August 4, 2024

VIA ELECTRONIC SUBMISSION
Meena R. Sharma
Director
Office of Investment Security Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20008

Docket ID TREAS-DO-2024-0012-0001
RIN 1505-AC82

Re: Notice of Proposed Rulemaking on Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern

Dear Ms. Sharma:

The American Investment Council ("**AIC**")[1] appreciates the opportunity to submit comments to the U.S. Department of the Treasury's ("**Treasury**") Office of Investment Security ("**OIS**") regarding its notice of proposed rulemaking ("**NPRM**") to establish a framework to restrict certain U.S. outbound investments in certain covered foreign persons ("**U.S. Outbound Investment Security Program**" or the "**Program**"). AIC also appreciates Treasury's efforts to engage with stakeholders and solicit input on the development and implementation of the Executive Order (the "**Order**") signed by President Biden on August 9, 2023, including through the prior issuance of the advance notice of proposed rulemaking.

As previously noted in our September 28, 2023 comment letter (the "**ANPRM Letter**"), AIC supports Treasury's attention to national security concerns while simultaneously seeking to maintain an open investment policy and supporting cross-border investment. AIC again urges Treasury to continue to bear in mind and appropriately balance these twin objectives as it finalizes the regulations for the Outbound Investment Security Program.

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[1] AIC is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, AIC develops, analyzes, and distributes information about the private equity and private credit industries and their contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, AIC is based in Washington, D.C. AIC's members are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest. For further information about AIC and its members, please visit our website at http://www.investmentcouncil.org.

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AIC welcomes the additional clarifications provided by the NPRM. We would urge Treasury to consider the following additional points, which have been informed by our close review of the NPRM. AIC continues to support Treasury's objectives in implementing the Order while taking into account practical realities faced by our members.

Accordingly, as discussed in our ANPRM Letter, AIC urges Treasury to ensure that the final regulations contain clear requirements to facilitate compliance while minimizing burdens on capital flows and the private sector. AIC welcomes the additional clarifications contained in the NPRM, but certain provisions remain ambiguous or unclear in terms of their practical application. AIC respectfully asks that Treasury consider the following recommendations.

I. General Comments

As a general matter, AIC is concerned that the Program, if adopted as proposed, will impose unreasonable and disproportionate burdens on asset managers. As discussed below, AIC respectfully requests that Treasury develop further relief to address each of these concerns. AIC remains available to aid Treasury in addressing each of these concerns.

a. The Program should not be implemented until after the legislative process has run its course. Members of Congress have introduced numerous bills during the 118th Congress that would expand and/or alter the mechanics (and the corresponding burdens of complying with) outbound investments involving China.[2] In addition, certain members of the House of Representatives are aiming to pass a package of China-focused legislation this fall, including additional legislation focused on outbound investment to China.[3] As a result, U.S. investors and U.S.-based asset managers face the real prospect that the Program, if adopted, may impose obligations and burdens that are later superseded by legislation. Indeed, U.S. persons may be taking steps to ensure compliance with a program that may be significantly altered before or after the final regulations are issued, which presents an undue burden and unnecessary costs.

This risk is compounded by the view of many AIC members that the compliance costs estimated in the NPRM do not fully capture the strategic and organizational implications of the Program, let alone the commercial realities of developing policies and procedures reasonably designed at ensuring compliance with the Program. The prospect of the Program has already generated significant uncertainty among our members, many of which maintain active investment strategies in the Indo-Pacific region.

Recommendation: AIC respectfully requests that Treasury not set an effective date for the Program that arises before the legislative process has run its course and that any

[2] CONG. RSCH. SERV., *Proposals to Regulate U.S. Outbound Investment to China*, https://crsreports.congress.gov/product/details?prodcode=IF12629.

[3] Press Release, United States House Select Committee on Strategic Competition between the United States and the Chinese Communist Party, Moolenaar on Speaker Johnson's Plan to Renew the Select Committee (July 8, 2024), https://selectcommitteeontheccp.house.gov/media/press-releases/moolenaar-speaker-johnsons-plan-renew-select-committee.

effective date be set for such a time that U.S. persons are able to assess and prepare for the impact of the Program.

b. Take steps to limit disadvantages and unintended consequences for U.S. persons. The final regulations should ensure that U.S. person investors are not harmed by transactions contemplated or entered into before the effective date that then become unexpectedly or unintentionally covered. For example, in the case of existing debt financing arrangements not initially covered, the behavior of a China-based borrower could give rise to equity interests or decision-making rights in the event of a default. As it currently stands, the borrower could take steps (either intentionally or unintentionally) that make it a covered foreign person under the rules; any default by that borrower then could prevent the U.S. person from exercising certain of its valid rights—such as rights to engage in governance or to obtain preferred equity—arising out of the pre-existing financing arrangement. Or, as another example, imagine a U.S. investor that lawfully invests in a Chinese company after the effective date because the company is not engaged in any activity that would make the investment a covered transaction; now imagine that the U.S. investor wants to exit the investment, but the Chinese company is concerned about the reputational or financial ramifications of that exit. In that situation, the Chinese company may be tempted to engage in conduct that would make it impossible for the U.S. investor to sell to another U.S. investor, or that would require notification under the rules, thereby frustrating or limiting the range of potential exit opportunities. U.S. persons should be shielded from such possibilities through the provision of a safe harbor mechanism, as discussed in further detail below.[4]

In addition, the final regulations should avoid disadvantaging asset managers in the United States vis-à-vis their foreign counterparts. The NPRM in its current form presents a competitive disadvantage for U.S. funds given the outright prohibitions and increased compliance costs and complexities around diligence that will be imposed, thereby giving non-U.S. funds a competitive edge over U.S. asset managers. In addition, U.S.-based limited partner ("**LP**") investors may continue to invest through non-U.S. funds that give them access to Chinese markets but present comparatively less risk of running afoul of the Program's regulations and prohibitions.

Furthermore, the Program as currently contemplated exposes U.S. asset managers to too significant uncertainty around the standards that will be used to judge the adequacy of their diligence processes. Importantly, this could also expose U.S. asset managers to significant

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[4] At a minimum, the final regulations should make clear that U.S. persons may engage in transactions necessary to protect their lawfully obtained contractual rights, including for debt financing arrangements entered into prior to the effective date of the regulations. This would, for example, authorize a lender to convert its debt to equity in a situation where that lender lawfully entered into a debt financing arrangement with a Chinese company that at the time of the debt financing agreement was not engaged in covered activity but later engages in conduct that would make it difficult for the lender to exercise its rights to convert debt to equity. Such transactions should not be covered under the final regulations. As a compromise, the final regulations might require notification of such a transaction.

commercial disadvantages in deals not involving Chinese companies as a result of the requirements imposed on them to ensure that their potential investment does not have connections to China. Indeed, the Program as contemplated would impose significant diligence requirements that constitute a disproportionate burden for U.S. asset managers as compared to their foreign counterparts and could impede their ability to compete in the domestic and international marketplaces, thereby reducing the prospect of U.S. capital driving innovation in other areas not intended to be captured by the Program.

These dynamics present more specific concerns in the context of credit markets. Given that enforceability of collateral rights could trigger a covered transaction, the draft regulations as written would create burdens for both lenders and equity investors, causing ripple effects on investors requiring finance—both in terms of costs and the ability to provide lenders with sufficient collateral to secure financing—thereby impacting the economics of a wide scope of transactions.

Recommendation: AIC respectfully submits that Treasury should create a "no-fault" safe harbor and apply the Program consistently so as to not disadvantage U.S. asset managers. Treasury should explicitly acknowledge that due diligence efforts will be evaluated in a manner that is proportionate to the commercial realities and complexities attendant to international transactions. AIC would also ask that Treasury consider the practical implications of the program in the market, particularly in the context of credit transactions, by expressly providing a safe harbor for U.S. persons that adequately conduct due diligence, solicit contractual representations and warranties prohibiting counterparties from engaging in activities that constitute covered action, and otherwise take appropriate and reasonable steps to comply with the rule. As an example, this would mean authorizing U.S. lenders in a debt financing transaction to convert debt to equity where the U.S. lenders conducted adequate due diligence at the time of the debt financing transaction and took reasonable commercial steps to prevent the borrower from engaging in covered activities.

c. Account for the changing nature of new and emerging technologies. The changing nature of new and emerging technologies also poses compliance challenges for the Outbound Investment Security Program and risk of overcapture and undercapture for Treasury, which will not advance the objectives of the Program. As currently written, the NPRM attempts to capture current products and technologies most likely to have military, intelligence, surveillance, or cyber-enabled capabilities. The NPRM includes both specific capabilities and technical parameters for covered products and technologies. However, particularly in the case of artificial intelligence, the AIC is concerned that Treasury will seek to change parameters over time to address emerging or changing technology. Doing so risks exposing U.S. investors to the risks discussed above (in subpart b, namely, that U.S. investors may be held captive by Chinese companies through no fault of the U.S. investor).

More specifically, the expansive coverage of AI systems used for a variety of applications appears overly broad and goes beyond the policy goals of the Program. For example, the notifiable category covers AI systems intended to be used for "the control of

robotic systems," which could capture AI systems that have no military, intelligence, surveillance, or cyber-enabled capabilities and otherwise do not implicate national security. In addition, with the current definition of "AI systems," even hardware that utilizes AI systems appears to be covered. An example of the consequences of this would be that the portfolio company of a U.S. private equity firm that utilizes AI in robotic systems to enable chicken-deboning in factories could qualify as a covered foreign person. AIC assumes that the Program does not intend to cover such AI systems, but the rule as currently written arguably does.[5]

Recommendation: AIC urges Treasury to guarantee a notice-and-comment process for any updates to covered products and technologies and provides greater clarity confirming that AI activities that are not geared toward military, intelligence, surveillance, or cyber-enabled capabilities and otherwise do not implicate national security concerns are not within scope of prohibited transactions. Moreover, AIC asks Treasury ensure that this process prevents the penalization of U.S. persons for investing in companies that become covered foreign entities through no fault of their own.

d. Provide for safe harbor and lenient enforcement policy. To account for all of the uncertainties described above, AIC urges Treasury to provide for a safe harbor to account for the commercial realities of transactions, including their size and scope, and the difficulties of conducting adequate and legal diligence in China, as discussed further below. To the extent that any information obtained through the diligence process at the time of a transaction proves to be inaccurate or false, Treasury should define the circumstances in which a safe harbor can be secured and also provide for a lenient enforcement policy, whether through the regulations themselves or in additional guidance. For example, U.S. persons should not be held responsible for anything that a target company fails to disclose—whether willfully, purposefully, or inadvertently—during the diligence process. U.S. persons that engage in good faith and market diligence processes should not be required to engage in due diligence that exceed standard market conventions.[6] This is consistent with the policy goals of the Order and the Program, which focus on preventing covered foreign persons from exploiting the benefits of U.S. investment—not punishing U.S. persons for the effects of the difficult commercial regulatory environment in China.

[5] Additionally, U.S. persons may not be able to reasonably anticipate the potential applications of certain technologies to end-uses that the Program intends to cover. It is important that the final rule make clear that any knowledge standard will be applied based on the knowledge and understanding prevalent at the time the covered transaction is undertaken, not at some later date.

[6] Most U.S. investors engage in due diligence that is proportionate to the nature and complexity of a particular investment, scaling their due diligence activities to be commensurate with (among other factors) the risk profile of the target company and the financial stake being contemplated. The final rule should acknowledge that U.S. persons' due diligence activities should be evaluated pursuant to that risk-based approach.

Recommendation: AIC respectfully asks that Treasury adopt a rule protecting U.S. investors against fraud or improper conduct by Chinese companies that puts U.S. investors at risk of being in violation of the Program through no fault of their own.

II. Comments on Specific Provisions

In addition to the general concerns outlined above, AIC respectfully submits that certain textual clarifications are warranted. Accordingly, AIC provides the following comments on specific provisions in the NPRM.

a. Clarify ambiguities around specific definitions and their application within the regulations. The NPRM contains additional ambiguities around certain definitions and their interaction with other provisions of the rule. For example, there is no definition of "engages in" in the definition of "covered foreign person," leaving unmanageable levels of ambiguity as to what the standard is to determine whether a person of a country of concern meets the criteria for covered activities. Even if Treasury does not choose to adopt a *de minimis* threshold in this regard, additional clarity is warranted to distinguish, for example, between activities that are legitimately part of a Chinese company's normal operations and those activities that might be conducted by individual employees or without the guidance or supervision of Chinese management—*i.e.*, activities that are truly so *de minimis* that no U.S. investor should suffer the risk of being in violation of the Program or of being held captive in its investment by virtue of such activities. In addition, defined terms are sometimes used in the rule, while in other cases certain components of the definition are spelled out. This leaves ambiguity in the covered transactions category for LP investments in non-U.S. pooled funds, for example, which suggests that only investments in certain types of covered foreign persons are covered transactions in this context.

Recommendation: AIC requests that Treasury provide a clearer definition of "engages in," including with respect to minimal activities that should not otherwise be covered under such a definition. In addition, AIC respectfully suggests that Treasury use defined terms consistently throughout the final regulations and otherwise provide context where only certain components of a definition are used.

b. Resolve uncertainty around coverage of LP investments. As currently drafted, the NPRM's application to U.S. LP investments in U.S.-based pooled investment vehicles is ambiguous. Presently, the NPRM only expressly covers—*i.e.*, prohibits and/or requires notification of—U.S. LP investments into non-U.S. pooled funds where the U.S. person knows at the time it commits its capital that the non-U.S. pooled fund "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 if such fund then undertakes a transaction that would be covered if undertaken by a U.S. person. § 850.210(a)(6). Nevertheless, the NPRM also expressly prohibits *indirect* acquisitions, which could also theoretically cover other LP investments into U.S. funds that are not expressly captured by § 850.210(a)(6), particularly where there is knowledge by the LP that the pooled investment vehicle might acquire equity in a covered foreign person. *See*

§ 850.210(a)(1). The issue is particularly acute when the prohibition on indirect acquisitions is read in tandem with the evasion provision. *See* § 850.604. Commentary in the NPRM suggests that "only an investment into a non-U.S. person pooled investment fund" would be captured as a covered transaction. *See* NPRM, Subpart B—Definitions: Investment Made as an LP. But that commentary is not expressly adopted or provided for in the draft regulations. Treasury should expressly clarify that the prohibition on indirect investments does not apply to LP investments into U.S. funds.

Recommendation: The regulations should contain express language to the effect that investments made by an LP into a U.S. fund are *either* not captured by § 850.210(a)(1) or are excepted under the final regulations.

c. Account for the practical implications of the knowledge standard. Although the additional details on how Treasury plans to apply the knowledge standard in the NPRM are helpful, the final regulations and corresponding guidance would benefit from further consideration of the commercial realities surrounding various types of transactions, including the potentially limited scope of information available. In short, AIC asks that Treasury clarify that the standard for knowledge should be based on market conventions. Market conventions may differ based on the commercial realities of a transaction, including its size and complexity, and should also take into account historical practices. The standards for a reasonable and diligent inquiry will differ depending upon the nature of the transaction and the role of the U.S. person, as Treasury has acknowledged in the context of LP investments into non-U.S. pooled funds. For example, in certain contexts it may be impracticable to account for all of the enumerated factors listed for the knowledge standard, including the ability to obtain non-public information or credibly assess the presence or absence of warning signs.

The regulations should also take into account the unique difficulties presented by the requirement of conducting due diligence in China. The U.S. Government has acknowledged this in the context of other new regulatory programs, which have imposed diligence requirements in China that have been difficult, and in some cases impossible, to achieve in practice.[7] In addition, China has recently revised its counterespionage and state secrets laws,[8] posing additional risks for due diligence in cross-border transactions. U.S. due diligence firms operating in China have already suffered challenges as a result.[9] In addition, for China-based entities, answering any due diligence questions could run afoul of China's state secrets law, making it difficult to rely on any related representations. Treasury should thus make clear that any assessment of knowledge will

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[7] Richard Vanderford, *U.S. Forced Labor Crackdown Is Tough, But Opaque*, WALL ST. J. (Feb. 16, 2023, 1:42 PM) https://www.wsj.com/articles/u-s-forced-labor-crackdown-is-tough-but-opaque-a463d6e7.

[8] Feifei Ren and John Davis, *China's revised and more stringent state secrets law takes effect,* Reuters (May 7, 2024, 10:50 AM), https://www.reuters.com/legal/legalindustry/chinas-revised-more-stringent-state-secrets-law-takes-effect-2024-05-07/.

[9] Elaine Yu, *U.S. Companies in China Worry Due Diligence Will End in Spy Dramas*, WALL ST. J. (May 5, 2023, 12:26 AM), https://www.wsj.com/articles/foreign-firms-in-china-squeezed-by-u-s-disclosure-demands-beijings-security-clampdown-658ef8f.

take into account these factors without imposing more burdensome diligence requirements and undue risk on U.S. persons.

Recommendation: AIC respectfully requests that the Program be more appropriately and carefully tailored to the aforementioned commercial and regulatory realities in terms of both the final regulations and their application, including through a safe harbor or guidance on mitigating factors Treasury will consider in its enforcement policy as described above. AIC also asks that greater clarity could be provided around what constitutes knowledge "at the time of a given transaction."

d. Explain interaction with other U.S. Government lists. AIC understands that the goal of the provisions prohibiting transactions with individuals and entities identified on other U.S. Government lists if they engage in any covered activities is to enhance restrictions on such individuals and entities because they have already been determined to pose a threat to the United States. AIC would welcome additional clarity on the interaction of the Program with these various other sanctions and export control programs, each of which contain different types of restrictions on dealings with U.S. persons. For example, does the knowledge standard from the NPRM apply to understanding whether a person or activity is also subject to the Export Administration Regulations?

Recommendation: AIC respectfully requests that Treasury provide explanatory guidance, whether through frequently asked questions or otherwise, that help explain how the Program works in terms of cross-referencing other U.S. Government lists, with the aim of avoiding both inconsistency and redundancy.

III. Additional Requests for Comment

In response to the additional questions posed in the Request for Comment section of the NPRM, AIC provides the following comments.

a. Tiered ownership structures for controlled foreign entities and persons of a country of concern (Question 11): The NPRM proposes methods to determine whether entities constitute a "controlled foreign entity" or a "person of a country of concern." It would be helpful to harmonize these methods for consistency to avoid confusion in application of the regulations. For example, in the case of a controlled foreign entity, the threshold is *more than 50 percent*, whereas in the case of a person of a country of concern the threshold is *50 percent or more*. In addition, the NPRM discusses the fact that indirect transactions (with the example of an acquisition of equity interest in a special purpose vehicle that then acquires an interest in a covered foreign person) can qualify as covered transactions. AIC respectfully submits that Treasury clarify how this discussion of intermediary entities applies in the context of tiered ownership structures. For example, Treasury should make clear the prohibition on indirect investments does not apply to an investment in a parent or holding company unless one of its subsidiaries meets the thresholds for revenue, net income, capital expenditure, or operating expenses in § 850.209(a)(2).

Recommendation: AIC respectfully requests that Treasury provide further guidance as to how these rules should be applied in the context of complex transactions involving acquisitions through special purpose vehicles or other indirect transactions, including by making clear that if the acquisition of a non-Chinese company does not meet the thresholds in § 850.209(a)(2), then both the direct acquisition of the company and the indirect acquisition of its interest in its subsidiary are not covered transactions.[10]

b. LP Exception (Question 22): Of the two alternatives for the LP exception in the NPRM, AIC would prefer the adoption of Alternative 1, which provides that LP investments are excepted where the LP's rights are consistent with passive investment and the committed capital is not more than 50 percent of the total assets under management. Although Alternative 2 provides a clear bright-line rule by excepting any transaction where the LP's committed capital is not more than $1,000,000, the threshold is so low that the exception is unlikely to capture most passive LP investments as intended. AIC views Alternative 1 as more easily administrable for U.S. LP investors, whereas Alternative 2 would capture transactions that do not necessarily pose national security concerns or help address the policy goals of the Program—indeed, the exception would effectively be unavailable for most, if not all, LP investments given the low monetary threshold.

In terms of the application of Alternative 1, AIC would welcome additional clarity on (1) how the 50-percent threshold would apply in the context of fund families and (2) when the ownership percentage would be measured, as applied to both closed-end and open-end funds. On the first point, in AIC's experience, it is not unusual for LP investors to invest through multiple vehicles alongside a lead fund, rather than through a comingled entity. The LP in these cases may hold more than 50 percent of the assets under management of the vehicle that is co-investing alongside the lead fund, but not more than 50 percent of the capital invested by the fund family. It would be helpful to confirm that such LP investments would also qualify for the exception and further describe how the threshold should be calculated in the context of fund families.

On the second point, AIC recommends that the 50-percent threshold be tested at the time of the fund's final close if it is a closed-end fund. For open-end funds, such as hedge funds, AIC recommends the 50-percent threshold be tested each time the LP makes a commitment or investment into the fund since assets under management can fluctuate over time.

Recommendation: AIC recommends that Treasury adopt Alternative 1 for the LP investment exception. AIC would also ask that Treasury provide additional clarity or guidance on (1) how the 50-percent threshold for Alternative 1 would operate in the context of fund families and (2) when the 50-percent test will be applied in the context of both closed-end and open-end funds.

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[10] Moreover, the final regulations should clarify that ancillary transactions—such as incentive-based compensation or carried interest—are beyond the scope of covered transactions.

***c. National Interest Exemptions (Question 24)*:** AIC welcomes the proposal for the Program to include a national interest exemption. Although AIC understands that Treasury is not seeking to implement a licensing process akin to those administered in many U.S. sanctions programs, the national interest exemption provides an important means to account for the fact-specific complexities around different transactions and avoid unneeded overreach that goes beyond the scope of the Program's policy goals. AIC would respectfully recommend the adoption of liberal agency guidance with respect to the national security exemption process that accounts for the previously discussed practical realities of implementing the Program.

Recommendation: AIC respectfully requests that Treasury issue explanatory guidance regarding the process for applying for a national interest exemption and tailor any such process to the commercial and regulatory realities outlined above. AIC also recommends that Treasury clarify that the national interest consultation and determination can be made by individuals with delegated authority.

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AIC welcomes the opportunity to further engage with Treasury on the implementation of the U.S. Outbound Investment Security Program and stands ready to answer any questions that you might have concerning our comments.

Respectfully submitted,

s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council