

ALERT

Treasury Issues Draft Regulations for Outbound Investment Security Program; Comments Due August 4

July 16, 2024

An August 4 deadline is fast approaching for comments to the U.S. Department of the Treasury's Notice of Proposed Rulemaking (NPRM) that was issued June 21. The NPRM will restrict, for national security purposes, specific types of outbound U.S. investments involving certain technologies and products in countries of concern (currently, the People's Republic of China (PRC), along with the Special Administrative Region of Hong Kong and the Special Administrative Region of Macau).

The scope of the potential outbound investment restrictions involve the following categories of national security technologies and products:

- Certain semiconductors and microelectronics,
- Quantum information technologies, and
- Artificial intelligence (AI) technologies or products that are critical for military, intelligence, surveillance, or cyber-enabled capabilities.

This NPRM follows President Biden's August 9, 2023 Executive Order (Outbound Order) directing regulation of certain outbound investments and Treasury's Advance Notice of Proposed Rulemaking (ANPRM) released concurrently with the Outbound Order. As previously summarized by Wiley, the Outbound Order directs Treasury to issue regulations that (1) require U.S. persons to notify the U.S. government of certain transactions involving a "covered foreign person" that "may contribute to the threat to the national security of the United States" (notifiable transactions); and (2) prohibit U.S.

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persons from engaging in certain other transactions involving a covered foreign person that “pose a particularly acute national security threat because of their potential to significantly advance the military, intelligence, surveillance, or cyber-enabled capabilities of countries of concern” (prohibited transactions).

The NPRM includes draft regulations implementing the Outbound Order as well as an explanatory discussion. Although the proposed rule is not yet final and does not currently impose any new obligations on U.S. persons, it is expected that the final regulations will generally implement the provisions of the NPRM. Treasury invites comments on various topics detailed in the NPRM in anticipation of issuing a final rule implementing the Outbound Order. Comments on the NPRM are due **August 4, 2024**.

1. Who Is Affected by the Executive Order?

The proposed rule would place certain obligations on a “U.S. person” in connection with a “covered transaction” involving or resulting in the establishment of a “covered foreign person” where the U.S. person has “knowledge” that the investment is subject to the Outbound Investment Security Program (as established by the Outbound Order).

The proposed rule defines “U.S. person” to include any U.S. citizen, lawful permanent resident, entity organized under U.S. law, and any person in the United States. The proposed rule’s obligations also generally apply to U.S. persons working with non-U.S. persons. In other words, under the proposed rule, a U.S. person would be prohibited from knowingly directing a transaction that would be prohibited if undertaken by a U.S. person. Additionally, a U.S. person who controls any foreign entity (including a U.S. parent company of a foreign subsidiary) is obligated to take all reasonable steps to ensure its controlled foreign entity complies with the prohibitions and notification requirements that would apply to U.S. persons.

2. What Types of Transactions Are Covered?

The NPRM either prohibits “covered transactions” or requires that the “covered transaction” be notified to the U.S. Government. The definition of “covered transaction” includes (1) equity investments, (2) non-equity investments that convey interests similar to equity investments, and (3) investments under certain limited partnership arrangements. The proposed rule specifically includes the following types of transactions, whether direct or indirect, involving a covered foreign person:

- **Equity:** Acquisition of an equity interest, contingent equity interest, or conversion of debt or a contingent equity instrument into an equity interest.
- **Convertible Loans:** Provision of a loan that is convertible to an equity interest or which affords the U.S. person the right to make management decisions or to appoint members to the board of directors. This includes loans secured by an equity interest.
- **Greenfield or Brownfield Investment:** Acquisition or leasing of land, property, or other asset that will (or is intended to) either:
 - Establish a new covered foreign person (e.g., establish a foreign integrated circuit (IC) manufacturing facility abroad), or

- Shift an existing entity's operations into a new covered activity where it was not previously engaged (e.g., retool a factory to pivot operations to produce equipment for advanced IC packaging).
- **Joint Ventures:** Entrance into a joint venture that will (or is intended to) engage in a covered activity.
- **Investment Funds:** Investment in a non-U.S. person venture capital or investment fund that invests in a covered foreign person.

Each of these transaction types includes a specific U.S. person knowledge requirement, which is detailed in the proposed rule.

3. What Types of Transactions Are Not Covered?

The proposed rule identifies particular factors that would cause an otherwise "covered transaction" to be treated as an "excepted transaction" where prohibiting or requiring notification of the investment generally would not advance U.S. policy objectives. The proposed rule also specifies a process through which a party to a "covered transaction" could apply for an exemption from certain obligations on national interest grounds, which, if granted, would cause the transaction to be an exempted transaction. These excepted transactions include:

- **Publicly Traded Securities:** The proposed rule would not apply to many investments in publicly traded securities, such as those traded on securities exchanges (U.S. and non-U.S. exchanges), over-the-counter securities, or issued by investment companies, such as index funds and mutual funds.
- **Non-Control Limited Partnership Investors:** Transactions made as a limited partner in a venture capital or private equity fund are generally excluded if the partner does not control the fund's investment decisions or interact regularly with the pooled fund's investment targets.
- **Buyouts:** Acquisitions of covered foreign persons are excluded if the acquired company would not be a covered foreign person upon the conclusion of the transaction.
- **Partnerships Regulated by Allies:** Transactions by U.S. persons that are made "with or involving" a person of a country with outbound investment policies that adequately address U.S. national security concerns (as specified by the Treasury Secretary).
- **Prior Commitments:** Transactions made pursuant to a binding commitment entered into prior to the effective date of the Outbound Order.
- **Certain Bank Syndicate Financing:** The proposed rule would not apply where a U.S. person lender is part of a bank syndicate that acquires a voting interest in a covered foreign entity as a result of default on a loan, provided that the U.S. person does not have a lead role in the syndicate.
- **National Interest (case-by-case exemption):** U.S. persons involved in covered transactions that are not included in any of the general exemptions may nevertheless request that the Treasury Secretary deem the transaction to be in the national interest. For the request, the U.S. person must submit all relevant information to Treasury and articulate the basis for its request, including an analysis of the transaction's impact on national interests. Treasury may impose conditions on the transaction, which would be

binding, when exempting the transaction on the grounds of national interest.

4. What Sectors Are Covered?

In accordance with the Outbound Order, the proposed rule would apply to “covered activities” related to the semiconductors and microelectronics, quantum information technologies, and AI systems sectors. A “covered transaction” may be a “prohibited transaction” that could not legally be undertaken unless an exemption applies, or a “notifiable transaction” that would be permitted under the proposed rule, but would require the submission of specified transaction-related information to Treasury.

Semiconductors and Advanced Integrated Circuits

- Prohibited Transaction: Covered Activities
 - *Advanced integrated circuit design and equipment.*
 - Developing or producing any of the following:
 - Electronic design automation software for the design of integrated circuits or advanced packaging;
 - Front-end semiconductor fabrication equipment designed for performing the volume fabrication of integrated circuits;
 - Equipment for performing volume advanced packaging; or
 - Commodity, material, software, or technology designed exclusively for use in or with extreme ultraviolet lithography fabrication equipment.
 - *Advanced integrated circuit design and production.*
 - Designing any integrated circuit that meets or exceeds the performance parameters in Export Control Classification Number (ECCN) 3A090.a in supplement No. 1 to 15 CFR part 774, or integrated circuits designed for operation at or below 4.5 K;
 - Fabricating 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;
 - 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;
 - Integrated circuits designed for operation at or below 4.5 Kelvin; or
 - Packaging of any integrated circuit using advanced packaging techniques.

- *Supercomputers.*
 - Developing, installing, selling, or producing 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 Transaction: Covered Activities
 - Design, fabrication, or packaging of any integrated circuit that is not covered by the prohibited transaction definition.

Quantum Information Technologies

- Prohibited Transaction: Covered Activities
 - *Quantum computers and components.*
 - Developing a “quantum computer” or producing any of the critical components required to produce a quantum computer (e.g., a dilution refrigerator or two-stage pulse tube cryocooler).
 - *Quantum sensors.*
 - Developing or producing 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.
 - *Quantum networking and quantum communication systems.*
 - Developing or producing any quantum network or quantum communication systems designed for, or which the relevant covered foreign person intends to be used for:
 - Networking to scale up the capabilities of quantum computers;
 - Secure communications, such as quantum key distribution; or
 - Any other application that has military, government intelligence, or mass-surveillance end use.
- Notifiable Transaction: Covered Activities
 - *The proposed rule does not specify any notifiable transactions involving quantum technologies.*

AI Systems

The proposed rule significantly alters the ANPRM’s definition of “AI system” to align with President Biden’s October 30, 2023 Executive Order 14110, “Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence.” Under the new proposed definition, 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)."

While the NPRM indicates that further changes to rules on AI notifications are possible, the proposed rule narrows the scope of prohibited transactions related to the development of an AI system from the ANPRM in response to comments that the ANPRM would have included AI systems intended only for civilian end uses that do not have potential national security consequences.

- Prohibited Transaction: Covered Activities

- Developing any AI system that is designed to be exclusively used for, or which the relevant covered foreign person intends to be used for, any military end use or government intelligence or mass surveillance end use (including AI systems with cybersecurity and robotics applications).

In addition, Treasury seeks comments on computing power thresholds for prohibited transactions involving AI systems as follows:

- Developing any AI system that is trained using a quantity of computing power greater than:

- 10^{24} or 10^{25} or 10^{26} computational operations (e.g., integer or floating-point operations); or
- 10^{23} or 10^{24} computational operations (e.g., integer or floating-point operations) using primarily biological sequence data.

- Notifiable Transaction: Covered Activities

- Developing any AI system that is not covered by the prohibited transaction definition and that is:

- Designed to be used for any military end use, government intelligence, or mass-surveillance end use;
- Intended by the relevant covered foreign person to be used for cybersecurity applications, digital forensics tools, penetration testing tools, or the control of robotic systems; or
- Trained using a quantity of computing power greater than a certain level of computational operations (e.g., integer or floating-point operations) yet to be determined. *Treasury is considering three potential alternatives for the level of computational operations – 10^{23} , 10^{24} , or 10^{25} .*

5. How Does Treasury Define "Covered Foreign Person"?

As noted, the proposed definition of "covered foreign person" focuses on the person's (1) relationship to a country of concern (which is currently defined to include the PRC, Hong Kong, and Macau) and (2) involvement in one or more covered activities related to certain national security technologies and products.

Covered activity refers to any activity that makes a transaction notifiable or prohibited under the proposed rule. For persons engaged in covered activity, the proposed rule includes three categories of persons as covered foreign persons: (1) persons of a country of concern, (2) specified investors, and (3) specified joint

venture partners.

- **Persons of a Country of Concern.** A “person of a country of concern” engaged in a covered activity is considered a “covered foreign person.” Persons of a country of concern include governments of countries of concern, citizens or permanent residents of a country of concern, and entities that are incorporated, headquartered, organized, or have a principal place of business in a country of concern. Companies that are at least 50% owned or controlled by persons of a country of concern are also deemed to be persons of a country of concern. As such, a U.S. entity that is majority-owned or controlled by a Chinese entity or national would be deemed to be a person of a country of concern.
- **Investors.** The definition of “covered foreign persons” in the NPRM also includes certain persons that are not themselves “persons of a country of concern” but who have a close relationship with countries of concern. The relationship must meet two conditions: the person must (1) have an interest in a country of concern, and (2) be “significantly financially connected” to a covered activity in the country of concern. Any equity interest in a person of concern satisfies the first requirement, regardless of the size of the interest. Alternatively, investors who hold a voting interest, board seat, or otherwise have the power to direct management policies also satisfy this requirement. The proposed rule includes a higher bar for the “significantly financially connected” standard. Covered foreign persons engaged in covered activity that account for more than 50% of a person’s (1) revenue, (2) net income, (3) capital expenditure, or (4) operating expenses meet the definition of “significantly financially connected.” Any person who meets at least one of the criteria for both the interest requirement and significantly financially connected requirement is considered a covered foreign person.
- **Joint Venture Partners Rule.** The proposed rule also includes a special provision for joint venture partners. If a person of a country of concern enters into a joint venture with a U.S. person, and the joint venture engages in a covered activity, then the foreign joint venture partner is a covered foreign person. This applies regardless of whether the foreign partner is engaged in covered activity separately from the joint venture.
- **Special Rule for High-Risk Foreign Persons.** Transactions that would otherwise be notifiable are prohibited if the covered foreign person is a military end user or is included on the Entity List, the Specially Designated Nationals and Blocked Persons list (SDN List), or Treasury’s list of Non-SDN Chinese Military-Industrial Complex Companies (NS-CMIC List), or is designated as a foreign terrorist organization.

6. How Do I Know if a Transaction Is a Covered Transaction?

When Treasury issues a final rule, U.S. persons will be responsible for complying with the Outbound Investment Security Program regulations, including conducting the due diligence necessary to determine whether a given transaction is a covered transaction. In assessing whether companies conducted a reasonable and diligent inquiry, Treasury considers the questions that the U.S. person asked of its investment target; the contractual representations in the investment agreement; efforts to obtain and review both public and non-public information; whether the U.S. person purposefully avoided obtaining information; and the presence or absence of warning signs. Treasury does not intend to maintain a list of covered foreign persons

who would be subject to the proposed rule.

Because U.S. persons are responsible for determining whether a transaction is prohibited, notifiable, or not a covered transaction, the U.S. person's knowledge of the relevant facts and circumstances is a key consideration. Based on responses to the ANPRM, Treasury relaxed its standards for the knowledge requirement in the proposed rule. Under the ANPRM, the knowledge requirement would have been satisfied whenever a U.S. person "would need to know, or reasonably should know" that the transaction was covered. Based on commenters' concerns that the "should know" standard would be difficult to enforce, the proposed rule specifies that certain provisions of the rule will apply only if the U.S. person has "knowledge" of the relevant facts or circumstances at the time of the transaction.

The proposed rule further defines knowledge to include actual knowledge that the relevant facts exist or are substantially certain to occur, an awareness of a high probability of a fact's existence or future occurrence, or reason to know of a fact's existence. In certain cases, the proposed rule also considers whether a U.S. person *intended* for a transaction to involve or establish a covered foreign person.

7. What Will I Need to Do to Notify a Transaction?

Under the proposed rule, U.S. persons would be required to file a notification within 30 calendar days of completing a notifiable transaction. This applies equally to any transaction by an entity that the U.S. person controls if the transaction would be notifiable if completed directly by the U.S. person. Additionally, if a U.S. person learns that a transaction was a covered transaction after the transaction has occurred, they must promptly notify Treasury of the transaction no later than 30 days after the U.S. person actually learned that the transaction would have been covered.

The Treasury notification must include information on the parties involved, including a post-transaction organizational chart, the commercial rationale for the transaction, and a description of the covered activities performed by the covered foreign person. The notification must also include details on the transaction itself, including the total value, equity interests, voting interests, and board seats the U.S. person holds, and why the U.S. person has determined the transaction is notifiable. When a U.S. person notifies Treasury about a completed transaction that was a covered transaction, the notification must also include an explanation for how the U.S. person learned the transaction was covered and why the U.S. person did not know the transaction was covered at the time of the transaction. Treasury may follow up with the U.S. person for clarification or additional detail on any notified transaction.

8. What Will Happen if I Violate the Rule?

Treasury, in consultation with other agencies, may nullify, void, or otherwise compel the divestment of any prohibited transaction after the effective date of the final rule. Additionally, civil penalties may be imposed up to the greater of twice the amount of the transaction or \$368,136 per unlawful act. Criminal penalties apply for willful violations, including up to 20 years in prison and fines up to \$1,000,000. Any person who violates the proposed rule may voluntarily self-disclose the violation. Treasury will consider such self-disclosures when determining the appropriate response to any violation.

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Christopher Abbott, a Wiley 2024 Summer Associate, contributed to this alert.