The New U.S. Outbound Investment Final Rule

By Paul B. Edelberg[1]

In August of 2023, President Biden issued Executive Order No. 14105, introducing the first U.S. outbound foreign direct investment regime. Proposed regulations were issued within a matter of days, and in July of 2024 revised rules were issued. In November of 2024, the final rule was published. The new final rule took effect on January 2 of this year. Its impact on U.S. companies and private equity firms with investments in certain technology sectors in the greater China area have the potential to be significant.

The new rule, in general, imposes restrictions on investments in certain advanced electronic technologies by a U.S. investor in certain entities or persons in the greater China area. Certain of these investments are prohibited, while others require post-closing notification to the U.S. Treasury Department. U.S. investors, including private equity funds and their investors, are held to a high level of due diligence. This Final Rule is now in effect and carries substantial civil money and criminal penalties.

The rule focuses on investments in "Countries of Concern", which are defined as the Peoples Repubic of China, Macao, and Hong Kong. The technologies encompassed by the Executive Order and the Final Rule are the design, development, and/or production of certain advanced semiconductors and microelectronics, quantum information technologies, and AI systems.

The thrust behind the Executive Order is to protect U.S. national security interests, to maintain and promote a competitive edge in favor of the U.S. over China in these particular industry sectors, and to limit investments that may convey capital and intangible benefits to these sensitive critical technologies that can be used for military, intelligence, surveillance, or security purposes by China. The Final Rule is intended to complement other U.S. laws such as export controls with foreign regimes.

The Final Rule

The Final Rule impacts "covered investments" by a "U.S. Person" in a "covered foreign person" carrying on a "covered activity." The Final Rule prohibits certain covered investments and mandates notification to the U.S. Department of Treasury for others. Notification of those investments must be given to the Department of Treasury within 30 days after closing on the transaction. Notification is to be given through the U.S. Department of Treasury portal, which can

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be found through the Treasury Department's website (https://home.treasury.gov/policy-issues/international/outbound-investment-program).

Unlike the regulation of inbound foreign transactions for national security purposes by the Committee on Foreign Investment in the United States (CFIUS), notifiable transactions require notification subsequent to closing by filing with the Treasure Department, but there is no pre-closing review. So an investor cannot obtain guidance from government officials before making an investment.

Covered Activities

The "covered activities" are the design, development, fabrication and/or production of semiconductors and microelectronics, quantum information technologies, and AI systems as specified in the Final Rule. Prohibited investments include:

- The design, development, fabrication or production of integrated circuits that meet or exceed prescribed performance parameters or that use certain specified architecture or components;
- The development or production of certain equipment and software used in the development, fabrication or production of integrated circuits;
- The packaging of any integrated circuit using advanced packaging techniques;
- The development, installation, sale or production of any supercomputer enabled by advanced integrated circuits that meet or exceed prescribed performance parameters;
- The development of a quantum computer or production of its critical components;
- The development or production of any quantum sensing platform or quantum network or quantum communication system designed for or to be used for military, government intelligence or mass-surveillance end use or to be used for other specified purposes;
- The development of any AI system designed exclusively for or to be used for military, government intelligence or mass-surveillance end use;
- The development of any AI system that is trained using a prescribed level of computing power; and
- The relevant foreign person is included on the Bureau of Industry and Security's Entity List, the Bureau of Industry and Security's Military End User List or included on the Treasury Department's Specially Designated Nationals List or list

of Non-SDN Chines Military-Industrial Complex Companies or designated a foreign terrorist organization by the Secretary of State.

The following are covered activities that require notification to Treasury:

- The design, development or fabrication of any integrated circuit that is not included in the list of prohibited covered activities;

- The development of any AI system that is not included in the list of prohibited covered activities and that either (1) is designed to be used for military, government intelligence or mass-surveillance end use, (2) is intended to be used for cybersecurity applications, digital forensic tools, penetration testing tools, or the control of robotic systems, or (3) is trained using a prescribed level of computing power.

Who is a "Covered Foreign Person"?

A covered foreign person is a Person of a Country of Concern that engages in a covered activity. It also includes any person or entity that holds a board seat on or a voting or equity interest in a Person of a Country of Concern if it derives more than 50% on an individual or aggregated basis of its revenue or its net income from such Person of a Country of Concern or incurs on an individual or aggregate basis more than 50% of its capital expenditures or its operating expenses from such Person of a Country of Concern. A "Person of a Country of Concern" includes citizens or permanent residents of a Country of Concern who are not U.S. citizens or permanent residents of the United States, an entity with a principal place of business or headquarters or otherwise organized under the laws of a Country of Concern, a government of a Country of Concern (including political subdivisions and state-owned enterprises), certain persons acting on behalf of a company of a Country of Concern, government controlled entities, or any such person that holds at least a 50% voting interest, voting power on the board or equity interest in any of the above entities. In other words, a "covered foreign person" generically is a Chinese individual, company, or governmental unit that owns, controls or derives a significant economic benefit from a covered foreign person engaged in a covered activity.

Who is a "U.S. Person"?

A U.S. Person is any U.S. citizen, a lawful permanent resident, a person in the United States, or an entity organized under U.S. law and includes foreign branches of any such entity.

What types of transactions are covered by the final rule?

Transactions covered by the Final Rule, called "covered transactions," include the following:

- Acquisitions of equity interests and contingent equity interests in a person that the U.S. Person *knows* at the time of the acquisition is a covered foreign person;

- Debt financing arrangements to a person that the U.S. Person *knows* at the time of the financing is a covered foreign person, where the debt financing affords the U.S. Person an interest in profits of the covered foreign person, the right to appoint board members, or other comparable financial or governance rights characteristic of an equity investment and not of a loan;

- Conversion of a contingent equity interest in a person or entity that the U.S. Person *knows* at the time of the conversion is a covered foreign person, provided that the contingent equity interest was acquired on or after January 2, 2025;

- Greenfield and brownfield investments;

- A joint venture, wherever located, that is formed with a Person of a Country of Concern, and the U.S. Person *knows* that the joint venture will engage or plan to engage in a covered activity; or

- Certain limited partner investments as described below.

In all of the above instances, the U.S. Person must *know* at the time of the investment that the investment is in a covered foreign person. This "knowledge" standard imposes on the U.S. person a high level of due diligence, as discussed in more detail below.

A limited partner investment by a U.S. Person in a non-U.S. fund is also a covered transaction if the U.S. Person *knows* at the time of the investment that the fund likely will invest in a Person of a Country of Concern that is involved in a covered activity, ***and*** such fund undertakes a transaction that would be a covered transaction if undertaken by a U.S. Person. There is an exception for limited partner investments of US$2 million or less on a fund-aggregated basis, provided that there are binding contractual assurances by the fund that the U.S. Person's capital in the fund will not be used to engage in a covered transaction.

Exceptions

The following investments by U.S. Persons are excepted from the investment restrictions:

- Investments in publicly traded securities, index funds, mutual funds, and EFTs issued by registered investment funds;

- Investments in business development companies under the Investment Company Act of 1940; and

- Investments in derivatives that do not confer the right to acquire equity or assets of a covered foreign person.

These exceptions are conditional on the investment not giving the U.S. Person rights beyond standard minority shareholder protections, which are spelled out in the final rule.

In addition, there are exceptions for:

- Transactions made after January 2, 2025 pursuant to a binding, uncalled capital commitment entered into before January 2, 2025;

- Acquisition of a voting interest by a covered foreign person by a U.S. Person upon default under a loan syndication financing, provided that the U.S. Person is not the syndication agent and cannot initiate any enforcement action;

- Stock option grants as part of employment compensation; and

- Transactions with persons of another country of territory that has a similar outbound investment regime.

If a U.S. Person acquires the entire equity interest held by a Person of a Country of Concern so that following the acquisition the entity does not constitute a covered foreign person, then that investment is not a covered transaction.

There also is a national security exemption to be issued by the Treasury Secretary, in consultation with the Secretary of State and Congress, based on U.S. national security needs determined on a case-by-case basis. As of the date of this article, no such exemption has been granted to the knowledge of this author.

"Knowledge" Standard

As mentioned above, the U.S. Person must not have *known* that the investment was being made in a covered foreign person. "Knowledge" is defined in the final rule as either (1) "actual knowledge that a fact or circumstance exits or is substantially certain to occur; (2) an awareness of a high probability of a fact or circumstance's existence or future occurrence; or (3) reason to know of a fact or circumstance's existence". The assessment of whether the U.S. Person has or had such knowledge requires that the U.S. Person conduct "reasonable and diligent inquiry," which will be assessed by Treasury on a case-by-case basis on "consideration of the totality of relevant facts and circumstances." The Final Rule sets forth certain factors that Treasury will examine, as follows:

- The inquiry a U.S. Person has made regarding the investment target, including questions asked of the investment target at the time of the transaction;

- The contractual representations and warranties that the U.S. Person receives or attempts to receive in the investment documentation;

- The efforts by the U.S. Person at the time of the transaction to obtain and consider non-public information;

- Available public information and the efforts taken by the U.S. Person to obtain and consider such information;

- Use of available public and commercial databases;

- The presence or absence of warning signs, such as evasive responses or non-responses from the investment target; and

- Whether the U.S. Person purposely avoided learning or seeking relevant information.

This knowledge standard imposes a high level of due diligence on the part of the U.S. Person. Failure to meet the standard could result in severe criminal penalties, particularly with respect to prohibited transactions. Those private equity funds that do not intend to invest in Covered Foreign Persons will need to revise their investment documentation to include the appropriate representations and warranties. The inquiry by a U.S. Person could involve considerable expense, and consideration should be given to allocation of those expenses to the parties involved. Moreover, since there is no governmental agency review or approval of the investment, a U.S. Person will not know whether it satisfied the knowledge standard at the time of the transaction. It will make the investment at its own peril, with the risk that it could be fined subsequent to the transaction. The Committee on Foreign Investment in the United States has a unit that investigates transactions with China, so there is a strong likelihood that transactions will be uncovered after-the-fact.

Knowingly Directing a Transaction

A U.S. Person is prohibited from "knowingly directing" a prohibited transaction by a non-U.S. Person had it been engaged in by a U.S. Person. Thia applies to a U.S. Person who has authority, individually or as part of a group, to make or substantially participate in decisions on behalf of the non-U.S. Person and exercises that authority to participate in approving the transaction. An officer or director of a non-U.S. Person or a U.S. Person serving on the investment committee of a non-U.S. fund would be such a person. However, the Final Rule makes an exception if that U.S. Person recuses himself or herself from participating in the decision-making process or participating in the transaction, as defined in the Final Rule. Care must be taken to properly document such recusal.

Violations and Penalties

The Final Rule grants the authority to the Treasury Department of imposing both civil money and criminal penalties. Civil money penalties cannot exceed the greater of $250,000 or an amount that is twice the amount of the transaction. Criminal penalties are capped at not more than $1,000,000 or not more than 20 years' imprisonment, or both. Moreover, the Secretary of Treasury has the power to void a prohibited transaction or order its divestiture . There is a voluntary self-disclosure process that potentially can ameliorate or avoid the penalties if reported to the Department prior to Treasury learning of the violation.

Confidentiality

Notifications and other submissions to the Treasury Department are confidential and not subject to Freedom of Information requests, except that disclosure is permitted in the following circumstances:

- In connection with any relevant judicial or administrative proceeding;
- In reports to Congress;
- To U.S. and foreign governments for national security concerns;
- Pursuant to consent of the relevant parties; and
- Treasury publications on an anonymized basis.

Conclusion

The Final Rule tries to maintain a balance between maintaining the longstanding U.S. policies and tradition of allowing an open investment environment, on the one hand, and the need to protect the national security of the U.S., on the other. However, the knowledge standard is not well defined, is fact-sensitive, and will be judged by Treasury on a retrospective basis. It is crucial that U.S. Persons contemplating an investment in semiconductors, microelectronics, quantum information technologies or AI systems with a potential China tie seek appropriate written representations from covered foreign persons and from private equity funds that may be investing in companies involved in these covered activities and conduct extensive due diligence to assure themselves that the investment either is not prohibited under the Final Rule or, if it requires notification to Treasury, that the appropriate filing will be made. Since there is no pre-transaction governmental review, there is a high level of risk, with significant civil and criminal penalties.

Congress is also considering legislation to curtail U.S. investments in Chinese technology. The proposed Comprehensive Outbound Investment National Security Act of 2024 (the COINS Act), introduced in December of 2024, legislatively mandates requirements similar and in addition to the Final Rule, and it is possible under the Trump Administration we will see additional action.

More significantly, on February 21, 2025, the Trump Administration announced a new "America First Investment Policy" Memorandum that outlined the Administration's proposed review of the Final Rule and the U.S.'s outbound investment policies generally. One can anticipate an expansion of restrictions and prohibitions on outbound investments by U.S. Persons into China and Chinese companies, as well as an expansion to other unfriendly countries.