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Assessing the Impact of the Outbound Investment Security Program on Debt Transactions

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On January 2, 2025, the US Department of the Treasury implemented the new Outbound Investment Security Program (OISP), which prohibits or imposes notification requirements on certain investments by US persons in persons that have a qualifying nexus to China (including Hong Kong and Macau) and specified technology sectors (including semiconductors and microelectronics, quantum information technology, and certain artificial intelligence). Those with such a nexus are referred to as "covered foreign persons" (CFPs). CooleyREG published a detailed November 2024 client alert on the OISP's genesis, policy and implications.

As its name would suggest, the OISP has implications for US venture capitalists and other investors making equity investments in CFPs, but the rule's ambit covers a variety of transactions and arrangements outside of equity. The purpose of this client alert is to discuss the potential impact of the OISP on debt financing transactions, in particular.[1] Given its broad application and the potentially severe consequences for noncompliance – including divestment or nullification of covered transactions, significant fines, and, in some cases, individual civil and criminal penalties – it is critical for US lenders and debt investors to understand their obligations under the OISP and identify transactions potentially subject to it.

Among other "covered transactions," the OISP expressly applies to:

- Any acquisition of a contingent equity interest in a person that the US investor knows is a CFP.
- Any debt financing arrangement knowingly provided to a CFP that affords the US investor **any** of the following:
  - An interest in the profits of such CFP.
  - The right to appoint members to the board of directors (or equivalent) of such CFP.
  - Other comparable financial or governance rights characteristic of an equity investment but not typical of a loan (31 CFR § 850.210(a)).

This may apply to many common debt financing structures and features, including, among others:

1. Convertible loans: Instruments convertible into equity of a CFP are treated as contingent equity interests for purposes of the OISP and are therefore covered transactions (31 CFR § 850.2 button205). However, investments in publicly traded securities are exempt from the OISP, meaning that convertible notes issued by publicly traded issuers would not be subject to the OISP (31 CFR § 850.501).

2. Secured loans: The OISP's implementing regulation makes clear that while the making or holding of a loan secured by a pledge of voting equity in a CFP does not itself constitute a covered transaction, foreclosure that results in possession of such equity does (31 CFR § 850.210).[2]

3. Warrants: Receipt of any warrant for private company stock – whether or not in connection with a debt financing – would constitute a covered transaction.

4. Royalty and revenue interest financings: Whether structured as a true sale or as debt, royalty and revenue interest financings, or loans with royalty or revenue interest components, could be construed as profit interests and therefore may be subject to the OISP.

5. Capital call financings: Investment funds whose portfolios consist of CFPs may, subject to conditions enumerated in the OISP, themselves be treated as CFPs (31 CFR § 850.209).

Lenders and other investors engaging in transactions that may be subject to the OISP will need to develop processes in order to ensure compliance.

Crucially, for purposes of the OISP, "knowledge" includes constructive knowledge – i.e., reason to know based

on reasonably available information and appropriate investment due diligence – in addition to actual knowledge (31 CFR § 850.216). Investors are therefore responsible for conducting due diligence sufficient to identify borrowers that are CFPs and/or transactions that may be "covered transactions" for purposes of the OISP. Many debt investors already thoroughly assess borrowers' operations, management and ownership structure, and conduct know your customer (KYC) checks on relevant personnel, before moving forward with any given transaction. OISP-focused checks may be incorporated into this process to ensure – and create a record of – compliance.

In addition, loan and other debt financing documents will likely incorporate new representations, warranties and/or covenants designed to identify potential OISP issues and demonstrate to regulators that investors are making appropriate efforts to comply with OISP. Of note, the National Venture Capital Association (NVCA) recently published model representations for stock purchase agreements to help surface OISP concerns. A similar approach could be taken in debt financing documents. However, such provisions are only one component of what must be a multipronged approach, including active due diligence sufficient to satisfy the OISP's constructive knowledge standard.

As a new and complex program, the OISP's application, interpretation, impact, and enforcement, as well as how the US debt market will respond and adapt, remain to be seen. Nonetheless, debt investors should review whether their portfolios and prospects implicate the technologies and jurisdictions covered by the OISP, and develop formal systems and processes to ensure that they undertake the due diligence and other steps necessary to satisfy the OISP requirements.

If you have any questions about the above, please reach out to Mike Tollini or Matt Scarano on the Cooley debt finance team, or Kevin King, Chris Kimball, Annie Froehlich or Dillon Martinson on the CooleyREG team.

Notes

1. Please note that other elements of the OISP covered in CooleyREG's November 2024 client alert are beyond the scope of this client alert – including analysis of whether a "US person" is involved in a transaction; the scope of "covered transactions" other than debt financings; whether a counterparty to any transaction is a "covered foreign person" and/or engages in a "covered activity"; whether a covered transaction is prohibited or merely subject to notice requirements; and the OISP's enforcement mechanisms.
2. Equity pledges in existence before January 2, 2025, are not affected.

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