

U.S. Treasury Proposes Regulation of U.S. Outbound Investments



By **Richard Rowe**
Special Counsel | Corporate



By **Erin Ward**
Law Clerk | Corporate

On June 21, 2024, the U.S. Department of Treasury (“Treasury”) issued a [notice of proposed rulemaking](#) (“Proposed Rule”) that would regulate certain U.S. transactions with persons of a country of concern involved in the semiconductor and microelectronics, quantum information technology and artificial intelligence (AI) sectors, as authorized by [Executive Order 14105](#) (“EO 14105”). The Proposed Rule maintains the two-tiered regulatory framework announced in the [advance notice of proposed rulemaking](#) released in August 2023 that would prohibit entirely some transactions and require notification to the Department of the Treasury for others. Given its scope, the Proposed Rule has the potential to impact U.S. investors, including investment funds, in their investment decisions and approach to deal diligence generally.

Scope of the Proposed Rule

The Proposed Rule would only apply to outbound investment transactions that meet certain criteria. The jurisdiction is scoped based on (1) the involvement of a U.S. person in the transaction, (2) the nature of the transaction undertaken and (3) the characteristics of the target. Implicated transactions are those by “U.S. persons” where the target is a “covered foreign person” – a person of a country of concern (*i.e.*, the People’s Republic of China or PRC, including the Special Administrative Regions of Hong Kong and Macau) that a U.S. person knows or intends will be engaged in a “covered activity.”

1. “U.S. person” includes U.S. citizens and permanent residents, entities organized under U.S. law and any person otherwise present in the United States. Certain obligations under the Proposed Rule would also extend to the activities of foreign entities controlled by U.S. persons.
 2. A “covered transaction” includes various types of transactions (equity acquisitions, convertible debt financing, greenfield investments, formation of joint ventures, limited partnership investments and others) and also requires that the U.S. person know (or should know) or intend that the transaction involves a “covered foreign person.”
 3. A “covered foreign person” is scoped by both the characteristics of the person *and* the activities of such person.
 - A person of a country of concern is a PRC citizen or resident or entity organized under the laws of, headquartered in, or with its principal place of business in the PRC, or any entity controlled by the foregoing person or entity.
- “Covered activities” establish the connection to the national security-related technologies and products that were identified in EO 14105 as the rationale for the outbound investment regulations. Covered activities are those related to the certain *activities* with respect to certain *technologies or products* (*e.*, developing, installing, selling, or producing any supercomputer meeting certain specifications). The Proposed Rule sets out these activities, technologies and products by grouping them into distinct categories that

scope the “prohibited” and “notifiable” transactions under the two-tiered approach.

Notified and Prohibited Transactions

Prohibited transactions are covered transactions that involve covered foreign persons engaging in activities with respect to technologies and products that pose a “particularly acute” national security threat. The Proposed Rule sets forth a list of activities that would be prohibited, including those related to semiconductors, quantum computing and related sectors. One example given in the Proposed Rule is a covered transaction in which the covered foreign person “develops” any AI system that is designed to be exclusively used for military end use or government intelligence or mass surveillance.

Notifiable transactions by definition do not overlap with prohibited transactions and are scoped by covered foreign persons engaging in activities with respect to technologies and products that may contribute to the threat to the national security. For example, if the covered foreign person “develops” any AI system (that does not fall under the scope of the activities, technologies and products described in the definition of prohibited transactions) designed to be used for any government intelligence or mass-surveillance end use or military end use. Notifiable transactions would require notification to the Department of the Treasury no later than thirty days after completion.

Takeaways

The Proposed Rule outlines a regulatory system that will likely require many U.S. investors and other market participants to expand their diligence activities to include evaluating transactions for outbound investment restrictions. True to the policy outlined in EO 14105, while very narrowly tailored by a target’s operating sector (the activities, technologies and products described above), the proposed regime is very broadly structured to capture numerous types of transactions where U.S. persons transact with PRC persons engaged in those narrowly scoped activities.

The Proposed Rule’s knowledge requirement for a transaction to be a “covered transaction” will likely be impactful, particularly because knowledge not only means actual knowledge but also “an awareness of a high probability of a fact or circumstance’s existence or future occurrence” and “reason to know of a fact or circumstance’s existence.” As the Proposed Rule explains, the deemed knowledge requirement is meant to incentivize proper diligence: “If a U.S. person failed to conduct a reasonable and diligent inquiry at the time of a transaction and undertook the transaction where a particular fact or circumstance indicative of a covered transaction was present, the Department of the Treasury may find in the course of determining compliance with the proposed rule that the U.S. person had reason to know of such fact or circumstance...”

The public comment period for the proposed rule ends August 4, 2024. EO 14105 was published amid increasing interest in Congress in regulating U.S. outbound investment.^[1] Interest likely remains high in this space, and the implementation of the final rules with respect to outbound investment could be impacted by additional actions by the legislature or one or more administrations.

^[1] See, e.g., Outbound Investment Transparency Act of 2023, S. 2678, 118th Cong. (2023); 2021 National Critical Capabilities Defense Act, S. 1854, 117th Cong. (2021) (later incorporated into America COMPETES, passed by the House in February 2022, which was targeted at bolstering competition with China. H.R. 4521, 117th Cong. (2022)).