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Report from Washington

Treasury Finalizes Regulations for Outbound Investment Security Program

October 30, 2024

On October 28, 2024, the U.S. Department of the Treasury (“Treasury”) issued a final rule containing the regulations that will make up the new Outbound Investment Security Program (the “Program”). As discussed in our previous client alert regarding the related notice of proposed rulemaking (“NPRM”), issued in June of this year, the Program implements President Biden’s August 2023 Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern (the “Order”). The Order prohibits or requires notification for specified categories of investments by U.S. persons into companies involved in certain sensitive technologies—specifically, semiconductors and microelectronics, quantum computing, and artificial intelligence (“AI”) systems—when those companies are located in or owned by persons in a “country of concern.” Presently, China (inclusive of Hong Kong and Macau) is the Program’s only designated country of concern.

Although the Program was finalized near the eve of the presidential election in the United States, outbound investment regulation has broad bipartisan support in Washington. Therefore, regardless of the election’s outcome, it is likely that the Program’s key features will remain in effect in the next Administration—albeit perhaps with some modifications or enhancements as the Program evolves over time.

The Program will be housed within the newly formed Office of Global Transactions, which sits within Treasury’s Office of Investment Security. The final regulations will take effect on January 2, 2025, after which U.S. persons must comply with these requirements and conduct the requisite diligence to determine whether a transaction is prohibited or requires notification. In advance of the rule’s effective date, we would encourage dealmakers, private equity sponsors, institutional investors, and other companies pursuing investments in affected sectors to consider the Program’s impact and incorporate these issues into related diligence workstreams moving forward.

Summary of Requirements

The Program prohibits or requires notification of certain categories of financial transactions by U.S. persons into "covered foreign persons," defined as persons (i) of a country of concern (pursuant to the Order, the People's Republic of China, along with Hong Kong and Macau)[1] that (i) are engaged in certain covered activities with respect to specified technologies and products or (ii) meet certain criteria establishing a sufficient nexus to such persons (such as through certain vested financial interests or participation in joint ventures).

Although the Program is targeted at financial investments—*i.e.*, acquisitions of equity interests—the Program applies to other types of financial transactions, including acquisitions of contingent interests, debt financings that afford certain rights to the lender, the conversion of contingent interests into equity, greenfield investments, joint-venture arrangements, and certain investments made as a limited partner ("LP") into a non-U.S. pooled investment vehicle.

In addition, U.S. persons have certain obligations with respect to their "controlled foreign entities," or entities in which the U.S. person: (i) holds more than 50 percent of the outstanding voting interest or voting power of the board of the entity; (ii) is a general partner, managing member, or equivalent of the entity; or (iii) is an investment adviser to an entity that is a pooled investment fund. Specifically, U.S. persons are required to take steps to ensure that their "controlled foreign entities" act as if they were U.S. persons (*i.e.*, to avoid prohibited transactions and to give notice of notifiable transactions). Furthermore, U.S. persons that possess authority at non-U.S. entities are also prohibited from "knowingly directing" transactions by the non-U.S. entity that would otherwise be prohibited for U.S. persons.

The Program exempts certain transactions, including transactions involving publicly traded securities, certain passive LP investments (such as investments of less than $2,000,000), derivatives, investments involving 100 percent of the equity interests of a company, intracompany transactions, equity-based compensation, and certain syndicated debt financings.

The Program prohibits or requires notification of transactions only where the U.S. person has knowledge that such transaction is prohibited or notifiable. "Knowledge" is deemed to exist both where actual knowledge exists and where there is a "high probability" that the target company is engaged in the covered activities. Additionally, U.S. persons will be

[1] This includes (i) individuals who are citizens or permanent residents of a country of concern, (ii) entities organized under the laws of, headquartered in, incorporated in, or a principal place of business in a country of concern, (iii) the government of a country of concern or a person acting for or on behalf of a country of concern, and (iv) any entity that is, directly or indirectly, 50 percent or more owned by any person in (i)-(iii).

deemed to have the "knowledge" of someone who could have possessed such knowledge through a reasonable and diligent inquiry.

Key Observations on the Final Rule

As discussed in our previous client alert, many unanswered questions remained after the issuance of the NPRM in terms of the Program's scope and application. Namely, it was not necessarily clear how the knowledge standard would apply in unanticipated circumstances, such as where diligence would be difficult or impossible. In addition, it was unclear whether there was a *de minimis* level of engagement in a covered activity that would not trigger the Program's obligations. Treasury addressed these ambiguities in the final rule by providing additional clarity on how the knowledge standard would be assessed and addressing concerns about the lack of a *de minimis* exception.

The Program also reflects Treasury's attempt to address concerns that the U.S. businesses could face a disproportionate impact on their businesses. For example, Treasury addressed the concern that U.S. LPs might be incentivized to invest in foreign pooled investment vehicles (as opposed to U.S. pooled investment vehicles) by adjusting the exception applicable to such passive investments and by clarifying that LPs in U.S. pooled investment vehicles are not indirect investors in a pooled investment vehicle's activities. Additionally, Treasury addressed concerns that a U.S. lender might be disadvantaged if it could not collect collateral on a defaulted loan.

All told, we highlight the following as key take-aways from the final rule:

- **Additional Clarity on Knowledge Standard**

  As a general matter, the final rule clarifies that Treasury's assessment of a U.S. person's efforts at conducting a "reasonable and diligent inquiry" under the knowledge standard will be based on "a consideration of the totality of relevant facts and circumstances" as "of the time of the transaction" (§§ 850.104(c)-(d)). Thus, while Treasury declined to include a safe harbor or proscribe specific steps that could satisfy the diligence inquiry, Treasury's commentary reflects that it will consider a U.S. person's diligence efforts on an ad-hoc basis, and that this evaluation will assess the U.S. person's efforts to obtain and evaluate (as appropriate) public and non-public information, contractual representations and warranties, and consider and evaluate "red flags" or "warning signs."

- **Final Exception for LP Investments Into Non-U.S. Pooled Funds and Additional Clarity on Coverage of LP Investments**

  The final rule adopts a new exception for covered transactions involving LP investments into non-U.S. pooled funds. The NPRM included two alternative

proposals for this exception, as discussed in our previous client alert. Instead of adopting either of these specific alternatives, Treasury has adopted a hybrid version that defines the exception to include (i) any U.S. LP investment of $2,000,000 or less, aggregated across any investment and co-investment vehicles of the fund or (ii) U.S. LP investments where the LP receives binding contractual assurance that its capital will not be used to engage in a prohibited or notifiable transaction. In the discussion of the final rule, Treasury noted that this approach is intended to prevent the transfer of intangible benefits afforded to covered foreign persons by U.S. person investments, "including standing and prominence, managerial assistance, and enhanced access to additional financing."

In addition, the final rule contains an explicit clarification that U.S. LP investments into U.S. pooled funds which proceed to invest in covered foreign persons are not considered covered transactions (*see* Note 1 to § 850.210). In other words, absent other relevant facts, U.S. LPs will not be held liable for investments by U.S. pooled investment vehicles that fail to comply with the Program.

- **No "*De Minimis*" Threshold for "Engages In," But Some Clarity**

  Many commentators were concerned that the Program would apply to transactions where a company from a country of concern was not principally involved in any of the covered activities, but had a single employee or a limited, *de minimis* amount of activity that was not core to the target's business. This concern arose out of the fact that the NPRM would apply to companies from a country of concern that "engage in" any covered activity, but the term "engaged in" was undefined. The final rule addresses, but does not resolve these concerns. Specifically, Treasury declined to adopt a *de minimis* exception for "engages in." Thus, investments involving companies from a country of concern are prohibited or notifiable even if such company "engages in" only in a *de minimis* amount of covered activities.

  However, the final rule does provide clarity on when a subsidiary or affiliate of the target company's status as a "covered foreign person" can create a prohibited or notifiable transaction. Specifically, investments into a "parent" company are prohibited or notifiable only if the subsidiary or affiliate is engaged in a covered activity and only if that subsidiary or affiliate (i) accounts for more than 50 percent of the parent's revenue, net income, capital expenditure, or operating expenses and (ii) the net income, capital expenditure, or operating expenses is greater $50,000 or the equivalent. In other words, revenue, net income, capital expenditure, or operating expenses attributable to a covered foreign person should only be considered when they meet or exceed $50,000 or the equivalent from each covered

foreign person. As a result, subsidiaries or affiliates that contribute less than $50,000 to a parent company's relevant financial metrics should not be included in the final calculation to determine whether the 50-percent threshold is met.

- **Finalization and Clarification of Covered "AI Systems"**

  In the final rule, Treasury added some clarifying notes around what qualifies as covered activities with respect to AI systems.[2] Specifically, and in reference to the definition of "develop" (§ 850.211)[3], notes to the final regulations reflect that (i) users of third-party AI systems must actually engage in "design or substantive modification" with respect to such systems in order to meet the relevant criteria and (ii) customizing, configuring, or fine-tuning third-party AI models for internal, non-commercial use is not a covered activity unless it is done so for certain end-uses.

  In addition, the final rule establishes which of the proposed compute thresholds will be used to identify certain AI systems that fall within the scope of covered activities. For the notifiable category, AI systems trained using a quantity of computing power greater than 10^{23} computational operations are covered. For the prohibited category, AI systems trained using a quantity of computing power (i) greater than 10^{25} computational operations or (ii) greater than 10^{24} when using primarily biological sequence data are covered.

  In its discussion of the final rule, Treasury also notes that computing power for AI systems derived from or that are a combination of other AI systems should be aggregated to determine the quantity of computing power required to train such systems. However, Treasury also clarifies that the end-use of a prior AI system need not be attributed to that of a successor AI system, as "the designed end-use or capabilities of a successor system could vary from a prior version."

  Although the final rule does not specifically address whether ownership and operation of a data center would be a covered activity, such activity would not appear to qualify as "develop[ing]" an AI system under the relevant definitions (*see* § 850.202; § 850.211). However, there may be cases where ownership and operation of a data center, hardware, software, or other services may involve the "design or substantive modification" of a third-party's AI model or machine-based system, and those situations should be evaluated on a case-by-case basis.

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[2] The definition of "AI system" is largely consistent with that included in the NPRM, as discussed in our previous client alert. *See* § 850.202.

[3] "Develop" is defined as "to engage in any stages prior to serial production, such as design or substantive 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." § 850.211.

- **Treatment of Foreclosures**

  In addition to the above, the final rule clarifies whether U.S. persons can be held liable in the context of foreclosures on existing debt financing arrangements that unexpectedly give rise to covered transactions. Previously, it appeared that the actions of a borrower that qualified as a covered foreign person could prevent U.S. persons from exercising their rights in the context of a foreclosure on a pre-existing debt financing arrangement. The final rule contains a note clarifying that foreclosure on collateral where the U.S. person does not know at the time of issuing or acquiring the secured debt that the pledged equity was in a covered foreign person is not a covered transaction (*see* Note 1 to § 850.210). This note also clarifies that foreclosure on equity pledged prior to the effective date of January 2, 2025 as collateral for secured debt is not a covered transaction.

- **Additional Exceptions**

  The final rule also contains some additional exceptions for covered transactions not included in the NPRM. Specifically:

  - **Employee Stock or Stock Options:** The final rule includes a new exception for "employment compensation by an individual in the form of an award of equity or the grant of an option to purchase equity in a covered foreign person, or the exercise of such option" (§ 850.501(f)). Treasury indicates that it considered the impact on U.S. persons' employment prospects and personal finances in adding this exception.
  - **Derivatives:** The final rule contains a new exception for investments by U.S. persons in derivatives "so long as such derivative does not confer the right to acquire equity, any rights associated with equity, or any assets in or of a covered foreign person." (§ 850.501(a)(1) (iv)).
  - **Certain Transactions Between a U.S. Person and Its Controlled Foreign Entities:** The final rule also clarifies that the exception for intracompany transactions excepts transactions in connection with "covered activities that the controlled foreign entity was engaged in prior to January 2, 2025." (§ 850.501(c)).
  - **Transactions Pursuant to Binding, Uncalled Capital Commitments:** The final rule adjusts this exception to exclude transactions made pursuant to binding, uncalled capital commitments prior to the effective date of January 2, 2025. The previous iteration of this exception only applied to such commitments made prior to the issuance of the August 2023 Order. Treasury adjusted this exception "given certain fairness considerations raised by the commenters" on the NPRM.

Parallel Proposals in Congress

Congress has also been focused on addressing U.S. investment into China and other countries for the last few years. Although no related bills were passed during the House of Representatives' so-called "China Week" last month (see additional details in our previous client memo), support for new measures remains robust among certain members on a bipartisan basis. The current draft of the National Defense Authorization Act for Fiscal Year 2025 includes an amendment incorporating the latest iteration of the Outbound Investment Transparency Act, which was first introduced in 2023 and would expand the notification requirements in the current regulations to cover additional sectors such as hypersonics, satellite-based communications, and networked laser scanning systems with dual-use applications. Other lawmakers, including the outgoing Chairman of the House Financial Services Committee Patrick McHenry, have advocated for a more targeted, sanctions-based approach that would designate and impose restrictions on investment into certain entities as opposed to entire sectors.

Future Implementation

Treasury's discussion accompanying the issuance of the final rule demonstrates the agency's intention to work with industry and various stakeholders to account for the practical realities of its implementation and the evolving nature of new and emerging technologies. We can expect additional guidance and engagement from Treasury on these issues going forward.

In terms of administration and enforcement, violations can result in both civil and criminal penalties under Section 206 of the International Emergency Economic Powers Act. These include civil penalties not to exceed the greater of $368,136, as periodically adjusted for inflation, or an amount twice the amount of the transaction that is the basis of the violation. Criminal penalties include fines of up to $1,000,000 or imprisonment for up to 20 years, or both.

Although the regulations take effect on January 2, 2025, the Program will ultimately be administered by the next administration. As a result, administrative and enforcement priorities could change depending on the outcome of next week's presidential election. Congress will also continue to debate whether to pass legislation on the subject before the 118th session of Congress ends in January 2025.

In addition, the European Commission and G7 countries are contemplating the creation of similar regimes in their jurisdictions, which would in theory operate in conjunction with the U.S. Program. The final rule's exception for transactions with or involving third countries that have implemented similar mechanisms, a determination ultimately made by the Secretary of the Treasury, is intended to account for such cooperation.

For additional details on the Program and its implementation, please refer to the following Fact Sheet issued by Treasury, which includes FAQs regarding the regulations.

Simpson Thacher & Bartlett LLP is experienced in navigating international regulatory and compliance issues, including with respect to sanctions, export controls, and foreign investment, and continues to follow developments of this new outbound investment review regime closely. We are available to discuss further questions on request.

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