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Biden administration releases proposed rule on outbound investments in China

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The Biden administration released its proposed rule that would establish a regulatory framework for outbound investments in China, following its advanced notice of proposed rulemaking released last August.

On June 21, 2024, the U.S. Department of the Treasury (Treasury) released its long-awaited notice of proposed rulemaking that would impose controls on outbound investments in China (the Proposed Rule). The Proposed Rule follows Treasury's advanced notice of proposed rulemaking (the ANPRM) released in August 2023 (discussed in this client update) and implements the Biden administration's Executive Order 14105 (the Executive Order), which proposed a high-level framework to mitigate the risks to U.S. national security interests stemming from U.S. outbound investments in "countries of concern" (currently only China). Like the Executive Order and ANPRM, the Proposed Rule reflects an effort by the Biden administration to adopt a "narrow and targeted" program and is in large part directed at the "intangible benefits" of U.S. investment (e.g., management expertise, prestige, and know-how), rather than capital alone.[1]

Consistent with the ANPRM, the Proposed Rule would:

- prohibit or impose notification requirements
- on investments by U.S. persons and entities they control (primarily, but not exclusively, acquisitions of non-publicly traded equity)
- in companies based in China or owned by Chinese interests
- conducting targeted activities in one of three sectors:
  - semiconductors and microelectronics,
  - quantum information technologies, and
  - certain applications of artificial intelligence (AI).

It is **not** the case that all investments in these sectors are restricted; the Proposed Rule provides detailed criteria for which activities render an investment prohibited or notifiable.

While the Proposed Rule generally follows the approach laid out in the ANPRM and makes some changes in response to comments received, a number of significant challenges remain.

- Most importantly, the Proposed Rule provides little or no guidance on how to evaluate the potential future development of early-stage companies whose final products and markets may be unclear and how long the time frame should be.
- The Proposed Rule's requirements are based on the investor's knowledge that the target is engaged in restricted activities, but it also incorporates a broad definition of "knowledge" that contemplates a detailed examination (and, perhaps, second-guessing) of the investor's due diligence process.

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- While the Proposed Rule targets equity investments, it also has important implications for lenders (who may face difficulty in executing on collateral or receiving equity in insolvency proceedings).
- The Proposed Rule contains two radically different alternative restrictions on U.S. institutional investment in non-U.S. private equity, venture capital, and other funds potentially making restricted investments in China (one limiting U.S. limited partners (LPs) to 50 percent of a fund and one limiting U.S. LPs to a maximum investment of $1 million).
- As a practical matter, the Proposed Rule may require ongoing monitoring of U.S. investments in companies that may engage in covered activities in China or with Chinese companies, as there are poorly defined requirements to provide updated information to Treasury as additional information is acquired.

To the extent the language of the Proposed Rule is broad or vague, the burden of interpretation falls on U.S. investors. There is no provision for case-by-case review and investors are responsible for making their own determinations as to whether an investment is restricted, at their own risk.

Treasury has requested comment on the Proposed Rule, including specific feedback on proposed definitions and standards for covered technologies and transactions. Comments are due by August 4, 2024.

Structure of the Proposed Rule and revisions to the ANPRM

The Proposed Rule would impose prohibitions or notification requirements on "U.S. persons" in connection with "covered transactions" that would involve or create a "covered foreign person." A covered foreign person is a "person of a country of concern" (currently only China) that engages in certain "covered activities" (such as research, development, or manufacturing) involving "covered national security technologies and products," which are sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and AI sectors that have military, intelligence, surveillance, or cyber-enabled capabilities. Depending on the nature of the "covered activity," a covered transaction may be prohibited (prohibited transactions) or require notification to Treasury (notifiable transactions).

Treasury received a number of comments in response to the ANPRM, which among other things, requested that Treasury broaden the scope of transactions that are excepted from the scope of the rule, narrow the activities and technologies covered (particularly with respect to AI), align the rule's technical standards with other federal regulatory schemes, and clarify compliance standards and expectations for U.S. investors. Treasury made a number of changes in response to comments, including, among other things:

- Proposing a broad "knowledge" standard (that covers actual and constructive knowledge) and specifying due diligence expectations for U.S. persons;
- Updating the scope of AI-related technologies covered by the Proposed Rule to align with the Biden administration's recent Executive Order 14110 on AI safety and security standards;
- Proposing standards used to determine when an LP investment is covered by the rule; and
- Expanding the categories of covered transactions to include debt financing that provides management or governance rights.

What does the Proposed Rule cover?

The core concept in the Proposed Rule is a "covered foreign person," which would mean an entity that is (1) Chinese or has a majority of its activities in China, and (2) engages in a covered activity. (The Proposed Rule applies generally to a "person of a country of concern"; currently, however, the only "country of concern" is China, including Hong Kong and Macau, though it is possible that the outbound investment control regime could later be expanded to other countries.)

What entities are potentially targeted?

Chinese entities

The base definition of "person of a country of concern" is straightforward. A "person of a country of concern" means: (a) any citizen or permanent resident of a country of concern that is not a U.S. citizen or permanent resident; (b) an entity

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with a principal place of business in or incorporated in a country of concern; (c) the government of a country of concern and entities that are 50 percent or more state-owned; and (d) any entity that is 50 percent or more owned or controlled, directly or indirectly, by any of the foregoing.[2]

Non-Chinese entities

The Proposed Rule would also capture entities that are not based in China or Chinese-owned if more than half of their activities are based in China. Specifically, a non-Chinese entity would be covered if (1) it holds any voting or equity interest (regardless of size) in, or board seat or power to direct or cause the direction of management or policies of, a covered Chinese entity, and (2) 50 percent or more of its revenue, net income, capital expenditure, or operating expenses are attributable to a Chinese entity engaged in a covered activity, based on its most recent financial statement. For example, this may capture a non-Chinese company that derives 50 percent or more of its revenue from a subsidiary in China that manufactures a covered technology.

Sanctioned persons

The Proposed Rule effectively expands sanctions against Chinese entities (or entities with a majority of their activities in China, as above) if they are also subject to U.S. export controls or sanctions. Entities on the Military End-User List, Military Intelligence End-User List, or Entity List maintained by the Department of Commerce, or the Chinese Military-Industrial Complex List maintained by the Office of Foreign Assets Control (OFAC),[3] will be subject to the Proposed Rule's investment restrictions if they engage in any covered activity (even if it is only notifiable rather than prohibited activity).

What activities are targeted?

The Proposed Rule would apply to investments in a person of a country of concern engaged in **covered activities**. Depending on the nature of those activities, the transaction would either be prohibited or notifiable. The covered activities that make a transaction notifiable versus prohibited are distinct and are not intended to overlap. Generally, activities and technology that are deemed to present the most acute national security concerns (e.g., development of AI technologies with mass-surveillance capabilities) would be prohibited, while other designated activities would be subject to notification requirements. The covered activities outlined in the Proposed Rule are generally consistent with the ANPRM, though, in some cases, actions underlying the activities have been further defined or additional end-use limitations have been added.

Targeted industries

The three industries currently targeted are:

- **Semiconductors and microelectronics.** Supercomputers; electronic design automation software; certain fabrication and advanced packaging tools; certain software, equipment, or advanced packaging techniques related to the development of integrated circuits; and the design or fabrication of integrated circuits with special characteristics.
- **Quantum information technologies.** The development of quantum computers and critical components of quantum computers; the development of quantum sensing platforms; and the development of networks or communication systems designed or intended to scale up the capabilities of quantum computers, secure communication, or any military, government intelligence or mass-surveillance end use.
- **AI systems.** The development of any AI system that is designed exclusively for or intended to be used for military, government intelligence, or mass-surveillance end uses or that is trained using a specified quantity of computing power.

Covered activities may be either prohibited or notifiable and Treasury has indicated that it is likely to add to this list in the future as it gathers information and national security threats evolve.

A detailed breakdown of the criteria for inclusion is attached as **Appendix A**, but a high-level summary follows:

Prohibited activities

Semiconductors and microelectronics

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- Developing or producing design automation software for integrated circuit design or packaging;
- Developing or producing equipment for semiconductor fabrication, volume advanced packaging, or extreme ultraviolet lithography;
- Designing or fabricating integrated circuits exceeding specified performance characteristics;
- Using advanced integrated circuit packaging techniques; and
- Developing, installing, selling, or producing supercomputers exceeding specified performance criteria.

Quantum information technology

- Developing or producing quantum computers or critical components;
- Developing or producing quantum sensing platforms intended for military, intelligence, or mass-surveillance end uses; and
- Developing or producing quantum networks or quantum communication systems intended for scaling quantum computing, secure communications, or military, intelligence, or mass-surveillance end uses.

AI systems

- Developing AI systems designed exclusively for or intended to be used for military, government intelligence, or mass-surveillance end uses; and
- Developing AI systems trained using more than a specified quantity of computing power.

Notifiable activities

Semiconductors and microelectronics

- Fabricating any integrated circuit, other than prohibited integrated circuits; and
- Packaging any integrated circuit, other than prohibited packaging.

Quantum information technology

No notifiable activities.

AI systems

- Developing non-prohibited AI systems designed for any military, government intelligence, or mass-surveillance end use (i.e., AI systems that are not designed exclusively for such uses);
- Developing AI systems intended for cybersecurity, digital forensics, or penetration testing;
- Developing AI systems intended for controlling robotic systems; and
- Developing AI systems trained using more than a specified quantity of computing power (presumably lower than the prohibition threshold).

What does “engages in covered activities” mean?

One significant potential source of ambiguity in the Proposed Rule is the absence of any definition of whether a company that qualifies as a person of a country of concern “engages in” a covered activity. The Proposed Rule considers and rejects a *de minimis* threshold for covered activities, and leaves unaddressed two critical questions: (1) the timeline upon which a company’s activities should be assessed and (2) the treatment of subsidiaries and affiliates of the company in which a U.S. person invests.

The question of timing raises a number of issues. A company may not currently be engaged in a covered activity, but it may have plans, of greater or lesser definiteness, to potentially engage in covered activities in the future. While the Proposed Rule uses the present tense “engages,” it also seems intended to capture investments in companies that plan to engage in covered activities—but, if so, how definite the plans must be and how far into the future the investors must look are left unaddressed. A company may also be engaged in the early-stage development of products or technologies

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that could foreseeably have potential applications in covered sectors, but what those applications may be, the technical performance that will be achieved, and the timeline for development (much less the ultimate end users or end uses of the technology once developed) are all potentially ambiguous. For rules based on technical performance characteristics, it also may well be that a company's current products fall well short of the thresholds—but technology evolves rapidly, and performance that is at the cutting edge today may well be in the middle of the pack for a lower-end producer (and therefore a reasonably predictable goal of the business) in 10 years. The Proposed Rule provides no guidance on how far into the future an investor must look, other than the vague "knowledge" standard discussed below.

The question of affiliate activities is also left unclear. Presumably, the Proposed Rule is intended to capture activities by subsidiaries of a person of a country of concern but the language, as drafted, is not clear (and characterizing investment in a parent as an "indirect" investment in its subsidiaries is inconsistent with the 50 percent rule for non-Chinese entities that may have Chinese subsidiaries engaged in covered activities). It is less clear whether investments in a corporate entity that may hold or make minority investments in covered foreign persons (for example, a Chinese bank or technology company) qualifies as "engaging" in covered activities. The Proposed Rule is also silent on whether a covered investment would include an investment in a company that does not itself engage in covered activities but is a subsidiary or affiliate of a covered foreign person (and therefore such investments are presumably not covered).

Who is a "U.S. person" required to comply with the rule?

The Proposed Rule would apply to "U.S. persons," which includes:

- any United States citizen or lawful permanent resident ("green card" holder);
- any entity organized under the laws of the United States or any jurisdiction within the United States, including any foreign branch of any such entity; and
- any person located in the United States.

Thus, the Proposed Rule can apply to persons located outside the United States, including persons employed by a non-U.S. company. For example, a Chinese citizen working in China who is also a U.S. citizen or green card holder would be bound by the Proposed Rule. The Proposed Rule also would apply to all persons and entities in the United States, which means a non-U.S. person would be required to comply with the Propose Rule (including with respect to any management or ownership role that person may have in a non-U.S. company) while in the United States.

The Proposed Rule also imposes requirements on a U.S. person with respect to any "controlled foreign entity" to which it is a "parent" (meaning directly or indirectly controlling a majority of the voting interest, acting as the general partner or managing member, or acting as an investment adviser to a pooled investment fund).[4] U.S. persons would be required to (1) take "all reasonable steps to prohibit and prevent" the controlled foreign entity from conducting a transaction that would be prohibited for a U.S. person and (2) notify Treasury of any notifiable transactions undertaken by the controlled foreign entity. "All reasonable steps" can include both the affirmative exercise of governance rights and the imposition of compliance policies and internal controls on a controlled entity.[5]

Finally, the Proposed Rule would prohibit a U.S. person from "knowingly directing" a non-U.S. person to engage in a transaction prohibited for a U.S. person (whether or not it is a controlled foreign entity). "Knowingly directing" includes having the authority "to make or substantially participate in decisions on behalf of a non-U.S. person" and exercising that authority "to direct, order, decide upon, or approve a transaction," including as part of a collective decision. Authority is presumed if the U.S. person is an officer, director, or senior advisor, or otherwise possesses senior-level authority,[6] but U.S. persons can avoid participation by recusing themselves from decision-making regarding a covered transaction. While the Proposed Rule indicates that the mere provision of services or performance of administrative tasks is not intended to be covered, it also explicitly leaves open the question of whether a U.S. person should be prohibited from "overseeing" a prohibited investment after completion.

Notably, there is no general "facilitation" prohibition, nor is there a prohibition on conducting transactions within U.S. jurisdiction. As explained above, U.S. entities that are merely service providers, such as banks processing payments, are not subject to the Proposed Rule's prohibitions or reporting requirements

What investments are covered?

The Proposed Rule primarily targets equity investments, but the scope of the rule's definitions are broad and have important implications for transactions well beyond the purchase of shares in Chinese companies.

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Equity

In the simplest case, the Proposed Rule covers an acquisition of an equity interest, a contingent equity interest, or an interest equivalent to an equity interest or contingent equity interest in a covered foreign person. An “equivalent” interest is not defined, which leaves ambiguity as to whether interests such as profit-sharing, “phantom stock,” carried interest acquired by employees, or economic exposure through derivative transactions might also be included.

Contingent equity interests are also evaluated both upon acquisition and upon conversion, such that if a U.S. person acquires (for example) a warrant to acquire stock in a company that is not, at the time the warrant is acquired, a covered foreign person, but the company later engages in new activities that make it a covered foreign person, exercise of the warrant may be prohibited.

The primary exceptions are for equity that is publicly traded (in any market) and any equity issued by an “investment company” under the Investment Company Act of 1940 that is registered with the Securities and Exchange Commission (as well as derivatives upon such investment companies, which implies that derivatives with equity of a covered foreign person as a reference security may be covered). The Proposed Rule also excepts acquisitions of all equity held by persons of a country of concern that result in a target entity no longer constituting a covered foreign person and investments by U.S. persons in their own controlled foreign entities that support ongoing activities not targeted by the Proposed Rule.

Debt

Debt transactions are not, standing alone, covered transactions, unless the debt is by its terms convertible to equity or permits the lender to “make management decisions” or appoint members of the board of directors. “Make management decisions” is not defined; while one would assume that market standard covenants are not intended to be covered, no clear guidance is provided.

However, even pure debt transactions may give rise to a covered transaction if they result in the acquisition of equity, such as where the lender executes upon collateral including equity of a covered foreign person or debt is converted to equity in an insolvency proceeding. In other words, traditional debt enforcement mechanisms could be impaired where the borrower is a covered foreign company. An exception is provided for acquisitions upon default where U.S. lenders are loan syndicate participants that do not have a lead role and cannot themselves initiate action.

Asset acquisitions

The Proposed Rule targets the establishment of new ventures (or the expansion of existing ventures) in China by including as a covered investment the “acquisition, leasing, or other development of operations, land, property, or other assets” that the U.S. person intends to establish a new “covered foreign person” or permit a Chinese entity to embark on new covered activities. This appears to be aimed at investments through affiliates that might not result in new equity interests.

Joint ventures

The Proposed Rule’s definition of a covered investment would also include a U.S. person’s “entrance into a joint venture, wherever located, that is formed with a person of a country of concern” if the U.S. person “knows” or “intends” that the joint venture will engage in a covered activity. “Joint venture,” however, is left undefined and the scope of the provision is not entirely clear. The easiest case appears to be a newly formed legal entity created by one U.S. person and one person of a country of concern for the purpose of engaging in covered activities, but the Proposed Rule provides no guidance as to the level of Chinese ownership required (for example, what if an entity is owned by a consortium of five persons?) or whether contractual joint ventures (for example, joint R&D or marketing agreements) might be covered.

Investment funds and other indirect investments

One of the biggest points of ambiguity is the coverage of U.S. person investments in non-U.S. private equity, venture capital, or similar funds controlled by foreign persons. Assuming that the investment is a typical LP interest with no governance rights, LP investments in a non-U.S. pooled investment fund are covered where (1) the U.S. person LP knows at the time of the investment that the fund is “likely” to invest in the relevant industries in China, and (2) the pooled investment in fact undertakes a transaction that would be a covered transaction if conducted by a U.S. person.

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This basic approach will be governed by one of two primary proposed exceptions with radically different implications for U.S. institutional investors. Under the first proposal, investments in a foreign fund would be exempt unless a U.S. limited partner's total interest exceeds 50 percent of the fund's total capital. That would, as a practical matter, exempt most passive private equity investments from the Proposed Rule, consistent with the treatment of passive investment in publicly traded securities. Under the second proposal, only investments in which the limited partner's total commitment to the fund is less than $1 million would be excepted, which would severely curtail the activities of U.S. institutional investors. The Proposed Rule would also exempt meeting binding capital commitments entered into prior to August 9, 2023 (the date of the Executive Order).

Furthermore, the Proposed Rule would apply to "indirect covered transactions," meaning that a transaction would be a covered transaction "regardless of the number of intermediary entities involved in such transaction." While there are some obvious cases (such as the example given in the Proposed Rule where a U.S. person makes an investment through a non-U.S. special purpose vehicle), as noted above, the implications may be more far-reaching for investments in large entities that may arguably have covered activities in an immaterial subsidiary.

What do "knowledge" and "intent" mean?

A U.S. person is required to comply with the prohibition or notification requirements when entering into an investment if the U.S. person *knows at the time of the transaction* that the counterparty is a covered foreign person. However, the definition of "knowledge" is much broader than actual knowledge and potentially opens U.S. investors to second-guessing.

The definition of "knowledge" not only includes **actual knowledge** that a fact or circumstance exists or is substantially certain to occur, but also an **awareness of a high probability** of a fact or circumstance's existence or future occurrence, or **reason to know** of a fact or circumstance's existence. In assessing whether a U.S. person had reason to know of a fact or circumstance's existence at the time of the transaction, Treasury will not rely solely on subjective knowledge or expectation but also whether the investor conducted a "reasonable and diligent inquiry." Treasury has indicated that it will consider the following factors, among others, in determining whether a reasonable and diligent inquiry was conducted:

- Diligence inquiries made of the target or counterparty by the investor or its counsel;
- Contractual representations or warranties obtained or sought relating to whether a counterparty is a covered foreign person and whether a transaction is a covered transaction;
- Efforts made to obtain and review available non-public information relevant to determine whether a counterparty is a covered foreign person and a transaction is a covered transaction;
- Use of public and commercial databases to identify and verify relevant information of an investment target or relevant counterparty;
- Available public information at the time of the transaction, efforts by the U.S. person to review such information, and the degree to which such information is consistent or inconsistent with other information available to the U.S. person;
- The presence or absence of warning signs (which may include evasive responses or non-responses from an investment target or refusal to make certain representations and warranties) and any purposeful avoidance of learning or sharing information by the U.S. person; and
- In the context of LP investments, where knowledge of what a fund is "likely" to do is relevant, facts such as the fund's investment history or geographies and sectors of focus.

Treasury has stated that a reasonable and diligent inquiry can be a shield from violation of the Proposed Rule's requirements; if after a reasonable and diligent inquiry a U.S. person still is not aware of a fact that would make a transaction a covered transaction, "the Department of the Treasury ordinarily (absent other circumstances) would not attribute knowledge of that fact or circumstance to such U.S. person even if the transaction has all of the other attributes of a covered transaction." However, in practice, the determination of whether adequate diligence has been conducted will be made in the first instance in hindsight, by definition, when in fact covered activities have occurred, and by officials with an unpredictable level of commercial experience. We would expect a degree of investor uncertainty and—where possible—an expansion of representations and covenants.

For certain categories of covered transactions, "intent" is also relevant but undefined. The issue here is less a question of the dictionary definition of the word than of whose intent is relevant and how the investor is meant to assess the intent of others. Many of the prohibited and notifiable activity categories turn on the "intended" end use or end users, which is not specifically a question of the investor's intent and can be very difficult to determine in an early-stage company. For example, if investment materials for an AI image recognition technology refer to possible applications in smart infrastructure and congestion pricing, among many others, is that evidence of "intent" to develop mass-surveillance

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capabilities? What if the intent of the parties differs? Again, there is room for ambiguity.

What does compliance entail?

Prohibitions

The outbound investment program would be managed by Treasury's Office of Investment Security, which is also responsible for managing the review process of the Committee on Foreign Investment in the United States (CFIUS). Unlike the CFIUS process, however, the Proposed Rule would not establish a process for a case-by-case review and clearance of transactions. Instead, the prohibitions of the regulations are self-executing and there is no review or advisory mechanism. U.S. investors are responsible for determining whether an investment is prohibited and should proceed at their own risk.

Notifications

Where notification is required, the mechanics of the notification process will be familiar to those who have experience with the CFIUS filing process. Under the Proposed Rule, U.S. persons must submit notifications (including notifications relating to foreign entities they control) electronically to Treasury no later than 30 days after the completion date[7] of the covered transaction.[8] The Proposed Rule sets out the information required to be submitted in a notification, which includes, among other things, a description of the U.S. person, a description of the transaction (including the commercial rationale for the transaction), information about the covered foreign person (including an organization chart, ultimate ownership, and the full legal name and title of each officer, director, and other member of management), and an explanation of why the transaction is a covered transaction. If a U.S. person cannot provide any of the information required for a notification, the filer must explain why not and describe the efforts made to obtain the missing information.

After the U.S. person files the notification, Treasury may follow up with the U.S. person with requests for additional information or documents. The U.S. person would be required to respond to any follow-up questions and requests within the time frame and in the manner determined by Treasury. The filing party must maintain copies of the notification (and any supporting documentation) for 10 years after the date of the filing.[9] Non-public information submitted in connection with the notification is confidential, except as disclosed to courts, Congress, or other domestic or foreign governmental entities under appropriate classification or confidentiality arrangements.

The individual submitting the information must be an authorized officer of the investor and must certify that the notification and other information provided fully complies with the Proposed Rule and is accurate and complete in all material respects to the best knowledge of the individual.[10] While this individual certification requirement is patterned on CFIUS filings, in this case (a) it applies to information regarding the target company that is not within the direct control of the investing entity and (b) it would seem to apply the same broad definition of "knowledge" to the individual certification that applies more generally under the rule (i.e., it is not limited to actual knowledge).

Ongoing monitoring requirements

Compliance obligations do not end when the investment is completed. If, following an investment, a U.S. person obtains actual knowledge of facts that would have made the investment prohibited or notifiable under the Proposed Rule had the investor known them at the time of the investment, the U.S. person must file a notification within 30 days, providing all relevant information, an explanation of why the information was not available to the U.S. person at the time of the transaction, and a description of the pre-transaction diligence conducted by the investor. Similarly, any person making any representation, statement, or certification to Treasury in connection with a notification has an affirmative obligation to notify Treasury within 30 days if that person becomes aware of any material omission or inaccuracy.

While on its face this requirement appears to apply to circumstances in which the transaction should have been identified as notifiable or prohibited at the time it was entered into, the potential applicability of the Proposed Rule to future activities by a target company and the absence of any time frame for the future activities that will be considered relevant will make it difficult to conclude with confidence that entry into covered activities by a company in which a U.S. person has invested is not notifiable. As a practical matter, these ongoing reporting requirements would appear to create at least some obligation to conduct ongoing monitoring of investments that may be relevant under the Proposed Rule.

The Proposed Rule also provides a process for U.S. persons to submit voluntary self-disclosures to Treasury if they believe they have violated any requirement under the Proposed Rule, consistent with the approach taken by a range of similar agencies. Voluntary self-disclosures will be taken into consideration when Treasury assesses the appropriate enforcement response to violations of the Proposed Rule.[11]

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National interest exemptions

There is a possibility to request a national interest exemption from either the prohibition or notification requirements applicable to covered transactions. The U.S. person seeking the exemption (on its own behalf or on behalf of a controlled foreign entity) is required to submit to Treasury information about the covered transaction, including a description of the scope of the covered transaction, the basis for the exemption request, and an analysis of the covered transaction's potential impact on the U.S. national interest. There would therefore appear to be little benefit to seeking an exemption from notification, as substantially the same information is likely to be required; exemptions permitting prohibited investments are probably unlikely to be frequent (and Treasury has not requested a large staff to administer this program, signaling that it likely does not expect to conduct a meaningful number of case-by-case reviews).

Penalties

The following would be violations of the Proposed Rule:

1. Taking any action prohibited by the Proposed Rule;
2. Failing to take any action required by the Proposed Rule within the time frame and in the manner specified;
3. Making materially false or misleading representations to Treasury in a notification; and
4. Evading or avoiding any of the prohibitions of the Proposed Rule.

Violations of the Proposed Rule would be subject to the penalties provided in section 206 of the International Emergency Economic Powers Act (IEEPA). Civil penalties could include a monetary penalty of up to twice the value of the underlying transaction (or, if greater, approximately $360,000). Treasury would also have authority to order the nullification or force the divestment of any prohibited investment. In the case of willful violations, criminal penalties of up to 20 years' imprisonment and a fine of up to $1 million are possible.

As noted in our previous client update, while the substantive prohibitions of the Proposed Rule apply to U.S. persons, IEEPA provides for liability for any person who conspires to violate or causes a violation of the statute or any regulation issued thereunder (which would include the Proposed Rule), which could provide a basis for liability for non-U.S. persons involved in a prohibited investment by a U.S. person.

Next steps

Treasury has solicited comments on the Proposed Rule generally, as well as on a number of specific issues, including, among other things, the technical standards for covered activities and technologies, the Proposed Rule's knowledge standard, and the scope of the rule as applied to LP investments and other categories of covered transactions. Comments on the proposed rule are due by August 4, 2024. Treasury will then consider comments and publish a final rule incorporating responses to comments and any revisions. The final rule will establish the effective date of the program, which Treasury has indicated is expected to be during Fiscal Year 2025 (thus, sometime after October 1 of this year).

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Appendix A

Covered National Security Technologies or Products:

Semiconductors and microelectronics

Proposed for prohibition:

– Develops or produces any electronic design automation software for the design of integrated circuits or advanced packaging.
  - Develop is defined under the Proposed Rule as engaging in any stages prior to serial production.
  - Advanced packaging is defined under the Proposed Rule as packaging integrated circuits in a manner that supports the two-and-one-half-dimensional (2.5D) or three-dimensional (3D) assembly of integrated circuits, such as by directly attaching one or more die or wafer using through-silicon vias, die or wafer bonding, heterogeneous

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integration, or other advanced methods and materials.
- Develops or produces any front-end semiconductor fabrication equipment designed for performing the volume fabrication of integrated circuits, equipment for performing volume advanced packaging or commodity, material, software, or technology designed exclusively for use in or with extreme ultraviolet lithography fabrication equipment.
- Designs any integrated circuit that meets or exceeds the performance parameters in Export Control Classification Number 3A090.a or is designed for operation at or below 4.5 Kelvin.
- Fabricates (i.e., forms) devices such as transistors, poly capacitors, non-metal resistors, and diodes on a wafer of semiconductor material, any integrated circuit that is a:
  - logic integrated circuit using a non-planar transistor architecture or with a production technology node of 16/14 nanometers or less, including a fully depleted silicon-on-insulator (FDSOI) integrated circuit;
  - NOT-AND (NAND) memory integrated circuit with 128 layers or more;
  - dynamic random-access memory (DRAM) integrated circuit using a technology node of 18 nanometer half-pitch or less;
  - integrated circuit manufactured from a gallium-based compound semiconductor;
  - integrated circuit using graphene transistors or carbon nanotubes; or
  - integrated circuit designed for operation at or below 4.5 Kelvin.
- Packages any integrated circuit using advanced packaging techniques.
  - Advanced packaging is defined under the Proposed Rule as packaging integrated circuits in a manner that supports the two-and-one-half-dimensional (2.5D) or three-dimensional (3D) assembly of integrated circuits, such as by directly attaching one or more die or wafer using through-silicon vias, die or wafer bonding, heterogeneous integration, or other advanced methods and materials.
- Develops, installs, sells, or produces any supercomputer enabled by advanced integrated circuits that can provide a theoretical compute capacity of 100 or more double-precision (64-bit) petaflops or 200 or more single-precision (32-bit) petaflops of processing power within a 41,600 cubic foot or smaller envelope.

Proposed for notification:

- Designs any integrated circuit other than certain high-performance integrated circuits discussed in the third activity above.
- Fabricates any integrated circuit other than certain specified integrated circuits discussed in the fourth activity above.
- Packages any integrated circuit other than through advanced packaging techniques discussed in the fifth activity above.
  - Package is defined under the Proposed Rule as assembling various components, such as the integrated circuit die, lead frames, interconnects, and substrate materials to safeguard the semiconductor device and provide electrical connections between different parts of the die.

Quantum Information Technologies

Proposed for prohibition:

- Develops a quantum computer or produces any of the critical components required to produce a quantum computer such as a dilution refrigerator or two-stage pulse tube cryocooler.
  - Quantum computer is defined under the Proposed Rule as a computer that performs computations that harness the collective properties of quantum states, such as superposition, interference, or entanglement.
- Develops or produces any quantum sensing platform designed for, or which the relevant covered foreign person intends to be used for, any military, government intelligence, or mass-surveillance end use.
- Develops or produces any quantum network or quantum communication system designed for, or which the relevant covered foreign person intends to be used for:
  - networking to scale up the capabilities of quantum computers, such as for the purposes of breaking or compromising encryption;
  - secure communications, such as quantum key distribution; or
  - any other application that has any military, government intelligence, or mass-surveillance end use.

Artificial Intelligence

Proposed for prohibition:

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- Develops any AI system that is designed to be exclusively used for, or which the relevant covered foreign person intends to be used for, any:
  - military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapon control, military decision-making, weapons design, or combat system logistics and maintenance); or
  - government intelligence or mass surveillance end use (e.g., through mining text, audio, or video; image recognition; location tracking; or surreptitious listening devices).
- Develops any AI system that is trained using a quantity of computing power greater than a certain amount of computational operations (e.g., integer or floating-point operations). Treasury has proposed a threshold of between 10^24 and 10^26 computational operations if the data used is primarily not biological sequence data and 10^24 if the data used is primarily biological sequence data.

Proposed for notification:

- Develops any AI system (other than those that lead to outright prohibition, see above) that either:
  - meets certain end-use requirements, namely that the system is designed for government intelligence, mass surveillance, or military end use;
  - is intended by the person of a country of concern to be used for cybersecurity applications, digital forensics tools, and penetration testing tools, or the control of robotic systems; or
  - was trained using computing power exceeding a certain amount of computational operations. (Treasury has proposed a threshold of between 10^23 and 10^25 computational operations.)

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1 Press Release, U.S. Dep't of the Treasury, Treasury Issues Proposed Rule to Implement Executive Order Addressing U.S. Investments in Certain National Security Technologies and Products in Countries of Concern (June 21, 2024), https://home.treasury.gov/news/press-releases/jy2421.

2 More precisely, the standard would be met where a person of a country of concern holds 50 percent or more of an entity's outstanding voting interest, voting power of the board, or equity interest.

3 The restrictions also apply to OFAC's Specially Designated Nationals (SDNs) and entities designated by the State Department as foreign terrorist organizations, which typically are also SDNs, but are redundant given that substantially all transactions by U.S. persons with such entities are already prohibited.

4 The Proposed Rule provides attribution rules for indirect investments, essentially attributing up to 100% of any voting interests held by controlled entities and a pro rata allocation of voting interests held by non-controlled entities.

5 Under the Proposed Rule, Treasury would consider, among other things, the execution of compliance agreements, periodic training, and the implementation and testing of internal controls.

6 Treasury clarified, however, that a person would not be deemed to "knowingly direct" a transaction merely through "the provision of third-party services such as banking services" or for "routine administrative work by a U.S. person who lacks substantial involvement in an investment decision."

7 The Proposed Rule would define the completion date as the earliest date upon which any interest, asset, property, or right is conveyed, assigned, delivered, or otherwise transferred to a U.S. person, or as applicable, its controlled foreign entity or applicable fund.

8 If a U.S. person files a notification prior to the completion date, the U.S. person is required to update the notification no later than 30 days after completion date if any information in the notification has materially changed.

9 Supporting documentation includes pitch decks, marketing letters, offering memorandums, transaction documents (including side letters and investment agreements), and due diligence materials related to the transaction.

10 Certifications by the U.S. person include a statement that all information provided to Treasury in the notification (1) fully complies with the applicable regulations and (2) is accurate and complete in all material respects (to the knowledge of the U.S. person). Certifications can be signed by the filing party's chief executive officer and any authorized designee, which would include a general partner and any officer of a corporation.

11 According to Treasury, a voluntary self-disclosure would be taken into consideration during its determination of the appropriate response to the disclosed violation.

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