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Treasury Adopts the "High Probability" Standard in Final Rule Restricting Certain Outbound Investments to China: What this Means, and How to Respond

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October 31, 2024 – On October 28, 2024, the U.S. Department of the Treasury ("Treasury") issued a final rule (the "Final Rule") implementing Executive Order 14105 of August 9, 2023, "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" (the "Outbound Order"). The Outbound Order directed Treasury to issue a new regulatory program to address the threat to U.S. national security posed by U.S. persons' investments that advance the development of key technologies and products by countries of concern ("covered transactions"). The Outbound Order identified the People's Republic of China ("China")—along with the Special Administrative Regions of Hong Kong and Macau—as a country of concern.

Key Takeaways:

1. The definition of "knowledge" in the Final Rule includes "an awareness of a high probability." This standard is not scientific; it will require in practice that financial institutions develop and execute methodologies in which to make—and through which to defend—inherently subjective judgments about risk.

2. The Final Rule imposes considerable compliance responsibilities on pooled investment funds, including certain investments as a limited partner. This is likely a new obligation for many LPs and will require both a new mindset and the development of new methodologies to implement.

3. Representations and warranties are only one of several factors Treasury will consider when determining whether a U.S. person has undertaken a "reasonable and diligent inquiry" with respect to a particular transaction. In the presence of "red flags" suggesting an investment may be a covered transaction, for example, representations and warranties will be necessary but likely not sufficient to meet the U.S. government's expectations and manage enforcement risk.

4. The Final Rule previews future Treasury guidance, which is standard practice from the "high probability" enforcement playbook we have seen the Department of Commerce recently apply and the DOJ, in the context of FCPA enforcement, apply before that. Under recent DOJ updates to its Effective Corporate Compliance Program ("ECCP") guidance, DOJ prosecutors are instructed to ask how entities track and respond to "lessons learned" in their industry. It will accordingly be important for the U.S. persons subject to this rule to track guidance—and any enforcement actions—related to the Final Rule.

Analysis

The Final Rule prohibits U.S. persons from "knowingly" engaging in certain covered transactions involving both (i) persons of a country of concern ("covered foreign persons") and (ii) certain covered activities related to the development of national security technologies and products within the semiconductors and microelectronics, quantum information technologies, and artificial intelligence sectors. The Final Rule also creates mandatory reporting requirements for other covered transactions in the semiconductors and microelectronics and artificial intelligence sectors that are not prohibited outright.

The term "covered transaction" includes a variety of direct and indirect modes of investment by a U.S. person in a covered foreign person or with a person of a country of concern that is likely to engage in a covered activity. It does not, however, include investments in publicly traded securities, index funds, mutual funds, or exchange traded funds. The Final Rule will become effective on January 2, 2025.

"Awareness of a High Probability" Standard

Key provisions of the Final Rule, including what constitutes a "covered transaction," only apply if a U.S. person has "knowledge" of relevant facts and circumstances. Yet the definition of "knowledge" in the Final Rule includes "an *awareness of ahigh probability* of a fact or circumstance's existence or future occurrence, or reason to know of a fact or circumstance's existence" (emphasis added).

Accordingly, for outbound investments, U.S. persons who are aware of facts or circumstances that indicate a "high probability" that the transaction involves or will in the future involve a covered foreign person and covered activity can be found in violation of the rule, even if the U.S. person was not absolutely aware that the transaction was a covered transaction at the time.

The Final Rule further imposes a due diligence requirement, to prevent U.S. persons from willfully blinding themselves to such facts. U.S. persons that fail to conduct a "reasonable and diligent inquiry" as of (i.e., up to and including) the time of a transaction risk a determination by Treasury that they had, essentially, constructive "knowledge" of a given (but avoided) fact or circumstance that would cause the transaction to be a covered transaction.

The Final Rule notes that by adding an "awareness of a high probability" to the definition of knowledge, it is adopting a standard consistent with the definition of knowledge under the U.S. Export Administration Regulations. We note further that the same standard also exists under the U.S. Foreign Corrupt Practices Act ("FCPA") and is the fulcrum on which FCPA enforcement has tipped, when coupled with the prioritization of FCPA enforcement since the early 2000s.

Key Takeaway: The "high probability" standard is not scientific; it will require in practice that financial institutions develop and execute methodologies in which to make—and through which to defend—inherently subjective judgments about compliance risk.

Compliance Responsibilities of Investment Funds

Under the Final Rule, a "covered transaction" includes the acquisition by a U.S. person, directly or indirectly, of a limited partner ("LP") or equivalent interest in a non-U.S. pooled investment fund (*e.g.*, a venture capital fund, private equity fund, fund of funds) that—

- a U.S. person knows—at the time of the acquisition—likely will invest in a person of a country of concern that is in the semiconductors and microelectronics, quantum information technologies, or artificial intelligence sectors, and
- such fund undertakes a transaction that would be a covered transaction if undertaken by a U.S. person.

Under the Final Rule, implicated LPs must engage in "a reasonable and diligent inquiry" at the time of the investment into the non-U.S. pooled investment fund to determine whether the fund is "likely" to invest in a person of a country of concern engaged in one or more of the three specified sectors.

Key Takeaway: This is likely a new obligation for many LPs. Identifying and analyzing compliance risks tied to such acquisitions or investments will require both a new mindset and the development of new risk-based methodologies.

Reliance on Representations and Warranties

In assessing whether a U.S. person has undertaken a reasonable and diligent inquiry with respect to a particular transaction, Treasury will consider the contractual representations or warranties the U.S. person has obtained (or attempted to obtain) concerning the determination of the status of the transaction and counterparty as a covered transaction and covered foreign person, respectively.

Representations and warranties, however, are only one of several factors that Treasury will consider as part of a broader, holistic analysis.

Other factors Treasury will consider include, where applicable: (i) the inquiry a U.S. person has made regarding an investment target or other relevant transaction counterparty; (ii) the efforts by the U.S. person as of the time of the transaction to obtain and consider available non-public information; (iii) available public information; (iv) whether the U.S. person purposefully avoided learning or seeking relevant information; (v) the presence or absence of warning signs (*e.g.*, evasive responses or non-responses from an investment target or other relevant transaction); and (vi) the use of available public and commercial databases.

Key Takeaway: In the presence of "red flags" suggesting the presence of a covered foreign person and a covered activity, representations and warranties will be necessary but likely not sufficient to meet the U.S. government's expectations and manage enforcement risk.

Future Guidance to Come

The Final Rule notes that Treasury anticipates making additional information available that can assist U.S. persons in understanding and complying with the Final Rule, including whether a particular transaction is covered, notifiable, or prohibited. Treasury is also considering providing additional information concerning a potential timeline for Treasury's internal review and determination. Previewing future guidance is standard practice from the "high probability" enforcement playbook, which has been used successfully by the U.S. Department of Justice.

Key Takeaway: Under recent DOJ updates to its Effective Corporate Compliance Program ("ECCP") guidance, DOJ will evaluate how U.S. persons track and respond to "lessons learned" in their industry. It will accordingly be important for the U.S. persons subject to this rule to track guidance—and any enforcement actions—related to the Final Rule.

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The Final Rule's adoption of the "high probability" standard creates many risks for U.S. persons making investments that might involve a covered foreign person and covered activity, but also allows for forward-leaning U.S. persons to design and defend methodologies for managing this risk. Our Sanctions, Export Controls & AML practice is well-positioned to help you understand and navigate these challenges.

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