

Treasury Proposes New U.S. Outbound Investment Rule

July 11, 2024

Introduction

On July 5, 2024, the U.S. Treasury Department's ("Treasury") Office of Investment Security published a Notice of Proposed Rulemaking (the "Proposed Rule") in the Federal Register that would establish a framework for controls on outbound investments that raise national security concerns, namely certain investments in or related to the People's Republic of China and the Special Administrative Regions of Hong Kong and Macau.¹ The Proposed Rule follows the issuance of Executive Order 14105 (the "Outbound Order") and a related Advanced Notice of Proposed Rulemaking (the "ANPRM") in August 2023, which we discussed previously [here](#).

Although the proposed regulations have been published by the Office of Investment Security, which leads Treasury's role on the Committee on Foreign Investment in the United States, the expectations and obligations arising from the Proposed Rule appear to incorporate important concepts found in both U.S. sanctions programs and export controls, notably including that U.S. persons are expected to develop compliance approaches and reach their own determinations of permissibility regarding outbound investments (which determinations could be subject to review in an enforcement context).

Treasury requests comments on the Proposed Rule by August 4, 2024, including on, among other things, the proposed knowledge standard and application to limited partner ("LP") investments, both discussed below.

¹ Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern, 89 Fed. Reg. 55846 (July 5, 2024), available [here](#).

Overview of the Proposed Rule's Requirements

As with the ANPRM, the Proposed Rule articulates a regulatory scheme under which notification obligations or an investment prohibition apply to “U.S. persons” engaging in “covered transactions” involving or establishing a “covered foreign person.” These key terms animate the scope of the proposal.

Who Is Subject to the Proposed Rule?

The Proposed Rule would impose obligations on “U.S. persons,” defined as United States citizens, lawful permanent residents, entities organized under the laws of the United States or any jurisdiction within the United States (including foreign branches of any such entity) or any persons physically present in the United States. This definition is familiar to those involved in sanctions compliance.

In addition, U.S. persons also would have certain obligations with respect to their “controlled foreign entities.” That term captures any entity in which a U.S. person directly or indirectly holds more than 50 percent of the outstanding voting interests or voting power of the board; is a general partner, managing member or equivalent of the entity; or, for pooled investment funds, is an investment adviser to any such fund.

The Proposed Rule would require U.S. persons to take “all reasonable steps” to ensure their “controlled foreign entities” comply with the requirements that would apply if undertaken by a U.S. person. In assessing whether a U.S. parent has taken “all reasonable steps” for these purposes, the Proposed Rule indicates Treasury would consider the totality of relevant facts and circumstances, including factors such as the “existence and implementation of periodic training and reporting requirements with respect to compliance with the proposed regulations and the implementation of internal controls” and the “size and sophistication” of the U.S. parent.

What Are Covered Transactions?

As noted, the Proposed Rule targets “covered transactions” by U.S. persons. Each “covered transaction” is subject to either notification obligations or an outright prohibition, depending on the “covered activity” engaged in by the covered foreign person (discussed below and in the Appendix).

Specifically, and unless excepted (discussed below), “covered transactions” include a U.S. person’s direct or indirect:

- Acquisition of an equity interest or contingent equity interest (or equivalent) in a person that the U.S. person knows at the time of the acquisition is a “covered foreign person”;
- Provision of a loan or a similar debt financing arrangement to a person that the U.S. person knows at the time of the provision is a “covered foreign person,” where such debt financing is (i) convertible to an equity interest in that person or (ii) affords or will afford the U.S. person the right to make management decisions, or the right to appoint members of the board of directors (or equivalent), of that person;
- Conversion of a contingent equity interest (or equivalent interest) or convertible debt in a person that the U.S. person knows at the time of the conversion is a “covered foreign person”;
- Acquisition, leasing or other development of operations, land, property or other assets in a “country of concern” that the U.S. person knows at the time of such acquisition, leasing or other development will result in, or that the U.S. person intends to result in, (i) the establishment of a “covered foreign person” or (ii) the engagement of a person of a “country of concern” in a “covered activity” where it was not previously engaged in such activity;
- Entrance into a joint venture, wherever located, formed with a person of a “country of concern” and that the U.S. person knows at the time of entrance into the joint venture will engage in, or the U.S. person intends the joint venture to engage in, a “covered activity”; and
- Acquisition of an LP or equivalent interest in a venture capital fund, private equity fund, fund of funds or other pooled investment fund (in each case where the fund is not a U.S. person) that a U.S. person knows at the time of the acquisition likely will invest in a “person of a country of concern” that is in the semiconductors and microelectronics, quantum information technologies or AI sectors, and such fund undertakes a transaction that would be a “covered transaction” if undertaken by a U.S. person.

The Proposed Rule provides that a U.S. person’s transaction, whether indirect or direct, would be a “covered transaction” if it meets the elements of the definition, regardless of the number of intermediary entities involved in such transaction.

Additionally, all covered transactions will be subject to a prohibition if conducted with an entity that is engaged in any “covered activity” and that: (i) is included on the Commerce Department’s Bureau of Industry and Security’s (“BIS”) Entity List or Military End User List, or meets the definition of a Military Intelligence End-User under the Export Administration Regulations (“EAR”); (ii) is a Specially Designated National (“SDN”) under any sanctions program maintained by Treasury’s Office of Foreign Assets Control (“OFAC”), whether by reason of designation on the SDN list or because of ownership by one or more persons on the SDN list, individually or in the aggregate, directly or indirectly, of a 50 percent or greater interest; (iii) is included on OFAC’s list of Non-SDN Chinese Military-Industrial Complex Companies; or (iv) is designated as a foreign terrorist organization by the Secretary of State under 8 U.S.C. § 1189.

Who Is a Covered Foreign Person?

A covered foreign person is a “person of a country of concern” that engages in “covered activities” related to “covered national security technologies and products” (i.e., sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies and AI sectors that are critical for military, intelligence, surveillance or cyber-enabled capabilities).

The Outbound Order identifies only one country, the People’s Republic of China, along with the Special Administrative Regions of Hong Kong and Macau, as a country of concern.

Treasury declined in the Proposed Rule to maintain a publicly available list of covered foreign persons; instead, the Proposed Rule defines three circumstances in which a person will be a “covered foreign person”:

First, a “covered foreign person” includes a “person of a country of concern” that engages in a “covered activity,” where a “person of a country of concern” is defined to include:

- An individual citizen or permanent resident of a country of concern, and not a U.S. citizen or permanent resident;
- An entity with a principal place of business in, headquartered in or incorporated in or otherwise organized under the laws of a country of concern;
- The government of a country of concern;

- An entity in which any persons identified in the above categories individually or in the aggregate, directly or indirectly, hold at least 50 percent of (i) the outstanding voting or equity interests or (ii) the voting power of the board.

Second, a “covered foreign person” includes any person directly or indirectly holding any voting interest, board seat (voting or observer) or equity interest in, or any power to direct the management or policies of, a “person of a country of concern” that engages in a “covered activity,” provided that such person derives or incurs more than 50 percent of its revenue, net income, capital expenditure or operating expenses from one or more “persons of a country of concern” engaged in a “covered activity.”

Treasury stated that it intends for this prong to capture persons that are not persons of a country of concern but that have significant financial connections to entities engaged in a covered activity. This aspect of the definition would, thus, encompass non-Chinese companies that derive significant business from covered activities in China.

Third, a “covered foreign person” includes a “person of a country of concern” that participates in a joint venture with a U.S. person if the joint venture is engaged in a “covered activity.”

What Are Covered Activities?

The Proposed Rule targets “covered foreign persons” engaged in three categories of “covered activities.” Certain covered transactions in covered foreign persons engaged in the activities would be prohibited; others would require notification.

Treasury declined to propose a de minimis threshold for “covered activities” and, consequently, engagement in any “covered activity” in any context or amount would be sufficient to meet the definition of a “covered foreign person.”

Semiconductors and Microelectronics

<u>Prohibited Transactions</u>	<u>Notifiable Transactions</u>
<ul style="list-style-type: none"> • Developing or producing electronic design automation software for the design or advanced packaging of integrated circuits. • Developing or producing equipment for certain semiconductor fabrication, volume advanced packaging or extreme ultraviolet lithography fabrication. • Designing or fabricating advanced integrated circuits meeting or exceeding certain technical thresholds. • Packaging any integrated circuit using advanced packaging techniques. • Developing, installing, selling or producing certain supercomputers exceeding certain compute thresholds. 	<ul style="list-style-type: none"> • Designing, fabricating or packaging any integrated circuits that is not covered by the prohibited transaction definition.

Quantum Information Technologies

<u>Prohibited Transactions</u>	<u>Notifiable Transactions</u>
<ul style="list-style-type: none"> • Developing or producing quantum computers or critical quantum computer components. • Developing or producing quantum sensing platforms designed or intended for military, government intelligence or mass-surveillance end uses. • Developing or producing quantum networks or quantum communication systems designed or intended for networking to scale up quantum computer capabilities, 	<ul style="list-style-type: none"> • None.

secure communications or military, government intelligence or mass-surveillance end uses.	
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AI Systems

<u>Prohibited Transactions</u>	<u>Notifiable Transactions</u>
<ul style="list-style-type: none"> • Developing AI systems designed to be exclusively used for or intended for military, government intelligence or mass surveillance end uses. • Developing AI systems trained using certain quantities of computing power. 	<ul style="list-style-type: none"> • Developing non-prohibited AI systems designed for military, government intelligence or mass-surveillance end uses. • Developing non-prohibited AI systems intended for cybersecurity applications, digital forensics tools and penetration testing tools. • Developing non-prohibited AI systems for the control of robotic systems. • Developing non-prohibited AI systems trained using certain quantities of computing power.

Are Certain Types of Transactions Excepted?

The Proposed Rule also includes a number of “excepted transactions” that would not be subject to prohibition or notification obligations, including:

- An investment in a publicly traded security (whether on a U.S. or non-U.S. exchange);
- An investment by a U.S. person in a security issued by an investment company, such as an index fund, mutual fund or exchange-traded fund;
- A U.S. person’s full buyout of all interests of any “person of a country of concern” in an entity, such that the entity would not constitute a “covered foreign person” following the transaction;

- An intracompany transaction between a U.S. person parent and its subsidiary to support ongoing operations (or other activities that are not “covered activities”);
- Fulfillment of a U.S. person’s binding capital commitment entered into prior to August 9, 2023; and
- The acquisition of a voting interest in a “covered foreign person” upon default or other condition involving a loan, where the loan was made by a lending syndicate and a U.S. person participates passively in the syndicate.

In addition to these exempted transactions, Treasury has proposed an exemption for U.S. persons investing as passive limited partners in foreign private funds. Treasury has, in fact, invited comment on two alternative exemptions, the first of which is much broader than the second. Under the alternatives, an investment by a U.S. person LP in a pooled investment fund would be exempt if:

- **Proposed Alternative 1:** The LP’s rights are consistent with passive investment and do not include certain governance rights, and the LP’s committed capital is not more than 50 percent of the total assets under management of the pooled fund, or the U.S. person secures a binding agreement that the pooled fund will not use its capital for a prohibited transaction; or
- **Proposed Alternative 2:** The LP’s committed capital is not more than \$1 million, aggregated across any investment and co-investment vehicles that comprise the fund, and the LP does not have rights beyond certain enumerated “standard minority shareholder protections” with respect to the covered foreign person.

Is There a Knowledge Standard?

The Proposed Rule sets forth a “knowledge” standard such that a U.S. person generally would not be held liable for a “covered transaction” unless the U.S. person knows (or in some circumstances, intends) at the time of a transaction that the transaction involves or will establish a “covered foreign person” or result in new “covered activity” by a “person of a country of concern.”

The definition of knowledge follows the EAR’s definition of that term closely and would include both actual knowledge that a fact or circumstance exists or is substantially certain to occur, as well as an awareness of a high probability of a fact or circumstance’s existence or future occurrence or reason to know of a fact or circumstance’s existence.

In assessing the extent of a U.S. person's knowledge, Treasury will consider certain factors to determine if a U.S. person undertook a reasonable and diligent inquiry at the time of the transaction, including:

- The inquiry a U.S. person, its legal counsel or its representatives made regarding an investment target or relevant counterparty as of the time of the transaction;
- The contractual representations or warranties the U.S. person has obtained or attempted to obtain from the investment target or relevant counterparty;
- The effort by the U.S. person at the time of the transaction to obtain available non-public information relevant to the determination of a transaction's status as a covered transaction and an investment target or relevant counterparty's status as a covered foreign person, and the efforts undertaken by the U.S. person to obtain and review such information;
- Available public information, the efforts undertaken by the U.S. person to obtain and review such information and the degree to which other information available to the U.S. person at the time of the transaction is consistent or inconsistent with such publicly available information;
- Whether the U.S. person, its legal counsel or its representatives have purposefully avoided learning or sharing relevant information;
- The presence or absence of red flags that may include evasive responses or non-responses from an investment target or relevant counterparty to questions or a refusal to provide information, contractual representations or warranties; and
- The use of public and commercial databases to identify and verify relevant information of an investment target or relevant counterparty.

Finally, as noted above in the discussion of "covered transactions," the Proposed Rule also sets forth an "intent" standard for certain greenfield or brownfield investments or joint venture investments, in addition to the "knowledge" standard. For greenfield or brownfield investments, a covered transaction would include a U.S. person's acquisition, leasing or development of operations, land, property or other assets in a "country of concern" when the U.S. person intends such acquisition, leasing, or development to (i) establish a "covered foreign person" or (ii) pivot an existing entity's operations into a new "covered activity." Similarly, for joint venture investments, a "covered transaction" would include a U.S. person's entrance into a joint venture, wherever located, with a "person of a country of concern" where the U.S. person intends that the joint venture will engage in a "covered activity."

The Proposed Rule provides a number of examples about how the knowledge or intent standard would be applied and indicates Treasury anticipates providing future frequently asked question guidance.

Compliance Obligations

The Proposed Rule does not provide for case-by-case review of, or establish a licensing process for, U.S. persons' participation in a "covered transaction." U.S. persons would have the obligation when undertaking a transaction to decide if the transaction is prohibited, subject to notification requirements, an excepted transaction or outside the scope of the Proposed Rule.

A U.S. person may seek a "national interest exemption" from notification or prohibition requirements for a covered transaction on a case-by-case basis, which exemption Treasury anticipates would be granted only in exceptional circumstances. Such a request would require the U.S. person to submit information about the transaction to Treasury, which may include some or all of the information otherwise required to be submitted for a notifiable transaction.

Notification Procedures

A U.S. person would be required to notify Treasury if it undertakes a notifiable transaction, its controlled foreign entity undertakes a transaction that would be notifiable if undertaken by a U.S. person or the U.S. person acquires actual knowledge following the completion date of a transaction that the transaction would have been a "covered transaction" if the U.S. person had known of relevant facts or circumstances as of the completion date.

Such notification would be required to be submitted no later than 30 calendar days following the completion date of a notifiable transaction (or 30 calendar days following the acquisition of actual knowledge in the case of post-transaction knowledge). The notification would be required to include various information about the U.S. person, the "covered transaction" and the "covered foreign person," including their "covered activities." If such information is not provided by the U.S. person, they would need to explain why the information is unavailable and their efforts to obtain such information, and would need to provide such information promptly if such information subsequently becomes available, no later than 30 calendar days following the availability of such information.

A U.S. person would be required to maintain a copy of the notification and supporting documentation (e.g., pitch decks, marketing letters and offering memorandums;

transaction documents, including side letters and investment agreements; and due diligence materials related to the transaction) for 10 years from the date of filing.

U.S. persons also would be obligated to promptly notify Treasury of any material omission or inaccuracy that they learn about following any information submission.

Penalties

Potential violations of the Proposed Rule would include:

- Taking any prohibited action;
- Failing to take any required action required within the timeframe and in the manner specified;
- Making materially false or misleading representations to Treasury when submitting any required information; or
- Evading or avoiding any of the prohibitions.

Penalties for noncompliance include civil and criminal penalties up to the maximum amount under section 206 of the International Economic Emergency Powers Act. This means civil penalties may go up to the greater of \$368,136 (as may be adjusted for inflation, usually on an annual basis) per violation or twice the amount of the transaction, and a willful violation may result in criminal penalties of up to \$1,000,000 and 20 years imprisonment.

Treasury also may nullify, void or otherwise compel divestment of any prohibited transaction.

The Proposed Rule provides a voluntary self-disclosure process by which a U.S. person may disclose actual or possible violations of the Proposed Rule to Treasury, which disclosure may be a mitigating factor in determining the appropriate response to any violation.

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Please do not hesitate to contact us with any questions.



Satish M. Kini
Partner, Washington, D.C.
+1 202 383 8190
smkini@debevoise.com



Rick Sofield
Partner, Washington, D.C.
+1 202 383 8054
rcsofield@debevoise.com



Robert T. Dura
Counsel, Washington, D.C.
+1 202 383 8247
rdura@debevoise.com



Jonathan R. Wong
Associate, London
+44 20 7786 3043
jrwong@debevoise.com

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Appendix—Covered National Security Technologies or Products

Semiconductors and Microelectronics

- Prohibited Transactions
 - Develops² or produces³ any electronic design automation software for the design of integrated circuits or advanced packaging.⁴
 - Develops or produces any: (1) front-end semiconductor fabrication equipment designed for performing the volume fabrication of integrated circuits, including equipment used in the production stages from a blank wafer or substrate to a completed wafer or substrate (i.e., the integrated circuits are processed but they are still on the wafer or substrate); (2) equipment for performing volume advanced packaging; or (3) commodity, material, software or technology designed exclusively for use in or with extreme ultraviolet lithography fabrication equipment.
 - Designs any integrated circuit that meets or exceeds the performance parameters in Export Control Classification Number 3A090.a in supplement No. 1 to 15 CFR part 774 or integrated circuits designed for operation at or below 4.5 Kelvin.
 - Fabricates⁵ any integrated circuit that meets any of the following criteria:
 - Logic integrated circuits using a non-planar transistor architecture or with a production technology node of 16/14 nanometers or less, including fully depleted silicon-on-insulator (FDSOI) integrated circuits;
 - NOT-AND (NAND) memory integrated circuits with 128 layers or more;

² Develop means to engage in any stages prior to serial production, such as design or modification, design research, design analyses, design concepts, assembly and testing of prototypes, pilot production schemes, design data, process of transforming design data into a product, configuration design, integration design and layouts.

³ Produce means to engage in any of the post-development stages of realizing the relevant technology or product, such as engineering, manufacture, integration, assembly, inspection, testing and quality assurance.

⁴ Advanced packaging means to package integrated circuits in a manner that supports the two-and-one-half-dimensional (2.5D) or three-dimensional (3D) assembly of integrated circuits, such as by directly attaching one or more die or wafer using through-silicon vias, die or wafer bonding, heterogeneous integration or other advanced methods and materials.

⁵ Fabricate means to form devices such as transistors, poly capacitors, non-metal resistors and diodes on a wafer of semiconductor material.

- Dynamic random-access memory (DRAM) integrated circuits using a technology node of 18 nanometer half-pitch or less;
- Integrated circuits manufactured from a gallium-based compound semiconductor;
- Integrated circuits using graphene transistors or carbon nanotubes; or
- Integrated circuits designed for operation at or below 4.5 Kelvin.
- Packages⁶ any integrated circuit using advanced packaging techniques.
- Develops, installs, sells or produces any supercomputer enabled by advanced integrated circuits that can provide a theoretical compute capacity of 100 or more double-precision (64-bit) petaflops or 200 or more single-precision (32-bit) petaflops of processing power within a 41,600 cubic foot or smaller envelope.
- Notifiable Transactions
 - Designs any integrated circuit that is not described in the third activity above.
 - Fabricates any integrated circuit that is not described in the fourth activity above.
 - Packages any integrated circuit that is not described in the fifth activity above.

Quantum Information Technologies

- Prohibited Transactions
 - Develops a quantum computer⁷ 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.

⁶ Package means to assemble various components, such as the integrated circuit die, lead frames, interconnects and substrate materials to safeguard the semiconductor device and provide electrical connections between different parts of the die.

⁷ Quantum computer means a computer that performs computations that harness the collective properties of quantum states, such as superposition, interference or entanglement.

- Develops or produces any quantum network or quantum communication system designed for, or which the relevant covered foreign person intends to be used for:
 - Networking to scale up the capabilities of quantum computers, such as for the purposes of breaking or compromising encryption;
 - Secure communications, such as quantum key distribution; or
 - Any other application that has any military, government intelligence or mass-surveillance end use.
- Notifiable Transactions
 - None

Artificial Intelligence Systems

- Prohibited Transactions
 - Develops any AI system⁸ that is designed to be exclusively used for, or which the relevant covered foreign person intends to be used for, any:
 - Military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapon control, military decision-making, weapons design or combat system logistics and maintenance); or
 - Government intelligence or mass surveillance end use (e.g., through mining text, audio or video; image recognition; location tracking; or surreptitious listening devices).
 - Develops any AI system that is trained using a quantity of computing power greater than:
 - The Proposed Rule proposes 3 alternative thresholds of 10^{24} , 10^{25} or 10^{26} computational operations (e.g., integer or floating-point operations) generally

⁸ AI system means: (a) a machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations or decisions influencing real or virtual environments—i.e., a system that uses data inputs to: (1) Perceive real and virtual environments; (2) abstract such perceptions into models through automated or algorithmic statistical analysis; and (3) use model inference to make a classification, prediction, recommendation, or decision; (b) Any data system, software, hardware, application, tool or utility that operates in whole or in part using a system described in (a).

or 2 alternative thresholds of 10^{23} or 10^{24} computational operations (e.g., integer or floating-point operations) using primarily biological sequence data.

- Notifiable Transactions
 - Develops any AI system that is not described above and that is:
 - Designed to be used for any government intelligence or mass-surveillance end use (e.g., through mining text, audio or video; image recognition; location tracking; or surreptitious listening devices) or military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapons control, military decision-making, weapons design or combat system logistics and maintenance);
 - Intended by the covered foreign person to be used for cybersecurity applications, digital forensics tools and penetration testing tools, or the control of robotic systems; or
 - Trained using a quantity of computing power greater than:
 - The Proposed Rule proposes three alternative thresholds of 10^{23} , 10^{24} or 10^{25} computational operations (e.g., integer or floating-point operations).