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Regulatory Update

Get Ready for the New Outbound Investment Security Program

By Keith Schomig, Talya Hutchinson, Ryan M. Poitras and Brad Dumbacher

The final regulations of the Outbound Investment Security Program, issued by the United States Department of the Treasury (the Treasury Department) on October 28, 2024 (the Final Rule), will become effective on January 2, 2025. The Final Rule implements a new regime that requires notification of (and in some instances, prohibits) investments by U.S. persons and U.S.-controlled entities where such investment could provide capital or intangible benefits (e.g., reputational benefits, managerial assistance, access to talent networks) and support the development of advanced technologies in, or by persons associated with, "countries of concern" in the areas of: (1) semiconductors and integrated circuits; (2) quantum computing, networking and communications; and (3) artificial intelligence. For now, the only "country of concern" is the People's Republic of China, including Hong Kong and Macau (collectively, China).

Except for a few key changes, discussed in detail below, the Final Rule is largely similar in substance and approach to the proposed regulations issued by the Treasury Department in June 2024 (the Proposed Rule). Once the Final Rule becomes effective, cross-border investors should be aware of its requirements and implement appropriate diligence and screening mechanisms to identify and ensure all regulatory conditions are met.

The Final Rule consists of two primary components: (1) a requirement that notification of certain transactions involving both a U.S. person and a "covered foreign person" (i.e., a person of a country of concern engaged in "covered activities" related to certain technologies and products) be provided to the Treasury Department by specified deadlines and (2) a prohibition on certain U.S.-person investments in a covered foreign person that is engaged in a more sensitive sub-set of activities involving identified technologies and products. As noted, China is the only jurisdiction currently identified in the Final Rule as a "country of concern" but additional jurisdictions may be identified by the Secretary of the Treasury Department (the Treasury Secretary) in the future.

The Final Rule addresses some ambiguities that were present in the Proposed Rule, provides guidance on the intended meaning of certain terms and addresses certain points that were raised and considered during the public notice and comment process following the publishing of the Proposed Rule. Below is a summary of the key changes between the Proposed Rule and the Final Rule and corresponding implications for persons involved in relevant transactions.

- Covered foreign persons: The Proposed Rule's obligations on U.S. persons extended beyond just transactions involving a "person of a country of concern" that engaged in a "covered activity"; the Final Rule clarifies the coverage of these requirements. Specifically, the Final Rule describes that

a person, wherever located, qualifies as a "covered foreign person" (and thus relevant transactions with such a person may be subject to notification or prohibition) if they hold (i) a voting interest, board seat, equity interest, or the power to direct or cause the direction of the management or policies of a person of a country of concern through contractual arrangements and (ii) more than 50 percent of the non-U.S. person's revenue, net income, capital expenditure or operating expenses is attributable to such person of a country of concern, individually or in the aggregate.

- Initial public offerings: In its commentary to the Final Rule, the Treasury Department included clarification on the scope of the Final Rule's exception for investments in publicly traded securities as applied to initial public offerings (IPOs). Specifically, the Final Rule states:

  > "The Treasury Department considers the acquisition of an equity interest in a covered foreign person that is not yet publicly traded for the purpose of facilitating an IPO, such as a purchase with the intent to create a market or to resell the security on a secondary market (e.g., as part of an underwriting arrangement), to be a covered transaction and declines to create an exception for such a transaction."

  Participants in an IPO must therefore be cognizant of the timing of their share purchase, as any purchase made prior to the relevant shares being publicly traded (i.e., available to the public generally and not just to IPO subscribers prior to listing) would not be eligible for the publicly-traded-securities exception.

- Carve-out for AI systems: The Final Rule emphasizes that the scope of covered activities related to AI systems is focused on entities that develop AI systems with applications that pose, or have the potential to pose, significant national security risks. Consistent with this policy objective, the Final Rule provides a carve-out for covered activities subject to notification and prohibition for entities that are solely engaged in customization, configuration or fine-tuning of a third-party AI model or machine-based system strictly for internal, non-commercial use (unless done for certain end-uses).

- Knowledge standard: Under the Proposed Rule, a U.S. person would have been subject to the regime's notification or prohibition requirements based on their knowledge of relevant facts or circumstances related to a given transaction. The Final Rule clarifies that whether relevant persons undertook a "reasonable and diligent inquiry" will be evaluated based on a consideration of "the totality of relevant facts and circumstances." The Treasury Department declined to provide a list of representative diligence questions that would constitute a "reasonable and diligent inquiry" and indicated that a U.S. person's efforts to review public and non-public information, obtain contractual representations and warranties and consider any warning signs or contradictory information could all be relevant factors in determining whether a "reasonable and diligent inquiry" was conducted.

- Recusal to avoid "knowingly directing" transactions: The Proposed Rule allowed U.S. persons to avoid participating in a prohibited investment decision via recusal, but it did not provide the specific actions that a U.S. person had to take to benefit from that carve-out. The Final Rule clarifies that a U.S. person will not be deemed to have "knowingly directed" a transaction by a non-U.S. person when the U.S. person recuses themselves from: (i) participation in formal approval and decision-making processes related to the transaction, including making a recommendation; (ii) reviewing, editing, commenting on, approving and signing relevant transaction documents; and (iii) engaging in negotiations with the investment target (or, as applicable, the relevant transaction counterparty, such as a joint venture partner).

- Limited partner investment exceptions: The Proposed Rule offered options for commentators to consider for an exception for U.S. person investments made as a limited partner (LP) in a pooled investment fund. After evaluating responsive public comments, the Treasury Department revised the exemption so that, in the Final Rule, LP investments of $2 million or less in a pooled investment fund are considered an excepted transaction. Under the Final Rule, a U.S. person's LP investment in a pooled investment fund is also considered an excepted transaction if the U.S. person obtains

a binding contractual assurance that its capital in the fund will not be used to engage in a transaction that would be a prohibited transaction or a notifiable transaction if engaged in by a U.S. person.

- Additional covered transaction exceptions: The Final Rule includes additional exceptions to the definition of covered transactions that were not included in the Proposed Rule, including: (i) an exception for receipt of employment compensation in the form of stock or stock options, or the exercise of such options; (ii) an exception for derivative transactions if the derivative does not confer the right to acquire equity, any rights associated with equity or assets of the entity; (iii) an exception for intracompany transactions between a U.S. person parent and its controlled foreign entity that supports new operations that are not covered activities or maintains ongoing operations (including existing covered activities); and (iv) an exception for investments made pursuant to binding, uncalled capital commitments established prior to January 2, 2025.

- Certain debt transactions: The Final Rule also includes certain clarifications relevant to debt transactions. Specifically, under the Final Rule, neither the issuance of a secured loan or similar debt financing for which equity is pledged as collateral, nor the acquisition of secured debt on the secondary market, is considered an acquisition of an entity interest. However, foreclosure on collateral where the debtholder acquires pledged equity *is* considered an acquisition of an equity interest if the equity was not pledged prior to January 2, 2025, or the U.S. person knew at the time of issuing or acquiring the debt that the pledged equity was in a covered foreign person.

- Treasury disclosure of non-public information: The Final Rule notably allows the disclosure of non-public information provided under the regime when the Treasury Secretary determines such disclosure is in the "national interest of the United States." The factors that the Treasury Secretary may consider include whether disclosure will further national security interests, address law enforcement needs, or promote compliance with the Final Rule. The Final Rule indicates that such a determination may not be delegated below the Assistant Secretary level and "anticipates this exception to be invoked rarely."

The Treasury Department has indicated that it anticipates providing additional information regarding the Final Rule through its Outbound Investment Security Program website as well as through further stakeholder outreach. An advisory opinion process to allow parties to request a formal determination of whether a particular transaction is a covered transaction is not contemplated in the Final Rule but has been included in recent legislative proposals in Congress.

The Outbound Investment Security Program is a new tool in the broader toolkit of the U.S. government's regulation of cross-border investment. Compliance with the Final Rule will require due diligence and screening mechanisms as well as close monitoring of the Treasury Department's practical implementation of the Final Rule. Paul Hastings global-trade experts are following these developments and are available to assist with any compliance-related matters pertaining to the Final Rule.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Keith Schomig
1(202) 551-1880
keithschomig@paulhastings.com

Talya Hutchison
1(202) 551-1930
talyahutchison@paulhastings.com

Ryan M. Poitras
1(202) 551-1977
ryanpoitras@paulhastings.com

Bradley D. Dumbacher
1(202) 551-1794
braddumbacher@paulhastings.com