



U.S. Treasury Department Issues Proposed Rule to Implement Outbound Investment Program

27 June 2024

On June 21, 2024, the U.S. Department of the Treasury (the “**Treasury Department**”) issued a [Notice of Proposed Rulemaking](#) (the “**Proposed Rule**”) which would impose a prohibition or a notification requirement regarding certain investments in Chinese entities engaged in activities related to certain technology (i.e., semiconductors and microelectronics, quantum information technologies, and artificial intelligence). A Treasury Department press release and fact sheet are available [here](#) and [here](#).

Under the Proposed Rule, U.S. persons will be prohibited from engaging in (or required to notify the Treasury Department regarding) any one of six categories of “covered transactions” involving investments in Chinese entities engaged in activities in the semiconductor/microelectronics, quantum information technology, and artificial intelligence sectors. The Proposed Rule also applies to covered transactions with *non*-Chinese entities, if more than 50% of the investment target’s revenue, net income, capital expenditure, or operating expenses are attributable a Chinese entity that engages in “covered activity.” The Proposed Rule would impose new due diligence obligations on parties engaging in potentially covered transactions, since it is only through adequate due diligence that the presence (or absence) of “covered activity” involving “covered foreign persons” can be ascertained and documented.

The scope of these restrictions would differ from Chinese Military-Industrial Company (“**CMIC**”) restrictions (implemented pursuant to Executive Order (“**E.O.**”) 13959, as amended by E.O. 14032), which only apply to entities designated on the Non-SDN Chinese Military-Industrial Complex Companies list, rather than entities affiliated with designated entities. Whereas U.S. persons are prohibited from investing in U.S. or foreign funds, such as exchange-traded funds or other mutual funds, that hold any publicly traded securities of a CMIC entity, the Proposed Rule specifically exempts investments by U.S. persons in securities issued by an investment company, such as an index fund, mutual fund, or exchange traded funds.

The public comment period ends on August 4, 2024. There is currently no timeframe for the issuance of a final rule or indication of when any restrictions will become effective. Once effective, violations of the final rule will be enforceable as violations under the International Emergency Economic Powers Act, which carry significant potential civil penalties and up to 20 years’ imprisonment for criminal violations.

The Proposed Rule includes broad exemptions for certain transactions, including investments in publicly traded securities and certain investments as a limited partner. Accordingly, after the effective date,

companies should analyze whether a proposed investment could fall with the scope of these restrictions or whether an exemption could apply.

Background

On August 9, 2023, President Biden issued E.O. 14105, “Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern.” On the same day, the Treasury Department issued a related Advanced Notice of Proposed Rulemaking (the “ANPRM”). Pursuant to the ANPRM, the E.O. 14105 program will be administered by the Office of Investment Security of the Treasury Department, rather than the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”) or the Committee on Foreign Investment in the U.S. (“CFIUS”).

In sum, E.O. 14105 directs the Secretary of the Treasury to issue regulations that prohibit U.S. persons from engaging in certain transactions involving certain technologies and products that pose a particularly acute national security threat to the U.S. and that require U.S. persons to notify the Treasury Department of certain other transactions involving certain technologies and products that may contribute to the threat to the national security of the U.S. More specifically, E.O. 14105 identifies three categories of national security technologies and products to be covered by the program: (i) semiconductors and microelectronics; (ii) quantum information technologies; and (iii) artificial intelligence. We previously discussed E.O. 14105 and the ANPRM in further detail on [August 10, 2023](#) and [August 11, 2023](#).

On June 21, 2024, the Treasury Department issued the Proposed Rule to implement E.O. 14105.

In general, the Proposed Rule builds upon the ANPRM and provides greater specificity regarding the scope of E.O. 14105. After the conclusion of the comment period on August 4, 2024, the Treasury Department will issue a final rule.

Summary of the Proposed Rule

Relevant Definitions.

The Proposed Rule would impose either a prohibition or a notification requirement for “U.S. persons” who possess “knowledge” that a “covered transaction” would involve a “covered foreign person” engaged in a “covered activity.” Whether the Proposed Rule would impose a prohibition or a notification requirement would depend upon the particular “**Covered Activity**,” as summarized below. Notably, although most of the Covered Activities under the Proposed Rule track existing items classified on the Commerce Control List, the Proposed Rule arguably reaches a broader array of conduct.

Transaction Prohibited

Transaction Subject to a Notification Requirement

	Transaction Prohibited	Transaction Subject to a Notification Requirement
Semiconductors and Microelectronics	<p>Covered Transactions related to:</p> <ul style="list-style-type: none"> • electronic design automation software; • certain fabrication and advanced packaging tools; • the design, fabrication, or packaging of certain advanced integrated circuits; or • supercomputers. 	<p>Covered Transactions related to:</p> <ul style="list-style-type: none"> • the design, fabrication, or packaging of integrated circuits not otherwise covered by the prohibited transaction definition
Quantum Information Technologies	<p>Covered Transactions related to:</p> <ul style="list-style-type: none"> • the development of quantum computers and production of critical components; • the development or production of certain quantum sensing platforms; or • the development or production of quantum networking and quantum communication systems. 	<i>Not applicable.</i>
Artificial Intelligence Systems	<p>Covered Transactions related to:</p> <ul style="list-style-type: none"> • the development of any artificial intelligence (“AI”) system designed to be exclusively used for, or intended to be used for, certain end uses. <p>Alternatively, Covered Transactions related to:</p> <ul style="list-style-type: none"> • the development of any AI system that is trained using a specified quantity of computing power, and trained using a specified quantity of computing power using primarily biological sequence data. 	<p>Covered Transactions related to:</p> <ul style="list-style-type: none"> • the development of any AI system designed to be exclusively used for, or intended to be used for, certain end uses not otherwise covered by the prohibited transaction definition. <p>Alternatively, Covered Transactions related to:</p> <ul style="list-style-type: none"> • the development of any AI system that is trained using a specified quantity of computing power, and trained using a specified quantity of computing power using primarily biological sequence data.

Below is a summary of the definitions of the terms used throughout the Proposed Rule:

- **U.S. Person:** The term “U.S. Person” includes any U.S. citizen or lawful permanent resident, as well as any entity organized under the laws of the U.S. or any jurisdiction within the U.S., including any foreign branch of any such entity, and any person in the U.S.
- **Knowledge:** The obligations imposed pursuant to the Proposed Rule would apply if the U.S. Person: (i) possesses actual knowledge that a fact or circumstance exists or is substantially certain to occur; (ii) possesses an awareness of a high probability of a fact or circumstance’s existence or

future occurrence; or (iii) could have possessed such information through a reasonable and diligent inquiry. This definition largely tracks the definition provided under the Export Administration Regulations and applicable to U.S. export controls.

- **Covered Transaction:** The Proposed Rule would apply to six categories of transactions by U.S. Persons, including the acquisition of an equity interest or contingent equity interest, certain debt financing that is convertible to an equity interest or that affords certain rights to the lender, the conversion of a contingent equity interest, a greenfield investment or other corporate expansion, a joint venture, and certain investments as a limited or equivalent in a non-U.S. Person pooled investment fund.
- **Covered Foreign Person:** The Proposed Rule would apply to certain transactions by a U.S. Person involving: (i) a Covered Foreign Person; or (ii) a person that holds a specified interest in a Person of a Country of Concern (e.g., a voting interest, board seat, equity interest, or the power to direct or cause the direction of the management or policies) and more than 50% of the person's revenue, net income, capital expenditure, or operating expenses are attributable to a Person of a Country of Concern. For example, the Proposed Rule would apply to a company that derives 50% of its revenue from a Chinese subsidiary that engages in a Covered Activity.
 - The term "**Covered Foreign Person**" refers to a person of a Country of Concern that is engaged in a Covered Activity.
 - The term "**Person of a Country of Concern**" would include an individual who is a citizen or permanent resident of a country of concern (and not a U.S. citizen or permanent resident of the United States); an entity that is organized under the laws of a Country of Concern, headquartered in, incorporated in, or with a principal place of business in a Country of Concern; the government of a Country of Concern; or an entity that is directly or indirectly majority-owned by any persons or entities in any of the aforementioned categories.
 - The term "**Country of Concern**" refers to China (including Hong Kong and Macau), pursuant to E.O. 14105.

Exemptions to the Scope of the Proposed Rule.

The Proposed Rule would exempt certain types of transactions (as summarized below), provided that such transactions do not afford a U.S. Person certain rights that are not standard minority shareholder protections.

- **Publicly traded securities:** An investment by a U.S. Person in a publicly traded security or a security issued by an investment company (e.g., an index fund, mutual fund, or exchange-traded fund) would be exempt from the scope of the Proposed Rule.
- **Certain limited partner investments:** A U.S. Person's investment of a certain size made as a limited partner or equivalent in a venture capital fund, private equity fund, fund of funds, or other pooled investment fund would be exempt from the scope of the Proposed Rule.
- **Buyouts of Country of Concern ownership:** A U.S. Person's full buyout of all Country of Concern ownership of an entity, such that the entity would not constitute a Covered Foreign Person following the transaction, would be exempt from the scope of the Proposed Rule.
- **Intracompany transactions:** An intracompany transaction between a U.S. parent and a majority-controlled subsidiary to support ongoing operations or other noncovered activities would be exempt from the scope of the Proposed Rule.

- **Pre-Outbound Order binding commitments:** A transaction fulfilling a binding, uncalled, capital commitment entered into prior to August 9, 2023 would be exempt from the scope of the Proposed Rule.
- **Certain syndicated debt financings:** Transactions where a U.S. Person, as a member of a lending syndicate, acquires a voting interest in a Covered Foreign Person upon default and the U.S. Person cannot initiate any action vis-à-vis the debtor and does not have a lead role in the syndicate, would be exempt from the scope of the Proposed Rule.
- **Third country measures:** Certain transactions involving a person of a jurisdiction outside of the U.S. may be excepted transactions where the Secretary of the Treasury determines that the jurisdiction is addressing national security concerns posed by outbound investment and the transaction is of a type for which associated national security concerns are likely to be adequately addressed by the actions of that jurisdiction.
- **National interest exemption:** A U.S. Person could seek an exemption from the application of the prohibition or notification requirement on the basis that a transaction is in the national interest of the U.S.

Notification Requirements

A U.S. Person subject to the notification requirement under the Proposed Rule would be required to file a notification form with the Office of Investment Security of the Treasury Department. Pursuant to the Proposed Rule, a notification must be filed: (i) no later than 30 days after a transaction is completed; or (ii) where a U.S. Person acquires actual knowledge after the completion date of a transaction that the transaction would have been a covered transaction if such knowledge had been possessed at the time of the transaction, no later than 30 days after the U.S. person's acquisition of such knowledge.

The notification form would be required to include information related to the transaction (e.g., details about the U.S. Person, the covered transaction, relevant national security technologies and products, and the Covered Foreign Person). Finally, a U.S. Person would be required to promptly notify the Treasury Department of any material omission or inaccuracy that the U.S. Person learns about following any information submission.

Upon receipt of a notification form, the Treasury Department could submit questions or document requests related to the transaction. Pursuant to the Proposed Rule, U.S. Persons would be required to respond to such requests within the timeframe and manner specified by the Treasury Department.

Potential Penalties

Pursuant to the International Economic Emergency Powers Act, a violation would be subject to civil and criminal penalties, or the Secretary of the Treasury could take an action to nullify, void, or otherwise require divestment of any prohibited transaction. The Proposed Rule notes that U.S. person's submission of a voluntary self-disclosure of a violation will be taken into any penalty consideration by the Treasury Department.

We will continue to monitor developments in this area, and encourage you to subscribe to be kept informed of latest developments. Please contact the authors or your usual Herbert Smith Freehills contacts for more information.

