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Treasury's Final Rule on Outbound Investments Takes Effect January 2



On January 2, 2025, the U.S. Department of the Treasury's (Treasury) regulation restricting U.S. outbound investments in certain advanced technology sectors in China (the Final Rule) takes effect. Thereafter, investments by U.S. persons in "countries of concern" (the People's Republic of China and the Special Administrative Regions of Hong Kong and Macau) involving certain advanced semiconductors and microelectronics, quantum computing and information technologies, and artificial intelligence (AI) will either be prohibited or will require notification to Treasury within 30 days of completion. According to the White House, the Final Rule is designed to "keep America safe by preventing countries of concern—namely the People's Republic of China—from advancing in key technologies that are critical to their military modernization."

The Final Rule prohibits U.S. persons from engaging in any "prohibited transaction," and requires U.S. persons to notify the U.S. government after engaging in any "notifiable transaction" involving a "covered foreign person" "who is engaged in covered activities." The Final Rule places the burden directly on U.S. persons to determine the new rule's applicability to contemplated transactions—including a strict "knowledge" standard requiring vigorous due diligence in connection with compliance.

Unlike existing U.S. export controls and sanctions regimes, and unlike the Committee on Foreign Investment in the United States (CFIUS) review of inbound foreign investment, the Final Rule does not include a license process or case-by-case review.

This Update breaks down the Final Rule's requirements and its implications for U.S. businesses and investors.

Moreover, legislation pending in Congress would further restrict U.S. investments in China in a broader scope of advanced technologies and impose broader notification and disclosure requirements. The legislative proposals, including the draft Comprehensive Outbound Investment National Security Act of 2024 (COINS Act), seek to ban U.S. investments in China in 15 "prohibited technologies," including advanced semiconductors, AI, quantum computing, hypersonics, satellite-based communications, and Lidar. Initial attempts in Congress to

attach the proposed COINS Act to the annual National Defense Authorization Act failed, and Congress is currently considering alternative legislative vehicles to enact the legislation on an expedited basis.

Covered “US Persons”

The Final Rule covers certain outbound investment activity by “U.S. Persons,” including U.S. citizens, lawful permanent residents, or entities organized under U.S. law. The Final Rule also requires that U.S. persons take “reasonable steps” to ensure that their “controlled foreign entities” (*i.e.*, entities controlled by a U.S. person or in which a U.S. person directly or indirectly holds more than 50% of the outstanding voting interest or voting power of the board) do not engage in investments that would be prohibited for U.S. person. Treasury will assess various factors to determine whether a U.S. person took reasonable steps. These factors include, but are not limited to:

- Whether there were any agreements between the U.S. person and its controlled foreign entity regarding compliance.
- Where the U.S. person had governance or shareholder rights in the controlled foreign entity.
- Whether there were any periodic training and internal reporting requirements by the U.S. person and its controlled foreign entity.
- Whether there were any internal controls of the U.S. person and its controlled foreign entity.
- Whether there were any testing or auditing processes for the internal controls.

“Covered Transactions”

- The Final Rule covers transactions, including acquisitions of equity interests or contingent equity interests in covered foreign persons, and conversions of contingent equity interests acquired on or after January 2, 2025.
- Certain debt financings with characteristics similar to equity interests.
- Conversions into equity of contingent equity interests acquired on or after January 2, 2025.
- Acquisition, lease, or other development of land, property, or other assets that will result in the establishment of a covered foreign person or covered activity.
- Certain joint ventures, limited partnership investments, and greenfield or brownfield investments.

Under the Final Rule, such transactions are covered only if the U.S. person involved in the transaction has “knowledge” at the time of the transaction that the transaction includes a “covered foreign person,” will result in the establishment of a “covered foreign person,” or will result in a person of a country of concern’s engagement in a “covered activity.” However, “knowledge” includes *actual* knowledge, as well as suspicion or *reason to know*. The U.S. person must conduct a “reasonable and diligent inquiry” to determine whether a proposed transaction is covered, including seeking representations and warranties, reviewing publicly available information, making efforts to obtain nonpublic information, utilizing commercial databases, and following up on evasive responses.

Certain transactions are excepted:

- Investments in publicly traded securities, unless the investment affords the U.S. person rights beyond standard minority shareholder protections.
- Receipt of equity compensation for employment in the form of stock or stock options, or the exercise of such options.
- Satisfaction of binding commitments predating January 2, 2025.
- Certain investments by non-U.S. funds with U.S. person limited partners.

- Certain investments by non-U.S. persons ordinarily controlled by a U.S. person, where such U.S. person has sufficiently recused itself.
- Full buyouts of Chinese ownership.
- Transactions between a U.S. person's parent and its subsidiary in a country of concern that do not expand the level of covered activity by the subsidiary.
- Certain syndicated debt financings.
- Derivative transactions that do not confer the right to acquire equity, any rights associated with equity, any assets, or rights beyond standard minority shareholder protections.

The Treasury secretary may also designate countries that have implemented adequate safeguards to address national security concerns posed by the outbound investment, such that persons from such countries would no longer be covered by the Final Rule. No countries are currently so designated.

Lastly, the Final Rule allows the secretary to make individual exceptions for transactions they determine to be in the national interest of the United States.

“Covered Foreign Persons”

The Final Rule covers two types of foreign persons who engage in “covered activities.”

The first is a “person of a country of concern”:

- A citizen or permanent resident of China who is not a U.S. citizen or U.S. permanent resident.
- An entity that has its principal place of business or headquarters in China or is incorporated in or organized under the laws of China.
- The Chinese government or any person acting on its behalf.
- An entity in which the Chinese government holds, directly or indirectly, 50% or more of the outstanding voting interest, board voting power, or equity interest, or that otherwise has the power to direct or control.
- An entity in which one or more persons identified above, individually or in the aggregate, directly or indirectly, holds at least 50% of the outstanding voting interest, board voting power, or equity interest.

The second is a person who directly or indirectly holds any voting interest or equity interest in, or has the power to direct, one or more “persons of a country of concern” from which it derives more than 50% of its annual revenue or net income, or incurs more than 50% of its annual capital or operating expenses (subject to a \$50,000 minimum).

Accordingly, U.S. persons should be aware that certain investments in non-Chinese entities may still be covered.

The Final Rule makes clear that *any* level of covered activity by a person of a country of concern is enough for the person to be a covered foreign person, even if that level of covered activity does not afford the person of a country of concern governance rights.

Treasury does not intend to publish a list of entities designated as covered foreign persons, and instead expects U.S. persons to conduct a reasonable and diligent inquiry to determine whether a transaction involves covered foreign persons.

“Covered Activities” Include Three Sensitive Technology Sectors

The Final Rule covers three technology sectors and sets forth prohibited and notifiable transactions within each.

Semiconductors and Microelectronics

- **Prohibited transactions.** Covered transactions related to certain electronic design automation software; certain fabrication or advanced packaging tools; the design or fabrication of certain advanced integrated circuits; advanced packaging techniques for integrated circuits; and supercomputers are prohibited.
- **Notifiable transactions.** Covered transactions related to the design, fabrication, or packaging of integrated circuits not otherwise covered by the prohibited transaction definition must be notified within 30 days.

Quantum Information Technologies

- **Prohibited transactions.** Covered transactions related to the development of quantum computers or production of any critical components required to produce a quantum computer; the development or production of certain quantum sensing platforms; and the development or production of certain quantum networks or quantum communication systems are prohibited.

Certain Artificial Intelligence (AI) Systems

- **Prohibited transactions.** Covered transactions related to the development of any AI system designed to be exclusively used for, or intended to be used for, certain end uses are prohibited. In addition, covered transactions related to the development of any AI system that is trained using a quantity of computing power greater than 10^{25} computational operations, or trained using primarily biological sequence data and a quantity of computing power greater than 10^{24} computational operations, are prohibited.
- **Notifiable transactions.** Covered transactions related to the development of any AI system not otherwise covered by the prohibited transaction definition, where such AI system is either designed or intended to be used for certain end uses or applications or trained using a quantity of computing power greater than 10^{23} computational operations, must be notified within 30 days.

In addition, “notifiable transactions” become prohibited if they involve certain persons restricted under U.S. export control and sanctions regimes.

Penalties

If a U.S. person either (1) engages in a prohibited transaction, (2) fails to timely notify Treasury of a notifiable transaction, or (3) makes material misrepresentations or omissions in submissions regarding a notifiable transaction, that U.S. person can face significant penalties, including civil fines of up to \$368,137 per violation or twice the amount of the transaction, whichever is greater. U.S. persons who willfully violate the Final Rule can face criminal penalties up to \$1 million or 20 years in prison. The U.S. government may also nullify, void, or otherwise require divestment of a prohibited transaction. U.S. persons may submit a voluntary self-disclosure for actual or apparent violations of the Final Rule. Like other voluntary self-disclosure regimes, Treasury will take such disclosure into account as a mitigating factor in assessing the appropriate penalties.

Takeaways for US Businesses

The Final Rule puts into place significant new regulations on U.S. investments in China. U.S. businesses exploring opportunities to invest in China, particularly in sectors that implicate advanced and sensitive technologies, should ensure they conduct robust due diligence as to whether a proposed transaction would be covered (either prohibited or notifiable) before undertaking any such transaction. Since there is no advance official review or licensing procedure under the Final Rule, U.S. persons must ensure that diligence is comprehensive. In addition, businesses should consider appropriate revisions to their fund and transaction

documents and ensure that they implement compliance and diligence procedures to prevent foreign companies they control from engaging in transactions that would violate the Final Rule.

Businesses should also understand that the Final Rule is only the first step by the U.S. government to impose restrictions on outbound investment transactions in China. There will likely be additional restrictions implemented in the near future, including potentially expansive Congressional legislation. Businesses should continue to stay abreast of developments in regulations on outbound investments, particularly into China and other potential countries of concern.

For questions related to outbound investments and diligence, businesses should consult experienced counsel.

Authors

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