

To read the Executive Order, please [click here](#).

To read the Advance Notice of Proposed Rulemaking from August 2023, please [click here](#).

To read the Notice of Proposed Rulemaking, please [click here](#).

The NPRM reflects input from public comments as well as U.S. engagement with allies and partners.

Report from Washington

Treasury Issues Proposed Rule on Outbound Investment Security Program

June 24, 2024

On June 21, 2024, the U.S. Department of the Treasury (“Treasury”) issued a Notice of Proposed Rulemaking (“NPRM”) in connection with its highly anticipated Outbound Investment Security program, including full draft regulations that will make up the new regime. The NPRM follows the issuance of President Biden’s August 2023 Executive Order (the “Order”) (the details of which we previously covered in this [client alert](#)) and the corresponding Advance Notice of Proposed Rulemaking (“ANPRM”). As previously noted, the new regime is intended to regulate investment from the United States into China or Chinese companies relating to three key sectors: (1) semiconductors and microelectronics; (2) quantum information technologies; and (3) artificial intelligence. Unlike the Treasury chaired Committee on Foreign Investment in the United States (“CFIUS”), the NPRM sets forth a regime that does not include case-by-case review of every covered transaction. The new regime, if finalized as drafted, will prohibit certain transactions and require notifications of other transactions to Treasury.

The NPRM reflects Treasury’s consideration of the public comments received during the initial 45-day public comment period for the ANPRM that ended on September 28, 2023. Based on those comments, the NPRM’s proposed rule differs in some key respects from the proposed rule in the ANPRM. Namely, the NPRM has refined the scope of coverage of transactions involving AI systems, the knowledge standard for covered transactions, the scope of the prohibition on U.S. persons “knowingly directing” certain transactions, and the scope of limited partner (“LP”) investments that would be covered by the proposed rules. In addition, the NPRM contains a new exception for transactions involving persons of third countries with similar outbound investment regimes, reflecting Treasury’s continued engagement with U.S. allies and partners on similar proposals.

These adjustments to the pending regime’s regulations reflect the Biden administration’s efforts to limit economic restrictions on U.S. business with China to its “small yard, high fence” approach to regulation, which focuses on protecting a narrow scope of technologies that pose significant national security concerns. Treasury will collect comments to the NPRM until August 4, 2024, so we would not expect the finalization of the regulations until late

2024. Separately, members of Congress have continued to advocate for different approaches to outbound investment regulation, which could result in additional changes to this regime going forward.

Recap of Sectors and Transactions Covered by the New Regime

As noted above, the underlying Order identified three categories of national security technologies and products that would be subject to the forthcoming regime: (1) semiconductors and microelectronics; (2) quantum information technologies; and (3) artificial intelligence. The ANPRM preliminarily identified the types of activities and technologies for which U.S. investment would be prohibited or notifiable within each of these three sectors. The annex to this alert reflects the types of activities and technologies that would be subject to the rule if the NPRM is adopted.

In terms of the covered technologies, the NPRM includes refined definitions of “artificial intelligence” and “AI system,” which are consistent with President Biden’s October 2023 Executive Order on *Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence* (the details of which we previously covered in this previous [client alert](#)). The ANPRM previously defined AI system as “an engineered or machine-based system that can, for a given set of objectives, generate outputs such as predictions, recommendations, or decisions influencing real or virtual environments. AI systems are designed to operate with varying levels of autonomy.” The NPRM more specifically defines an AI system as: “[a] machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations, or decisions influencing real or virtual environments...,” as well as “[a]ny data system, software, hardware, application, tool, or utility that operates in whole or in part using a [previously described] system.” The NPRM notes that Treasury invites additional comments on the definition of AI system. As with the ANPRM, the NPRM restrictions focus on a subset of AI designed for or intended for certain end-uses, with a particular focus on weapons, intelligence, and surveillance capabilities. The restrictions are not designed to broadly capture AI intended only for commercial applications or other civilian end uses.

Under the NPRM, covered transactions include acquisitions of equity interests (*e.g.*, mergers and acquisitions, private equity, and venture capital investments), contingent equity interests, certain debt financing transactions, greenfield and brownfield opportunities, joint ventures, and certain LP investments by U.S. persons. As previously contemplated by the ANPRM, excepted transactions include: publicly traded securities, certain LP investments, buyouts of a country of concern ownership, intracompany transactions, and certain syndicated debt financings. In addition, the NPRM makes clear that transactions made after

The NPRM further clarifies the scope of coverage for transactions involving LPs and the related exception.

Transactions made after the effective date of the pending regulations pursuant to a binding, uncalled capital commitment entered into before August 9, 2023 are excepted.

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The NPRM notably introduces a new exception for transactions involving third-country persons where Treasury determines that such countries have regimes in place that adequately address the national security concerns posed by outbound investment. No such regimes have come to fruition yet, but various proposals, including in the European Union, have taken shape since the G7 agreed to explore the issue at the May 2023 Leaders' Summit in Hiroshima, Japan.

U.S. Persons and Covered Foreign Persons

Consistent with the ANPRM, the NRPM defines U.S. person as “any United States citizen, lawful permanent resident, entity organized under the laws of the United States or any jurisdiction within the United States, including any foreign branch of any such entity, or any person in the United States.” In addition, the NPRM includes a definition of “controlled foreign entity” (which was not included in the ANPRM) as “any entity incorporated in, or otherwise organized under the laws of, a country other than the United States of which a U.S. person is a parent.” As a result, U.S. asset managers and their controlled subsidiaries outside of the United States could qualify as U.S. persons and controlled foreign entities, respectively, under the proposed regulations.

A covered foreign person is either: (1) a person of a country of concern that engages in a covered activity involving the covered technologies or products; or (2) a person that directly or indirectly holds any voting interest, board seat, or equity interest in any of the aforementioned persons described in (1), or holds any power to direct or cause the direction of the management or policies of any such person through one or more contractual arrangements, where the person (i) derives more than 50 percent of its revenue from an aforementioned person, (ii) derives more than 50 percent of its net income from an aforementioned person, (iii) incurs more than 50 percent of its capital expenditure through an aforementioned person, or (iv) incurs more than 50 percent of its operating expenses through an aforementioned person. The proposed regulations also note that variable interest entities are included in this latter category.

As a result, the non-U.S. funds of U.S. asset managers could be covered under this definition should they have the requisite nexus to a country of concern (currently, China, Hong Kong, or Macau). In addition, the U.S. funds and portfolio companies of non-U.S. asset managers could also be covered.

Transactions Involving LPs

The NPRM sets forth two separate categories of potential coverage of LP investments in a broadly defined pooled investment fund. First, with respect to investments into a non-U.S. person pooled investment fund, and separately an exception for certain LP investments into certain pooled investment funds.

For investments into non-U.S. pooled investment funds, investments where the U.S. LP knows at the time of the investment that the pooled fund will likely invest in a covered foreign person involved in covered technologies are “covered transactions.” In short, for a U.S. LP investment into non-U.S. pooled funds to be covered, the U.S. LP would need to know that the pooled fund is likely to invest in a covered foreign person and such pooled fund would need to undertake a transaction that would be covered if undertaken by a U.S. person. A U.S. LP may be considered to know or have reason to know that the non-U.S. pooled investment fund would likely invest in a covered foreign person based on, among other factors, (i) past investments made by a pooled fund’s manager or sponsor, (ii) engaging with the pooled investment fund’s general partner, or (iv) reviewing such fund’s prospectus or other documentation, including for geography and sector focus.

In terms of the LP exception, the NPRM proposes two alternative approaches for excepted transactions by U.S. person LPs. Under proposed Alternative 1, a U.S. person’s investment as an LP in a pooled fund is an excepted transaction if the LP’s rights are consistent with a passive investment and (a) the LP’s committed capital is not more than 50 percent of the total assets under management of the pooled fund (including any co-investment vehicles that make up a fund) or (b) when the fund is not a U.S. person or controlled foreign entity, the LP has secured contractual commitments that its capital will not be used to engage in transactions that would cause it to indirectly violate the regulations. Under proposed Alternative 2, a U.S. person’s investment as an LP in a pooled fund is an excepted transaction if the LP’s committed capital is not more than \$1 million (aggregated across investment vehicles and co-investment vehicles that make up a fund). Notably, and consistent with the ANPRM, the exception would not apply if the transaction affords the U.S. person rights beyond standard minority shareholder protections with respect to the covered foreign person. The NPRM clarifies, however, that an LP’s participation on an advisory board or committee of an investment fund does not qualify as a right beyond standard minority shareholder protections so long as the board or committee does not have the ability to approve, disapprove, or otherwise control investment decisions or decisions made by the general partner, managing member, or equivalent.

Consistent with the ANPRM, the NPRM also acknowledges that certain prohibited transactions may be exempted in exceptional circumstances if they would provide significant benefits to national security or the national interest and a process to request such an exception will be over seen by Treasury.

Additional Changes to Note

Additional differences between the ANPRM and NPRM include:

“Knowledge” Standard: The knowledge standard previously included a criterion that a U.S. person “reasonably should know” if a transaction is covered. The standard has been changed to apply only when a U.S. person has knowledge or reason to know of the relevant facts or circumstances at the time of the transaction. The definition of knowledge includes actual knowledge, awareness of the probability that a fact or circumstance exists or is substantially certain to occur, or reason to know of a fact or circumstance’s existence. Treasury will take into consideration adequate due diligence on a transaction to determine whether a U.S. person had in fact “knowledge.”

“Knowingly Directing” Transactions: As noted in our prior client alert, the Outbound Investment Security program has also drawn on principles from other national security regulatory regimes, including economic sanctions and export controls programs. The ANPRM contained a provision that would bar U.S. persons from “knowingly directing” an otherwise prohibited transaction if such a transaction were undertaken by a U.S. person, similar to so-called “facilitation” prohibitions in U.S. sanctions programs. In response to public comments on the ANPRM, Treasury updated the definition to clarify that a U.S. person “knowingly directs” such a transaction where the U.S. person “has authority, individually or as part of a group, to make or substantially participate in decisions on behalf of a non-U.S. person, and exercises that authority to direct, order, decide upon, or approve a transaction. Such authority exists when a U.S. person is an officer, director, or senior advisor, or otherwise possesses senior-level authority at a non-U.S. person.” The NPRM notes that this change was intended to clarify that ordinary third-party services such as banking services or routine administrative work are not included within the scope of this provision.

Looking Ahead

The public again has 45 days to file comments with Treasury in response to the NPRM, after which Treasury will finalize the regulations. We would not expect the regime to come into force until late 2024 at the earliest. Until then, asset managers, investors, and other players in the financial services space (including lenders with conversion rights), should evaluate

which of their financial activities are likely to be deemed within scope of the new regime, both because they might involve “U.S. persons” and because they might involve sensitive technologies. Like the ANPRM, the NPRM notes that the regulations are not intended to have retroactive applicability, and the prohibitions under the program will only apply after the effective date of the final regulations.

In addition, proposed legislation in Congress has the potential to shape the future contours of an outbound regime. Bills such as the National Critical Capabilities Defense Act, the Outbound Investment Transparency Act, and the Preventing Adversaries from Developing Critical Capabilities Act would codify and/or expand on the existing prohibitions proposed by Treasury. That being said, proposed legislation would likely not impact the current implementation of the NPRM.

Simpson Thacher & Bartlett LLP is experienced in navigating the complexities of foreign investment screening and the CFIUS review process, 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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Annex

Sector	Activities and Technology Proposed to Be Prohibited	Activities and Technology Proposed to Be Notifiable
Semiconductors & Microelectronics	<p>(i) Specific technology, equipment, and capabilities that enable the design and production of integrated circuits or enhance their performance</p> <p>(ii) Advanced integrated circuit design, fabrication, and advanced packaging capabilities for any integrated circuit</p> <p>(iii) The installation or sale of certain supercomputers, which are enabled by advanced integrated circuits</p>	Design, fabrication, and packaging of certain other integrated circuits that do not fall within a category that is prohibited
Quantum Information Technologies	<p>(i) Quantum computers and components, dilution refrigerators, or two-state pulse tube cryocoolers</p> <p>(ii) Quantum sensors designed to be used exclusively for military end uses, government intelligence, or mass surveillance</p> <p>(iii) Quantum networking and communications systems designed to be used exclusively for secure communications</p>	None under consideration

<p>Artificial Intelligence</p>	<p>Development of any AI system designed to be exclusively used for OR intended for use for any military, government intelligence, or mass surveillance end uses.</p> <p>Alternatives for a prohibition on covered transactions related to the development of any AI system that is trained using a specified quantity of computer power, and trained using a specified quantity of computing power using primarily biological sequence data. <i>[NPRM requires comments on this specific point.]</i></p>	<p>Development of any AI system designed to be used for <i>[not exclusively]</i> any government intelligence, mass surveillance, or military end use, or intended for use in cybersecurity applications, digital forensics tools, and penetration testing tools; the control of robotic systems, or is trained using a specified quantity of computing power.</p>
<p>Catch all</p>	<p>Engages in any covered activity with an entity that is:</p> <p>(a) Included on the Entity List (15 CFR Part 744, supplement no. 4);</p> <p>(b) Included on the Military End User List (15 CFR Part 744, supplement no. 7);</p> <p>(c) Meets the definition of “Military Intelligence End-User” in 15 CFR §744.22(f)(2);</p> <p>(d) Included on the U.S. Department of Treasury’s list of Specially Designated Nationals and Blocked Person (SDN List) or is an entity which one or</p>	<p>N/A</p>

	<p>individual or entities included on the SDN List, individually or in the aggregate, directly or indirectly, own a 50 percent or greater interest;</p> <p>(e) Included on the U.S. Department of the Treasury's list of Non-SDN Chinese Military-Industrial Complex Companies (NS-CMIC List); or</p> <p>(f) Designated as a foreign terrorist organization by the Secretary of State under 8 U.S.C. 1189.</p>	
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