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Outbound investment screening regime raises questions and challenges

On 9 August, the White House issued an executive order, entitled *Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern* (“EO 14105”). EO 14105 establishes a new regulatory regime that will prohibit, or require the notification of, certain investment activity by US persons involving China (including Macao and Hong Kong).

EO 14105 is relatively tailored and focuses on specific sectors, including: (1) microelectronics; (2) quantum computing technologies; and (3) AI (collectively, “covered national security technology or products” or “CNSTP”). Earlier proposals, that could have created a broad regime covering all investment in China, were ultimately rejected in favor of a more measured approach.

Much about the new regime remains unknown, as the EO must be implemented via regulation by the Department of the Treasury. However, EO 14105 and an advanced notice of proposed rulemaking (“ANPRM”) from Treasury provide insight on how the rules may be crafted, and point toward a complex regime with difficult compliance challenges.

Key questions and challenges

Knowledge standard for CFPs

The ANPRM indicates the regime will apply to Chinese persons that “a US person knows or should know” are engaged in or “will be engaged in” specified activities involving a CNSTP (i.e., a “covered foreign person” or “CFP”).

The ANPRM explains a US person would “need to know, or reasonably should know ... through a reasonable and appropriate amount of due diligence, that it is undertaking a transaction involving” a CFP. The ANPRM does not explain what would constitute a “reasonable and appropriate amount of due diligence”.

Given the challenges of conducting due diligence in China, it may be difficult to assess whether a company is a CFP. The need to consider both current and future conduct complicates that task.

Investors could run afoul of the rules if they engage in transactions with CFPs, even if those transactions are largely unrelated to any CNSTP. Conducting appropriate due diligence will be critical even where there is no clear nexus to a CNSTP.

US person-directed transactions

Treasury may prohibit US persons from knowingly directing transactions, if such transactions would be prohibited if engaged in by a US person. Treasury may define “knowingly” to mean “the US person had actual knowledge, or should have known, about the conduct, the circumstance, or the result”. It may define “directing” to mean “a US person orders, decides, approves, or otherwise causes to be performed a transaction that would be prohibited under these regulations if engaged in by a US person”.

The ANPRM indicates various individuals could “direct” a company, including GPs, officers, and senior managers, among others. This could have a significant impact on non-US entities that have US individuals serving in key roles or investment funds that have a US person GP.

Foreign entities controlled by US persons

Treasury may require US persons to (1) notify Treasury of “any transaction by a foreign entity controlled by such United States person that would be a notifiable transaction if engaged in by a United States person” and (2) “take all reasonable steps to prohibit and prevent any transaction by a foreign entity controlled by such United States person that would be a prohibited transaction if engaged in by a United States person.”

Treasury may define “controlled foreign entity” to mean “a foreign entity in which a US person owns, directly or indirectly, a 50 percent or greater interest.” The ANPRM does not define “all reasonable steps,” but includes “factors” such as “relevant internal policies, procedures, or guidelines” and “periodic training and internal reporting requirements,” among others.

The ANPRM does not discuss “indirect” ownership in detail, leaving open questions regarding complex ownership structures. This key issue remains under consideration by Treasury, and one of the ANPRM questions asks what types of “indirect” transactions should be covered.

The path ahead

Comments on the ANPRM are due 28 September. Treasury will review comments and eventually issue a proposed rule soliciting additional comments before publishing a final rule, which will likely follow in 2024. ■

About the authors:

Brian Fleming is a Partner and Evan Abrams is an Associate in the Washington, DC office of Steptoe & Johnson LLP.
www.steptoel.com