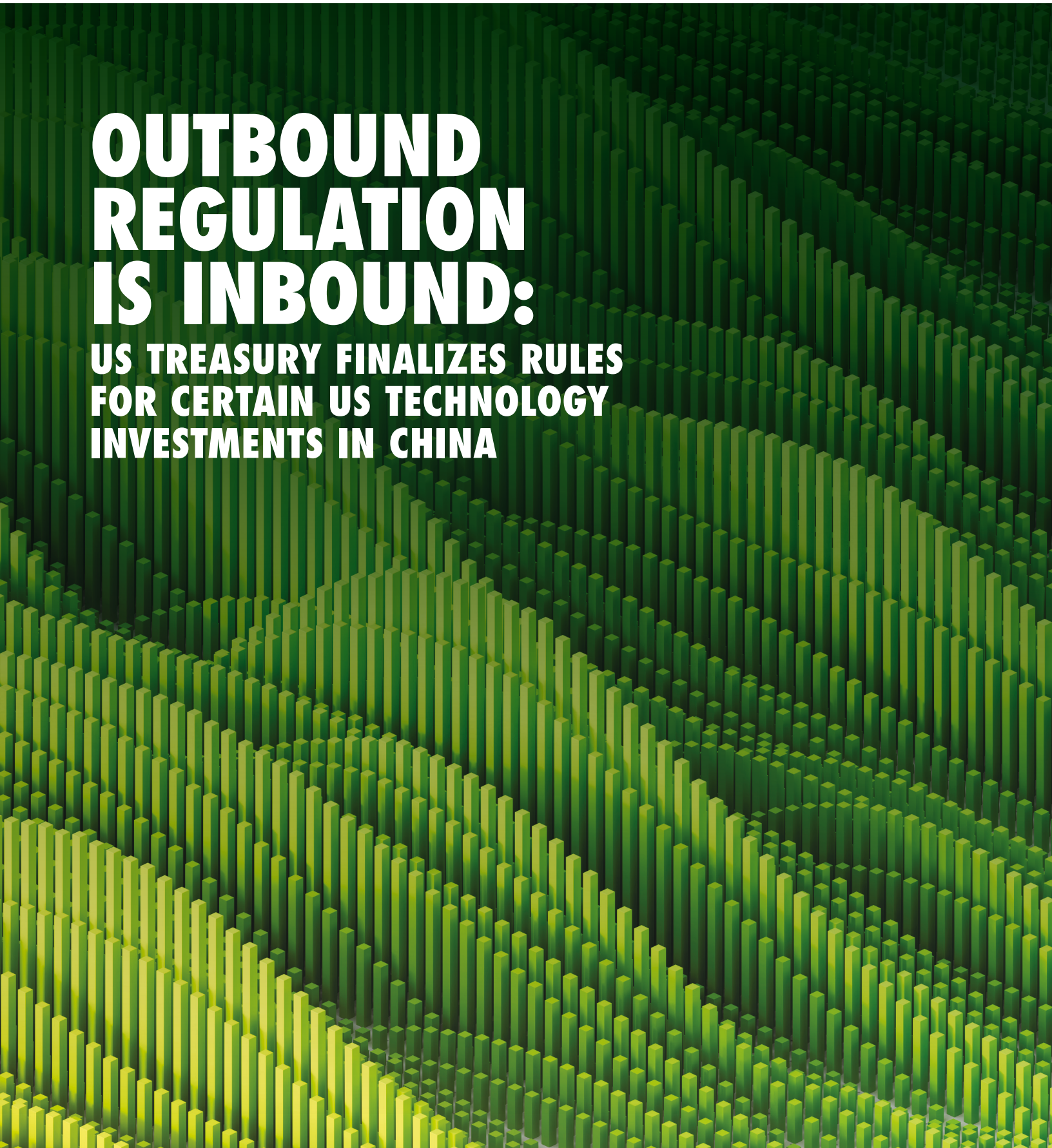
Morgan Lewis

REPORT



OUTBOUND REGULATION IS INBOUND:

US TREASURY FINALIZES RULES FOR CERTAIN US TECHNOLOGY INVESTMENTS IN CHINA

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The US Department of Treasury published its final regulations covering the national security review process for outbound investments on October 28, 2024. The regulations impose notice and prohibition requirements on specific technology sectors determined by President Joseph Biden to directly impact US national security concerns. Although focused on China (including Hong Kong and Macau), the regulations and the underlying executive order justifying the regulations leave open the possibility of adding more technology sectors and countries of concern. With the regulations already in effect as of January 2, 2025, investors must be ready to update diligence processes, address these issues for in-process investments, and assess how future investments in these technology sectors and in China will remain compliant.

On October 28, 2024, the US Department of the Treasury (Treasury) issued the Final Rule (published in the *Federal Register* on November 15, 2024) that established processes to restrict and monitor certain US outbound investment in China. The Final Rule became effective on January 2, 2025, and capped off a more than two-year process that began with Executive Order 14105 (Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern), and several rounds of comments in response to an Advanced Notice of Proposed Rulemaking and then a Notice of Proposed Rulemaking. As the White House notes, the Final Rule attempts to balance the importance of cross-border investments and an open investment environment with national security concerns over the development of sensitive technologies in countries of concern. The Final Rule covers investments transactions in the fields of semiconductors and microelectronics, quantum information technologies, and artificial intelligence (AI)—which the Biden-Harris administration called "core to the next generation of military, cybersecurity, surveillance, and intelligence applications." The Final Rule prohibits some investment while requiring notification of other investments to the newly created Office of Global Transactions (OGT) housed within Treasury. This new outbound investment regime supplements other existing regulations that can also serve to limit certain outbound investments, such as export controls and sanctions regulations.

The Final Rule is a significant addition to the financial aspect of the US national security enterprise. The regulations impact where and how US investors can invest in cutting-edge technology, driven by concerns over the development of sensitive technologies in countries of concern, particularly China. This is rooted in the belief that such technology investments, while financially beneficial, could indirectly aid in the advancement of foreign military, cybersecurity, and surveillance capabilities that pose potential threats to US national security. The Final Rule reflects refinements based on comments received, demonstrating Treasury's effort to address industry concerns raised during the rulemaking process, while seeking to provide greater clarity and guidance to investors.

The Final Rule is also designed to increase Treasury's visibility into investments that were previously unknown to the US government either through US export controls, sanctions, or other regulatory processes. According to the supplementary information in the Final Rule, Treasury confirms EO 14105's focus on more robust processes that provide details concerning a range of investments in countries of concern to inform policymakers, enhance US national security interests and ensure, where practicable, that regulatory requirements are narrowly tailored to target transactions involving quantum information technologies, AI, and semiconductors and microelectronics. It is also notable that although the program continues to apply to a broad swath of limited partner (LP) investments, Treasury broadened slightly the scope of those that are considered excepted transactions not subject to the Final Rule.

BACKGROUND

Regulation of outbound investment in sensitive technologies in China has been an issue for the past several years. The Biden-Harris administration, in its 2022 National Security Strategy (NSS), identified "Out-Competing China" as a national security priority. The NSS views competition in terms of specific technology sectors, civil-military fusion policies, and Chinese companies of concern based on published ties to the Chinese Communist Party or the Chinese government. Congress also attempted to legislate an outbound investment review process without success. In 2024, the House Select Committee on the Strategic Competition between the United States and the Chinese Communist Party also reported that major US financial institutions had provided more than $6.5 billion in funding to Chinese companies believed to be involved in advancing China's military capabilities or supporting human rights abuses.

Executive Order 14105 (the Outbound Order) and the subsequent implementing regulations appear to be a critical prong in the Biden-Harris administration's goal of outcompeting China. While the rule applies to investments in all "countries of concern," the only country identified in the Appendix to EO 14105 (and in the regulations) as currently a country of concern is China (including Hong Kong and Macau).

Although some have referred to the outbound investment regime as a "reverse CFIUS," it has been clear throughout the rulemaking that this regulatory process would not operate in a manner similar to the way that the Committee for Foreign Investment in the United States (CFIUS) works. For example, unlike CFIUS, the Office of Global Transactions is not an interagency group; rather, it is completely within Treasury. Additionally, rather than conducting national security reviews like CFIUS (which determines the national security risk and potential mitigation steps in each transaction), the only time Treasury approval or disapproval is required under the outbound investment program is in response to a request for a national interest exemption to an otherwise prohibited transaction (discussed below).

Instead of taking a case-by-case approach, the new regulation establishes two ways in which outbound investments in sensitive technologies qualify as "covered transactions":

- A notification, but not approval, process
- A prohibition on specific investments, depending on the types of investment and categories of the technology or product

Furthermore, instead of conducting national security reviews, and ordering mitigation or prohibiting transactions, Treasury's authorities are much narrower and focus on receiving notifications, gaining visibility into previously unknown investments in China and monitoring prohibited transactions. Treasury also retains the authority to penalize investors for failures to notify the Office of Global Transactions or engaging in prohibited transactions.

KEY PROVISIONS OF THE FINAL RULE

Who Is Obligated to Comply?

The Final Rule applies to all US persons, wherever located. "US person" is defined as "any United States citizen, lawful permanent resident, entity organized under the laws of the United States, or any jurisdiction within the United States, including any foreign branch of any such entity, or any person in the United States." This broad definition includes branches of US entities, US citizens and permanent residents located outside the United States, and US entities with non-US parents, but does not include the non-US parent itself. Treasury noted in its commentary to the rule that it plans to provide illustrative examples of who may be covered via its Outbound Investment Security Website.

Although the Final Rule defines US person narrowly, other aspects of the rules make the actual impact much broader. For example, non-US funds will effectively need to comply with the regulations if they involve US capital in notifiable or prohibited transactions because the regulations make clear that a foreign-based pooled fund that includes funds from US LPs can be subject to these requirements.

What Is a 'Person of a Country of Concern' and When Does Such a Person Become a 'Covered Foreign Person'?

The outbound regulations describe four circumstances that will cause a person to be a "person of a country of concern":

1. An individual is a citizen or permanent resident of a country of concern (excluding US citizens and US permanent residents).

2. An entity with a principal place of business in, headquartered in, incorporated in, or organized under the laws of, a country of concern.

3. The government of a country of concern, persons acting on behalf of such a government, and persons controlled by or directed by such a government.

4. Any entity, wherever located, in which one or more persons of a country of concern, individually or in the aggregate, holds at least 50% of any outstanding voting interest voting power of the board, or equity interest, regardless of whether the interest was held directly or indirectly.

The regulations also define three scenarios under which a person of a country of concern becomes a covered foreign person:

1. **Direct Engagement in Covered Activity**: A person is considered a covered foreign person if they are from a country of concern *and* engage directly in a covered activity.

2. **Significant Financial Connection with a Person of Concern**: A person not otherwise a covered foreign person will be *deemed* a covered foreign person if:

    - There is a specific corporate relationship with a person from a country of concern who is engaged in a covered activity (e.g., holding a voting/equity interest, board seat, or contractual control).
    - They derive more than 50% of the entity's revenue, net income, capital expenditure, or operating expenses from the "person of concern," either individually or in aggregate across multiple persons of concern engaged in covered activities. (Contributions under $50,000 from any person of concern are excluded from the 50% calculation. Financial metrics are assessed independently, not combined.)

    This provision targets entities that, while not directly engaged in covered activities, are financially connected to those who are, with the intent to capture indirect benefits passed from US investments to persons of concern.

3. **Joint Ventures with US Persons:** A person from a country of concern is also deemed a covered foreign person if that person participates in a joint venture with a US person, and the joint venture engages in a covered activity. This approach addresses potential transfers of intangible benefits from US persons to persons of concern through such joint ventures.

What Transactions Are Covered?

The Final Rule applies to covered transactions involving a covered foreign person that engages in a covered activity. The types of transactions that may constitute a "covered transaction" are as follows:

- The acquisition of an equity interest
- The acquisition of a *contingent equity interest*
- Certain debt financing convertible to an equity interest or that afforded certain rights to the lender
- The conversion of a contingent equity interest
- A greenfield, brownfield, or joint venture investment or other corporate expansion;
- A joint venture
- Certain investments as a LP or equivalent in a non-US person pooled investment fund

One of the goals, identified in the Executive Order and reiterated throughout the rulemaking process, is to address not only direct capital investments, but also investments from the United States that produce "intangible benefits" that help adversary companies succeed. In discussing the need to address this issue, Treasury identified several areas, such as managerial assistance, access to talent networks, enhanced standing, and market access. The Final Rule's definition of covered transactions therefore includes provisions that Treasury believes will address circumstances when a US person could directly or indirectly provide such benefits.

This concern also resulted in the expansion of the definition of "contingent equity interest" to refer to a "financial interest" in the Final Rule, instead of a "financial instrument"—which the Notice of Proposed Rulemaking had used, to include convertible interests and debt that can be converted to equity. Although Treasury intends to capture certain convertible interests, secured debt and the acquisition of such debt *by itself* is not a covered transaction. Issuers of such debt must still be cautious, however, because foreclosure or any other situation where the lender takes possession of a security or any other financial interest of the covered foreign person will be an acquisition of an equity interest that is covered by the rule. Thus, such a conversion could either be prohibited or subject to the notification provisions.

There remain some circumstances when US persons may end up investing in these specific national security technologies and products without triggering the rule. For example, in relation to the acquisition or conversion of a contingent equity interest, the Final Rule clarified in Note 1 to Section 850.210 that a US person is not considered to have indirectly acquired an equity interest or contingent equity interest in a covered foreign person when the US person acquires an LP interest in a venture capital fund, private equity fund, fund of funds, or other pooled investment fund if that fund previously acquired an interest in a covered foreign person. Despite this exception, investors should not use such vehicles to avoid the prohibition or notification requirement, as such tactics can be seen as prohibited evasion.

What Covered Transactions Are Prohibited Transactions or Notifiable Transactions?

The Final Rule prohibits transactions that:

- relate to the development or production of quantum information technology;
- support *some* AI development, depending on the end use, computing power, and whether it is trained with biological sequence data; or

- concern select and specified software and hardware semiconductors and microelectronics.

Covered transactions that are not *prohibited* for these national security technologies or products, require *notification* to Treasury. Specifically, investors must notify OGT when they conduct a covered transaction that:

- relates to the design, fabrication, or packaging of integrated circuits that is not prohibited by the regulation; or
- supports the development of any AI system that is not prohibited and intended to be used for certain end uses or trained using a quantity of computing power greater than 10^23 computation operations.

The Final Rule explains that these notifications will increase the federal government's visibility into transactions involving national security technologies and products and will inform future policy decisions.

The chart below summarizes the prohibited and notifiable transactions and the technologies to which they relate. Based on the language used in the preamble to the Final Rule, Treasury anticipates that it will expand the technologies covered or update the types of transactions that are prohibited or subject to notification.

Sector	Prohibited Transactions	Notifiable Transactions
Semiconductors and Microelectronics	Entities that develop or produce any electronic design automation software for the design of integrated circuits or advanced packaging. Entities that develop or produce any (1) front-end semiconductor fabrication equipment designed for performing volume fabrication of integrated circuits; (2) equipment for performing volume advanced packaging; or (3) commodity, material, software, or technology designed exclusively for use in or with extreme ultraviolet lithography fabrication equipment. Entities that design any integrated circuits that meet or exceed the performance parameters in Export Control Classification Number 3A090.a in supplement No. 1 to 15 CFR part 774, or integrated circuits designed for operation at or below 4.5 Kelvin. Entities that fabricate specific types of integrated circuits, including: 1. Logic integrated circuits with non-planar architecture or with a product	Entities engaged in the design, fabrication, or packaging of any integrated circuit that does not meet the parameters necessary to trigger a prohibition.

	technology node of 16/14 nm or less (e.g., FDSOI integrated circuit). 2. NAND memory integrated circuits with 128 layers or more 3. DRAM integrated circuits with an 18 nm half-pitch or smaller 4. Integrated circuits made from gallium-based compounds 5. Integrated circuits using graphene transistors or carbon nanotubes 6. Integrated circuits designed to operate at or below 4.5 Kelvin Entities that package any integrated circuit using advanced packaging techniques. Entities that develop, install, sell, or produce any supercomputer enabled by advanced integrated circuits that can provide a theoretical compute capacity of 100 or more double-precision (64-bit) petaflops or 200 or more single-precision (32-bit) petaflops of processing power within a 41,600 cubic foot or smaller envelope.	
Quantum Information Technologies	Entities that develop a quantum computer or produces any of the critical components required to produce a quantum computer such as a dilution refrigerator or two-stage pulse tube cryocooler. Entities that develop or produce any quantum sensing platform designed for, or which the relevant covered foreign person intends to be used for, any military, government intelligence, or mass-surveillance end use. Entities that develop or produce any quantum network or quantum communication system designed for, or which the relevant covered foreign person intends to be used for (1) networking to scale up the capabilities of quantum computers, such as for the purposes of breaking or compromising encryption; (2) secure communications, such as quantum key distribution; or (3) any other application that has any military, government intelligence, or mass-surveillance end use.	Not currently covered

Artificial Intelligence	Entities that develop any AI system that is designed to be exclusively used for, or which the relevant covered foreign person intends to be used for, any (1) military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapon control, military decision-making, weapons design (including chemical, biological, radiological, or nuclear weapons), or combat system logistics and maintenance); or (2) government intelligence or mass-surveillance end use (e.g., through incorporation of features such as mining text, audio, or video; image recognition; location tracking; or surreptitious listening devices); Entities that develop any AI system that is trained using a quantity of computing power greater than (1) 10^25 computational operations (e.g., integer or floating-point operations); or (2) 10^24 computational operations (e.g., integer or floating-point operations) using primarily biological sequence data.	Entities engaged in the development of AI systems that are designed for military, government intelligence, or mass surveillance end uses (but not exclusively). Entities engaged in the development of AI systems intended to be used for cybersecurity applications, digital forensics tools, penetration testing tools, or the control of robotics systems. Entities engaged in AI systems trained using computing power greater than 10^23 computational operations that are not prohibited transactions.
Other Categories of Transactions	Entities with a relationship to one or more covered foreign persons engaged in any covered activity through a specific relationship with a person from a country of concern, if (1) they hold a voting interest, board seat, equity interest, or management control through contractual arrangements, and (2) more than 50% of their revenue, net income, capital expenditures, or operating expenses are tied to that person from a country of concern. Entities engaged in a covered activity that are also designated on the Bureau of Industry and Security's Entity List, on the Bureau of Industry and Security's Military End User List, qualify as "Military Intelligence End-Users" under BIS regulations, are on the Treasury's Specially Designated Nationals (SDN) List or have 50% or greater ownership by SDN-listed individuals/entities, are on the Treasury's Non-SDN Chinese Military-Industrial Complex	Not applicable

	Companies (NS-CMIC) List, or are designated as foreign terrorist organizations by the secretary of state.	

When submitting a notification, the investor must provide specific information relating to the transaction, including the identity of the parties, the type of transaction, and the national security technologies and products. Filing must occur within 30 days after the transaction is completed. OGT has published on its website several templates as well as guidance for filing notifications that parties may use. This information can be found here.

Although submitted information is confidential, Treasury may disclose the information to Congress with relevant confidentiality and classification requirements. The Final Rule also authorizes Treasury to share the information with other government agencies and allied countries when "important to the national security analysis or actions of such governmental entity or the Department of the Treasury."

It is not clear whether Treasury will notify the parties who submitted filings of the government's intention to share confidential information included in their filings. Thus, parties who notify transactions under these rules should anticipate that OGT could share the information with others, including foreign governments with an interest in the data, whether for administration of similar regimes or other law enforcement purposes. The Final Rule notes that disclosure would only occur rarely, and that such a decision could not be delegated beyond the assistant secretary of the Treasury.

What Are the Available Exceptions and Exemptions?

Understanding that some types of transactions do not confer the same type of capital and intangible benefits that otherwise covered investments usually include, the Final Rule includes a list of exceptions and one exemption to the regulations.

The followings transactions are excepted from the notice and prohibition requirements of the regulation if the transactions would not provide the US person with any rights that are not standard for minority shareholders:

- **Publicly traded securities**: This would include securities issued by a registered investment company.
- **Some LP investments**: A US person's investment made as an LP in any type of pooled investment fund as long as the investment is either (1) equal to or less than **$2 million** (see detailed discussion below) or (2) includes "contractual assurances that its capital will not be used by the fund to engage in what would be a prohibited or notifiable transaction."
    - This exception represents a notable change because the Notice of Proposed Rulemaking had originally proposed two different options for exceptions for LP investments. The first option would have been for cases where the LP made a passive investment and committed less than 51% of the total assets under management. The second option would have made an exception if the LP's capital contribution was equal to or less than $1 million. Despite comments almost unanimously favoring option one, the Final Rule adopted option two with a higher dollar threshold. Treasury explained that option one would have been overly inclusive and permit large LP investments to confer significant benefits to

covered foreign persons, while the investment threshold was increased to $2 million for option two in response to criticism that the $1 million limit would make the exception practically unavailable to many institutional investors.

- **Derivatives**: The Final Rule clarified that this exception only applies as long as the derivative does not confer equity rights, associated equity rights, or assets related to a covered foreign person.
- **Buyouts of interests held by a person from a country of concern**: A full buyout of all the ownership rights of a person from a country of concern.
- **Intracompany transactions**: This addition to the Final Rule excepted transactions between a US person and a controlled foreign entity to (1) support operations that are not covered activities or (2) maintain the operations of covered activities that began prior to **January 2, 2025**.
- **Certain pre-Final Rule binding commitments**: Fulfilling a binding capital commitment entered prior to the implementation of the final rule.
- **Certain syndicated debt financing**: A US person, via passive membership in a lending syndicate, gaining a voting interest in a covered foreign person upon default.
- **Equity-based compensation**: This addition to the Final Rule includes receipt of employment compensation via a grant of equity in a covered foreign person or options to purchase such equity.
- **Third-country measures**: Some transactions involving a different country when the secretary of Treasury determines that country has adequate outbound investment regulations to combat the national security concerns identified in the Outbound Order and the Final Rule.

Notably, one transaction that Treasury refused to exclude from the regime is the acquisition of an equity interest in a covered foreign person for the sole purpose of facilitating an initial public offering. Even though the intent of the purchase may be solely to create a market for the security, the Final Rule determined that such transactions confer the type of benefits the rule is trying to prevent—providing enhanced standing and prominence, managerial assistance, access to investment and talent networks, market access, and enhanced access to additional financing. However, services ancillary to initial public offerings that do not include the acquisition of an equity interest, such as underwriting services, are separately covered transactions.

Passive Limited Partner Investments Exception

Treasury acknowledged the potential for unintended consequences and a desire to limit those consequences given the United States' longstanding open investment policy. In an effort to minimize the Final Rule's impact on certain passive investments, the Final Rule provides exclusions for some investments made by US LPs in foreign funds, evaluating both dollar-based and percentage-based thresholds. Passive investments under $2 million (which lack other indicia or factors that could trigger obligations under the rule) will generally fall outside the rule's scope, although US investors may still need contractual protections to exclude them from restricted transactions.

Similar to the CFIUS framework, the outbound regulations in § 850.501(a)(2) outline specific, permissible passive shareholder protections. These include the ability to block the sale or pledge of substantial assets or prevent voluntary bankruptcy or liquidation. Minority investors can also prevent the entity from entering into contracts or guaranteeing obligations with majority investors or their affiliates. Additionally, the regulations recognize traditional passive investments where the only rights provided are standard minority protections such as anti-dilution measures, allowing minority investors to maintain their

proportional ownership if new interests are issued, and the ability to block changes to the legal rights or preferences associated with their stock class. Finally, minority investors have the power to prevent amendments to organizational documents that would affect these protective rights, ensuring their position and investment value remain secure.

National Interest Exemption

In addition to the exceptions, the regulations provide a US person the ability to seek an exemption from the application of the prohibition or notification requirement. While Treasury noted that the outbound investment regulations were designed to apply on a transaction-by-transaction basis, the National Interest Exemption results in a Treasury review of the transaction, which is needed to make this assessment. The secretary of the Treasury can determine, after considering the totality of the circumstances and in consultation with the heads of other relevant agencies, that a certain transaction is in the national interest of the United States and is therefore exempt from some or all the regulations. Treasury anticipates this exemption will be granted only in exceptional circumstances and has provided guidance regarding the process for requesting a national interest determination as well as considerations applicable to such a determination.

What Are the Enforcement Mechanisms for Violations?

US persons violate the regulations when they, without an exemption, conduct prohibited transactions, fail to notify Treasury when required, or make materially false or misleading statements when submitting information.

Violations of the rule can result in a range of civil and criminal penalties as well as forced divestment. The rule was promulgated under the International Emergency Economic Powers Act (IEEPA) and the National Emergencies Act (NEA). Currently, violation of the Final Rule could result in civil penalties of either $368,136 (adjusted for inflation annually) or twice the value of the violating transaction—whichever is greater. Treasury is also authorized to refer criminal violations to the attorney general, and willful violations can result in criminal penalties of up to $1,000,000 or imprisonment of up to 20 years, or both.

Violators can submit voluntary self-disclosures, which can be taken into consideration when Treasury is determining the appropriate response to violations.

Important Transaction Due Diligence Considerations and Requirements

In its originally proposed form, these regulations raised a number of concerns, resulting in numerous comments and requests from the public for significant changes to the draft regulations. As a result of these comments, Treasury adjusted certain language in the Final Rule to address these concerns. Some of the more significant changes included clarifications on several key areas:

- The knowledge standard that specifies what a US person must know about certain facts in a transaction to trigger obligations under the Final Rule
- The prohibition on US persons "knowingly directing" certain transactions
- Clarifying the scope of LP investments considered covered transactions
- Clarifying the definition of a covered foreign person concerning persons with interests in countries of concern
- The treatment of specific debt and contingent equity transactions

These regulations will likely have a significant impact on the nature and scope of diligence in potentially covered transactions. Highlighted below are those areas where the requirements will likely result in the

need to adjust the diligence and investment process when dealing with specific technology sectors and investments in countries of concern.

Knowledge Standard

The knowledge standard incorporated into the Final Rule borrows from other national security statutes, in particular US export controls and sanctions. For a US person to run afoul of the outbound investment regulations, the party must have "known" that it was conducting a covered transaction with a covered foreign person at the time of the investment. However, the knowledge standard (specified under § 850.104) does not encompass only actual knowledge. Instead, knowledge may be imputed if the party has "an awareness of a high probability of a fact or circumstance's existence or future occurrence or reason to know of a fact or circumstance's existence." Thus, if an investor knows, has reason to know, or is aware of a high probability of a fact, the regulations consider that knowledge.

The Final Rule requires investors to undertake a "reasonable and diligent inquiry" (as described more fully below) before proceeding with a potentially covered transaction and expressly notes that incomplete or inadequate diligence can raise questions of evasion of the regulations that could result in penalties. In response to various comments, Treasury declined to embed a safe harbor provision, meaning that conducting adequate due diligence does not guarantee protection from liability.

In addition, the regulations appear to impose an ongoing obligation on investors to remain engaged as they uncover information even about closed investments. For example, Treasury requires notification if a US person later realizes that a past transaction was a covered transaction.

Due Diligence Criteria

In its discussion of the proposed rule, Treasury outlined standards for assessing whether a US person has conducted sufficient due diligence to avoid imputing knowledge. These standards include the following:

- Researching the nature of the counterparty's business and operations
- Researching public sources to understand how business is conducted
- Evaluating revenue streams and other operational expenses to assess whether they derive primarily, partially or not at all from sources in countries of concern
- Securing contractual representations where information may be more opaque or to affirm a party's representations regarding essential facts needed to determine whether an outbound investment is covered by the regulations, subject to notification or prohibited

The Final Rule further clarifies that Treasury will assess due diligence based on the totality of the circumstances, recognizing that the process may vary case-by-case. The rule also emphasizes that US investors are only required to investigate relevant counterparties, not unrelated third parties, and clarified that while the rule no longer references legal counsel, investigations by third parties will still be weighed in the due diligence evaluation.

US Persons May Recuse from Knowingly Directed Transactions

The Final Rule specifies that a US person may violate these regulations by knowingly directing transactions that would be covered if conducted by a US person, even if no US party is directly involved. A US person "knowingly directs" a prohibited transaction by a non-US person if they both (1) have authority to substantially participate in decisions on behalf of the non-US entity and (2) use that authority to guide or approve a transaction that would otherwise be restricted. However, if a US person recuses themselves from decision-making, they will not be considered to have knowingly directed a prohibited

transaction. This will be especially important for managers of funds located outside the United States where US persons might otherwise be involved in investment decisions.

Documenting decision-making, including recusals, will be key to ensuring that a party can demonstrate the reasonableness and reliability of actions taken when relying on a recusal process.

KEY TAKEAWAYS

The Final Rule introduces an important regime aimed at managing outbound investments related to national security concerns, offering both opportunities for insight and significant challenges for compliance. Below is a list of key takeaways and considerations:

- **Due Diligence Standard:** While the rule provides investors with essential guidance on due diligence obligations, it remains ambiguous in certain areas, such as what qualifies as "reasonable" due diligence. Although Treasury will apply a totality of circumstances standard for both knowledge and the approach to diligence, investors will need to ensure they obtain sufficient information to assess how to approach potentially covered transactions. Given that the rule requires meaningful inquiry, contractual protections, and verification of both public and non-public information, US persons must conduct a substantive investigation into the investment target or counterparty, including asking specific questions to assess if the counterparty is involved in restricted activities.
- **Focus on National Security in Sensitive Sectors:** Significant distinctions exist between notifiable and prohibited transactions, making it critical for investors to identify into which category a transaction falls, as different requirements apply. Notably, for AI, the Final Rule prohibits investments tied to developing any AI system intended exclusively for military or surveillance applications. This definition diverges from other frameworks, such as the EAR, by focusing specifically on end uses associated with national security. While no licensing mechanism exists to allow investors to seek approval for AI investments on a case-by-case basis, the Final Rule provides an exception for AI models developed strictly for internal, non-commercial use, which are presumed unlikely to pose a national security threat. Given the rapid evolution of AI technologies, Treasury expects further updates to some definitions, especially regarding computing clusters needed to train advanced AI systems. The commentary on the Final Rule indicated that future updates might specifically address these computing clusters and highlighted the potential need to revise computing power thresholds.
- **Contractual Clauses:** Treasury also advises obtaining contractual representations or warranties to confirm the transaction's status and whether the counterparty is a covered foreign person. These contractual protections can add a layer of security to the due diligence process, although they are not absolute safeguards. However, in most instances they cannot act *instead* of diligence, and thus parties should be careful to assess when and whether such provisions are by themselves adequate to the task.
- **Non-public information:** The Final Rule also emphasizes extending diligence efforts to include non-public information, as this may reveal critical insights into the counterparty's activities or affiliations. Publicly accessible data should be reviewed thoroughly, with a focus on identifying any inconsistencies with other findings. The Final Rule warns against "willful blindness," where an investor intentionally disregards relevant information, which could be interpreted as implicit knowledge of a covered transaction. Furthermore, warning signs—such as evasive responses, refusals to cooperate on representations,

failure to provide adequate information in response to diligence requests, or hesitancy in providing information overall—could trigger heightened scrutiny.

- **LP Exception is Limited:** The Final Rule's exception for passive LP investments is quite restrictive and likely will have limited application.
- **Imminent Effective Date:** The regulations are now in effect. Transactions closing after January 2, 2025 must account for these rules. Investors need to adjust their processes promptly, particularly with respect to due diligence, contractual representations, and warranties, and determining whether transactions fall under prohibited or notifiable categories. Notifications must be submitted within 30 days of a covered transaction.
- **Legislative and International Trends**: Congress may still legislate further in this area. Several attempts have been made to pass an outbound legislative regime, and this effort will likely continue in the new Congress. Additionally, other countries may follow suit, with the "third-country measures" exception adopted in § 850.501(g) of the Final Rule incentivizing foreign governments to adopt similar outbound investment regulations. This strategy mirrors the approach used in CFIUS to encourage other jurisdictions to align with US standards.
- **Connections to CFIUS and Export Controls:** The Final Rule draws heavily from existing regulatory frameworks like CFIUS, export controls, and sanctions. For instance, definitions and processes under the Final Rule echo those in CFIUS and the 50% rule from sanctions regimes. This familiarity may help investors adapt, but the overlapping frameworks require careful navigation.

Given the impact of these regulations and their complexity when it comes to certain definitions and standards, Treasury has issued additional guidance to assist with compliance, including details on notification filing and the national interest exemption process. More guidance will likely issue as challenges are identified.

Although these rules are final, they represent the beginning of a new and layered approach towards outbound investment. This regime reflects Treasury's perspective that while free economic activity is crucial to the United States, the financial system continues to be at the forefront of national security, and Treasury's regulatory authority and tools can continue to be deployed to address national security concerns.

CONTACTS

If you have any questions or would like more information on the topic of foreign direct investment regimes around the world, please contact any of the following regarding their respective laws and regulations:

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