’s remaining technological edge and preventing further erosion of the military balance.

New rules will help to counter China’s military modernization and protect U.S. technology restrictions, but they are flawed.

Congressional action to strengthen outbound investment restrictions for China remains urgently needed.

On October 28, 2024, the U.S. Treasury Department issued regulations to implement President Biden’s 2023 executive order designed to restrict certain investments in “countries of concern”—particularly China—and require the disclosure of others.¹ The new outbound investment rules expand on an effort started by President Trump’s Executive Order 13959 of November 2020, which began restricting capital flows to China’s military-industrial complex.² The new rules will help to counter China’s military modernization and reduce China’s ability to subvert U.S. technology restrictions, but they are compromised with significant flaws and omissions. Congressional action to strengthen outbound investment restrictions for China remains urgently necessary.³

This paper, in its entirety, can be found at <https://report.heritage.org/ib5365>

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Investment Prohibitions and Notifications

Biden's executive order and Treasury's implementing regulations address three technology sectors: semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI). For each sector, certain investment transactions with countries of concern are prohibited, while others require notification to the Treasury Department.

For example, the regulations implement an outright ban on some investments related to the manufacture, design, and packaging of certain advanced semiconductors and supercomputers, numerous applications of quantum computing, and AI that is trained to certain standards or "designed to be exclusively used for, or intended to be used for" military, intelligence, or surveillance purposes. In other cases, the regulations merely require "notification" for transactions involving AI systems with dual-use functions and investments in less advanced semiconductor technologies.

Flaws and Shortcomings

Treasury's new outbound investment rules have the following flaws and shortcomings:

Most U.S. Investment in China Remains Untouched. The new regulations do not apply at all to securities, which account for the vast majority of U.S. capital flows to China. The new rules pertain to direct investment but not the much larger stock of U.S. portfolio investment in China, which stands in the hundreds of billions of dollars and has crested to over a trillion dollars in recent years.⁴ The regulations also provide carveouts for certain investments made by limited partners.

Critical Sectors Unaddressed. The regulations leave many technologies with direct military applications, such as biotechnology, completely unaddressed. The regulation betrays its own shortcomings by applying stricter rules for biotechnology-related AI systems without scrutinizing biotechnology-related investments themselves.

Excessively Narrow Scope. Core aspects of the regulations' prohibitions and notification requirements are drawn too narrowly and fail to address major national and economic security concerns:

- The regulations do not prohibit investments in firms that design or produce "legacy" semiconductors, which do not rely on cutting-edge manufacturing techniques but are essential in innumerable supply chains. This omission is particularly glaring, as Commerce Secretary

Gina Raimondo has repeatedly underscored the threat of China's attempt to dominate legacy semiconductor manufacturing.⁵

- Major parts of the prohibitions and notification requirements for AI investments are narrowly drawn to AI “designed to be exclusively used for, or intended to be used for” military or surveillance use. Such narrow scrutiny is in tension with the nature of AI technology itself given the general-purpose applications of many AI systems and the emergent use cases that result. These components of the AI rules may be toothless, creating significant evasion risks and frustrating the underlying national security goals of the regulations.

Permits National Security Threats to Continue. The regulation points out its own shortcomings by applying a stricter standard for entities that are already included on various U.S. sanctions lists. For sanctioned entities, the rules prohibit investments that would otherwise be subject only to notification requirements. Put another way, the regulation acknowledges that these investments contribute to China's military-industrial complex or human rights atrocities but will permit them to continue anyway if a U.S. investor works with a Chinese company that is not currently sanctioned. This double standard seems to rest on the fallacy that ostensibly private entities in China are meaningfully beyond the reach of Beijing—and will likely contribute to evasion risks.

Congress Must Act

Time is of the essence. Ending outbound investment in China is a matter of protecting the United States' remaining technological edge and preventing further erosion of the military balance.⁶ China has already leveraged U.S. financing and technology to conduct gain-of-function research in Wuhan, develop hypersonic weapons the United States cannot counter, and operate high-altitude surveillance balloons over the continental United States.⁷ China should not be allowed to exploit the U.S. economy against U.S. national security for a single day more.

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Endnotes

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3. For further reading, see Bryan Burack, "The Truth About Investment in China," Heritage Foundation *Issue Brief* No. 5348, March 19, 2024, <https://www.heritage.org/asia/report/the-truth-about-investment-china>, and Kevin Roberts, "We're in a New Cold War With China. It's Time Our Politicians Acted Like It.," *The Daily Signal*, October 20, 2023, <https://www.dailysignal.com/2023/10/20/were-in-a-new-cold-war-with-china-its-time-our-politicians-acted-like-it/>.
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