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U.S. Government Issues Proposed Rules in Significant Step to Restrict Outbound U.S. Investment in Chinese Technology

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On June 21, 2024, the Treasury Department released long-expected proposed regulations to curtail investments by U.S. persons (including investments by U.S. limited partners in non-U.S. pooled funds) and U.S.-controlled entities (including U.S.-managed funds) that could support China's development of advanced technology in four key areas: (1) semiconductors and integrated circuits; (2) supercomputers; (3) quantum computing, networking and communications; and (4) artificial intelligence.

In taking this step, the U.S. Government is transferring to the private sector the responsibility to restrict the flow of U.S. capital and related intangible benefits (e.g., reputational benefits, managerial assistance, and access to talent networks) that could fuel Chinese progress in technologies deemed critical to U.S. national security. The scope of the new program is broad and will impose on U.S. investors, funds, and lenders substantial obligations to investigate not only the activities but also the upstream ownership and governance arrangements of those entities to which they provide capital. Entirely novel lines of due diligence, and in some cases compliance measures, will have to be developed to meet these obligations.

The proposed rules, which will implement President Biden's August 9, 2023 executive order "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" (the "Outbound Order"), remain subject to comment until August 4, 2024 and are not yet in effect. However, given the level of detail and prescription in the Treasury Department's effort—coming nearly 11 months after the Outbound Order and the Department's initial "Advanced Notice of Proposed Rulemaking" released on the same day—little is expected to change when the rules are formally codified as a new Part 850 to Title 31 of the Code of Federal Regulations.

As was the case with some of its other significant recent rulemakings, the Treasury Department has also released a helpful Fact Sheet providing an overview of the new regime. However, some of the most impactful aspects of the program only come into focus after reviewing the entire 165-page Notice of Proposed Rulemaking (the "Notice"). Here are some key takeaways:

I. Some "covered transactions" are "prohibited"; others are merely "notifiable."

The program will impose certain restrictions and requirements upon "U.S. persons" as to "covered transactions" (including equity investments, convertible debt transactions, entry into a joint venture or establishing a new business) involving "a covered foreign person." A "covered foreign person" is one with specified ties to a "country of concern" (currently, China, including Hong Kong and Macau) that engages in specified "covered activities" pertaining to the targeted advanced technology sectors. Following the structure of the Outbound Order, the rules outright prohibit certain "covered transactions" while permitting but requiring notification to Treasury of others.

A "covered transaction" will be "prohibited" (i.e., a U.S. person cannot engage in, direct, or support the transaction) where the involved "covered foreign person" (or a joint venture involving a "covered foreign person") is or will be engaged in any of the following "covered activities":

- The design, development, or fabrication of certain categories of semiconductors or integrated circuits and certain tools for the manufacture, fabrication, or packaging of some of these items;
- The development, installation, sale, or production of certain supercomputers;
- The development of quantum computers or production of certain key components thereof;
- The development or production of quantum sensing platforms, quantum networks, or quantum communications systems intended for specified purposes, including military, government intelligence, or mass surveillance end use; or
- The development of certain AI systems, including those capable of training "foundational" models, or exclusively designed for military, government intelligence, or mass surveillance end use or trained using a specified threshold of computing power.

31 C.F.R. 850.224.

A "covered transaction" will be "notifiable" (i.e., it will be permitted but must be reported to Treasury) where the involved "covered foreign person" (or a joint venture involving a "covered foreign person") is or will be engaged in any of the following "covered activities":

- The design, development, fabrication, or packaging of any integrated circuit for which the covered transaction is not prohibited; or
- The development of AI systems that, while falling below the parameters specified in the "prohibited transaction" rule, are still: designed for government intelligence, mass surveillance, or military end use; intended to be used for cybersecurity applications, digital forensics tools, and penetration testing tools, or the control of robotic systems; or trained using a (lower) specified threshold of computing power.

31 C.F.R. 850.217.

A notice must be filed with the Treasury Department no later than 30 days after completion of the covered transaction, 31 C.F.R. 805.404(c), except in the case that the U.S. person did not have "knowledge" (including "reason to know") that the transaction was "covered." However, if a U.S. person acquires actual knowledge after the completion date, they must submit a notification no later than 30 days after acquiring such knowledge, even if years after the fact. 31 C.F.R. 805.403.

II. "Covered foreign persons" are not just those based or located in China.

The entities targeted by the Outbound Order, and thus in whom covered U.S. outbound investments are restricted, are called "covered foreign persons." A covered foreign person is, in turn, (i) a "person of a country of concern" who is engaged in "covered activity," as well as (ii) a person that (a) directly or indirectly holds any equity interest, board seat, or voting interest in, or who through contractual arrangements holds any power to direct or cause the direction of the management or policies of, any person described in (i), and (b) derives more than 50% of its revenue or net income from, or incurs more than 50% of its capital expenditures or operating expenses through, any person described in (i), individually or in the aggregate. 31 C.F.R. 850.209.

A "person of a country of concern" includes (i) Chinese nationals, the Chinese government, and companies located, headquartered, or organized under the laws of China; (ii) any non-Chinese entity the majority of whose equity or board voting rights are owned or controlled, directly or indirectly, by one or more of the foregoing; and (iii) any other entity the majority of whose equity or board voting rights are owned or controlled by one or more entities described in (ii). 31 C.F.R. 850.221.

As explained in the Notice, the Treasury Department seeks to capture not only "persons of a country of concern" directly engaged in "covered activity," but also "those entities that, while not directly engaged in a covered activity themselves, are significantly financially connected to entities that are engaged in a covered activity." Notice at 23. Together, these concepts extend the restrictions to investment targets beyond Chinese borders and impose on U.S. persons an obligation, before making, directing, or supporting an investment in an entity or venture that is or will be engaged in "covered activity," to inquire into the upstream ownership and control of that entity or venture.

III. U.S. Persons are responsible for foreign entities they control and even some they do not.

A U.S. person (a U.S. citizen or permanent resident, entity organized under the laws of the United States, or person located in the United States) is subject to the prohibitions and reporting obligations of the Outbound Order whenever participating in a covered investment transaction in a covered foreign person. A U.S. person will also incur obligations in connection with transactions undertaken by any non-U.S. person entity that it controls, referred to as a "controlled foreign entity." 31 C.F.R. 850.206. But the proposed rule does not stop there. In some circumstances, a U.S. person would incur liability for investments made by an entity that it does not control.

First, the proposed rule includes as a category of "covered transaction" the investment by a U.S. person as a limited partner or equivalent ("LP") into a non-U.S. venture capital fund, private equity fund, fund of funds, or other pooled investment fund that invests in a covered foreign person. 31 C.F.R. 850.210. To incur liability for the fund's investment, the U.S. LP must know (or have reason to know) at the time of investing in the fund that it is likely to engage in investment activity that would be barred or reportable if undertaken by a U.S. person, even if the fund has not actually made any such investments to date.

Additionally, a U.S. person will be prohibited from "knowingly directing" a transaction that would be prohibited if undertaken by a U.S. person. 31 C.F.R. 850.303(a). Under the proposed rule, "a U.S. person 'knowingly directs' a transaction when such U.S. person has authority to make or substantially participate in decisions on behalf of a non-U.S. person entity and exercises that authority to direct, order, decide upon, or approve a transaction that would be a prohibited transaction if engaged in by a U.S. person." Notice at 54. The proposed provision specifies that a U.S. person would have authority "if such U.S. person is an officer, director, or senior advisor, or otherwise possesses senior-level authority."

Id. However, the U.S. person that has such authority and recuses themselves from an investment will not be considered to have "knowingly directed" the transaction. 31 C.F.R. 850.303(b).

Finally, certain transactions will be deemed "excepted" from restriction, even though they might involve the indirect investment by a U.S. person in a "covered foreign person," including:

- An investment by a U.S. person in a publicly traded security, including a security trading on a non-U.S. exchange or over the counter. 31 C.F.R. 850.501(a)(i).
- 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. 31 C.F.R. 850.501(a)(ii).
- An investment by a U.S. person LP that either does not exceed a specified percentage (50% of total committed capital) or a specified amount (under $1 million in the aggregate)—the rule currently proposes these as alternatives—in a pooled investment fund. 31 C.F.R. 850.501(a)(iii) (Alternatives 1 and 2).

In each of these cases, the transaction would not be "excepted" if the U.S. person acquired rights in a covered foreign person that exceed ordinary minority shareholder protections.

IV. Due diligence, contractual provisions, and compliance programs are critical– and save the receipts.

Penalties for violation of the Outbound Order and the new rules, issued under the authority of the International Emergency Economic Powers Act ("IEEPA"), 50 U.S.C. 1704, will be substantial and can include civil penalties of up to the greater of twice the value of the transaction or $368,136 (indexed for inflation) per violation. Willful violations are punishable by 20 years of imprisonment, a fine not to exceed $1 million, or both. 31 C.F.R. 850.701(A)(2).

Throughout the Notice, the Treasury Department emphasizes that whether or not a U.S. person will be liable turns largely on whether, at the time of engaging in an investment, that person had "knowledge" that it was a "covered transaction" subject to a prohibition or reporting requirement. "Knowledge" includes both "actual knowledge" and "reason to know" of a fact or circumstance's existence. 31 C.F.R. 850.216.

The determination of whether requisite knowledge exists to impose liability "will be made based on information a U.S. person had or could have had through a reasonable and diligent inquiry. A U.S. person that has failed to conduct a reasonable and diligent inquiry by the time of a given transaction may be assessed to have had reason to know of a given fact or circumstance, including facts or circumstances that would cause the transaction to be a covered transaction." 31 C.F.R. 850.104(b). In assessing whether a U.S. person has undertaken such a reasonable and diligent inquiry, the factors that will be relevant include:

- The due diligence questions asked of the counterparties prior to engaging in the transaction;
- Contractual representations sought;
- Examination of available public and non-public information;
- The presence or absence of warning signs, including evasion or refusal by the counterparty to provide relevant information; and

- Whether there is evidence that the investor or its representatives sought to purposefully avoid to obtain or share relevant information.

  31 C.F.R. 805.104(c).

In a similar vein, the Treasury Department will expect U.S. persons who control a foreign entity to take "reasonable steps" to ensure that the controlled foreign entity refrains from engaging in investment transactions that would be prohibited if undertaken by a U.S. person. In determining whether the relevant U.S. persons took all reasonable steps to prohibit and prevent such a transaction, the Department will consider, among other factors:

- The existence and implementation of periodic training and internal reporting requirements by the U.S. person and its controlled foreign entity;

- The implementation of appropriate and documented internal controls, "including internal policies, procedures, or guidelines that are periodically reviewed internally" by the U.S. person and its controlled foreign entity; and

- Implementation of "a documented testing and/or auditing process of internal policies, procedures, or guidelines."

  31 C.F.R. 805.302(b).

Because a U.S. person might be called upon to show that it conducted a "reasonable and diligent inquiry" regarding a transaction, or that it took "all reasonable steps" to prevent its controlled foreign entity from engaging in a covered transaction, it will be critical to document these efforts and retain the records for a period of at least 10 years to match the recent extension (Sec. 3111, Pub. L. 118-50) of the statute of limitations for enforcement actions under IEEPA.

The new rules can be expected to resonate throughout the U.S. private capital markets, and participants in those markets are well-advised to become familiar with the new prohibitions and reporting requirements imposed.

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