

SIDLEY UPDATE

U.S. Treasury Issues Final Rule Restricting Outbound Investments in Chinese-Affiliated Entities

December 12, 2024

On October 28, 2024, the U.S. Department of the Treasury (Treasury) released the [Final Rule](#) for its new regulations prohibiting or requiring notification of U.S. outbound investments in certain Chinese-affiliated companies in the semiconductor and microelectronics, quantum information technology, and artificial intelligence (AI) sectors. The Final Rule will take effect on January 2, 2025.

The Final Rule comes five months after Treasury published its [Notice of Proposed Rulemaking](#) (NPRM) for these regulations and just over a year after the Biden administration issued an [executive order](#) (EO) directing Treasury to create the program. The Sidley Update in connection with the NPRM is [here](#). Treasury's fact sheet and press release on the Final Rule are available [here](#) and [here](#) respectively.

What is the purpose of the Final Rule?

The Final Rule limits the ability of "U.S. persons" to invest in, knowingly direct investments in, or permit subsidiaries to invest in "persons of a country of concern" who are involved in or (in certain circumstances) may become involved in the development or production of certain high-end technologies within the semiconductor and microelectronics, quantum information technology, and AI sectors.

Specifically, the Final Rule prohibits or requires notification by "U.S. persons" of

- (a) certain "covered transactions" described in Attachment 1 to this Update that are
- (b) undertaken by "U.S. persons"
- (c) into or with a "covered foreign person" or that create a "covered foreign person."

As discussed further below, a "covered foreign person" is (1) a "person of a country of concern" engaged in one or more of the "covered activities" listed in Attachment 2 to this Update; (2) other persons with interests in, board seats in, or contract-based authority over a "covered foreign person," when such "covered foreign person" accounts for the majority of the former's revenue, income, capital expenditures, or operating expenditures; or (3) a "person of a country of concern" that participates in a joint venture (JV) that engages in covered activities.

The Final Rule also requires U.S. persons to take all reasonable steps to prevent their foreign subsidiaries from undertaking transactions that would have been prohibited if undertaken by a U.S. person.

Who is a "U.S. person"?

"U.S. persons" means

- (a) U.S. citizens,
- (b) lawful permanent residents,

- (c) persons located in the United States,
- (d) businesses organized in the United States, or
- (e) foreign branches of businesses organized in the United States.

Who is a “person of a country of concern”?

A “person of a country of concern” includes

- (a) a non-U.S. citizen or lawful permanent resident who is a citizen or permanent resident of country of concern;
- (b) an entity with its principal place of business, or that is incorporated or organized under, the laws of a country of concern;
- (c) a government of a country of concern and its instrumentalities, agents, and controlled entities, including entities (whether located inside or outside a country of concern) in which the government holds a $\geq 50\%$ interest or otherwise controls the management; or
- (d) entities (whether located inside or outside a country of concern) in which the above entities hold at least 50% of the outstanding voting interest, board voting power, or equity interest, directly or indirectly, individually or in the aggregate.

Currently, only China (including the People’s Republic of China (PRC), Macau, and Hong Kong) is designated as a “country of concern.”

Who is a “covered foreign person”?

A “covered foreign person” includes any

- (a) “person of a country of concern” engaged in a covered activity;
- (b) person that (1) directly or indirectly holds a board seat, voting interest, or equity interest of any size (other than securities, the acquisition of which by a U.S. person would qualify as an “excepted transaction”) in a person described in (a); or holds the power to direct management of a person described in (a) through a contractual arrangement and (2) derives more than 50% of its revenue or net income or incurs more than 50% of capital or operating expenses through such persons; or
- (c) a “person of a country of concern” that participates in a JV with a U.S. person, where the JV engages (or the U.S. person knows that the JV plans to engage) in a covered activity.

What is a “covered activity”?

The Final Rule defines “covered activity” to include a list of specific, high-end activities in the semiconductor and microelectronics, quantum information technology, and AI sectors. Attachment 1 to this Update lists these activities.

What types of transactions does the Final Rule cover?

The Final Rule covers “person of a country of concern” engaged in a covered activity;

- (a) certain transactions by a U.S. person with or into a “covered foreign person” (including a U.S. person’s entrance into a JV with a “person of a country of concern,” wherever located and regardless of the U.S. person’s ownership stake, when the U.S. person knows that the JV will engage in covered activities or intends for it to do so);

- (b) certain transactions by a U.S. person that the U.S. person knows will result in, or intends to result in, the establishment of a “covered foreign person” or the engagement by a “person of a country of concern” in a new covered activity; or
- (c) certain investments by a U.S. person as a limited partner (LP) or equivalent into a non-U.S. person pooled investment fund that in turn invests (or that the U.S. person knows is likely to invest) in a “covered foreign person.”

Attachment 1 to this Update describes these categories — which the Final Rule calls “covered transactions” — in detail. The Final Rule also exempts certain transactions otherwise caught by this definition, as discussed below.

How can I tell whether a “covered transaction” is prohibited or notifiable?

The Final Rule divides “covered transactions” into two groups. “Prohibited transactions” are barred outright. “Notifiable transactions” are permitted subject to a notification requirement.

Whether a covered transaction is prohibited or notifiable depends on two things:

- (a) *The specific kind of “covered activity” involved.* In addition to listing covered activities, Attachment 1 to this Update indicates which covered activities are prohibited or notifiable.
- (b) *Whether the “covered foreign person” appears on specified U.S. sanctions and export control lists.* If they do, the transaction will always be prohibited (even if activities by the “covered foreign person” would otherwise trigger only a notification requirement).

What are the requirements for *prohibited* transactions?

Prohibited transactions are barred outright. U.S. persons who engage in them may face civil or criminal liability. However, the Final Rule also imposes other requirements regarding prohibited transactions.

Prohibition Against Knowingly Directing Certain Transactions: The Final Rule prohibits U.S. persons who are officers, directors, or their functional equivalents from “knowingly directing” a transaction that the U.S. person knows at the time of the transaction would be a prohibited transaction if engaged in by a U.S. person. A person “knowingly directs” a transaction when they

- (a) have the authority, individually or as part of a group, to make or “substantially participate” in decisions on behalf of a non-U.S. person
- (b) exercise that authority to “direct, order, decide upon, or approve a transaction”

However, such persons will not be considered to have “knowingly directed” a transaction if they recuse themselves from the relevant transaction.

Requirement to Take “All Reasonable Steps” With Respect to a “Controlled Foreign Entity”: The Final Rule requires a U.S. person to take “all reasonable steps” to prohibit and prevent any transaction by a “controlled foreign entity” (i.e., the U.S. person’s foreign subsidiary) that would be a prohibited transaction if engaged in by a U.S. person. A “controlled foreign entity” is an entity wherein a U.S. person

- (a) directly or indirectly holds more than 50% of the outstanding voting interest or voting power of the entity’s board;
- (b) is the general partner, managing member, or equivalent of entity; or
- (c) is the investment advisor to a pooled investment fund.

“Reasonable steps” include, for example, agreements requiring compliance, exercising shareholder rights, internal training and reporting, internal policies and controls, and testing and auditing.

What are the requirements for *notifiable* transactions?

Notifiable transactions give rise to notification obligations but are not otherwise restricted.

Date of Notification: U.S. persons must notify Treasury of each notifiable transaction within 30 days of the transaction “completion date” (i.e., closing). In addition, if a U.S. person acquires actual knowledge after closing of facts or circumstances that, if known at the time of closing, would have made the transaction either a prohibited or notifiable “covered transaction,” the U.S. person must notify that transaction within 30 days of acquiring such knowledge.

Effect of Notification: Treasury may respond to notifications with requests for additional information. Otherwise, however, notification has no immediate consequences. It appears that Treasury intends to use information collected through the notifications to compile reports and determine whether to expand or modify the scope of the regulations.

What types of transactions are exempted from the Final Rule?

The Final Rule exempts certain kinds of investments:

- (a) passive investments into publicly traded securities
- (b) passive investments in the securities of investment companies (e.g., index funds, mutual funds, and exchange-traded funds) and businesses regulated as business development companies under Section 54 of the Investment Company Act of 1940
- (c) investments made by LPs in certain funds where (1) the LP’s committed capital is not more than \$2 million, or (2) the LP has obtained binding contractual assurances that its capital will not be used to engage in transactions that would be prohibited or notifiable if conducted by a U.S. person
- (d) investments in certain derivative securities
- (e) certain intracompany transactions that support operations that are not covered activities
- (f) U.S. persons’ buyouts of Chinese interests, such that a target company no longer qualifies as a “covered foreign person”
- (g) certain syndicated debt financings, where a U.S. person participates passively in the syndicate but acquires a voting interest in a “covered foreign person” upon default or other condition of the financing
- (h) U.S. persons’ receipt of equity or an option to purchase equity in a “covered foreign person” as employment compensation (as well as the exercise of such option)

Exceptions (a), (b), (c), and (d) are available only if the investor does not receive any governance rights with respect to the relevant “covered foreign person” beyond standard minority shareholder protections.

Under the Final Rule, Treasury may also exempt certain transactions on a national interest basis or where a given third country is already adequately addressing the national security concerns posed by outbound investment.

Other issues

- *No case-by-case reviews.* Unlike the Committee on Foreign Investment in the United States (CFIUS) process, where transaction parties can submit a declaration or notice to obtain clearance for a transaction, there is no approval process for the outbound screening program. Transaction parties will need to determine themselves whether their transaction is prohibited or requires notification. However, Treasury will allow U.S. persons to seek exemptions from the regulations for otherwise-prohibited or notifiable transactions that are in the U.S. national interest.
- *No strict liability.* U.S. persons' obligations under the Final Rule will apply when they have actual or constructive "knowledge" of relevant facts or circumstances related to a transaction. A U.S. person will be deemed to have the requisite "knowledge" if they have
 - (a) actual knowledge that a fact or circumstance exists or is substantially certain to occur;
 - (b) an awareness of a high probability of a fact or circumstance's existence or future occurrence; or
 - (c) reason to know of a fact or circumstance's existence.

Constructive knowledge will be assessed on the basis of the information a U.S. person "could have had through a reasonable and diligent inquiry." In response to commenters concerned about the challenges of conducting such inquiry in the PRC given the opacity of many PRC corporate structures, Treasury added to the Final Rule assurance that the assessment would proceed in view of "the totality of relevant facts and circumstances."

- *Potential penalties for noncompliance.* U.S. persons found to have violated the Final Rule may face (a) for nonwillful violations, civil penalties of up to \$368,136 (as adjusted annually for inflation) or twice the amount of the transaction, whichever is greater, or (b) for willful violations, civil penalties of up to \$1,000,000 and imprisonment of up to 20 years. However, the Final Rule also establishes a process for parties to submit voluntary self-disclosures. U.S. persons who voluntarily disclose violations of the Final Rule — especially before Treasury detects them — are likely to face milder penalties.
- *No retroactivity.* The Final Rule enters into force on January 2, 2025. It does not have retroactive effect. Moreover, the Final Rule does not apply to
 - (a) transactions made after January 2, 2025, pursuant to a binding, uncalled capital commitment entered into before January 2, 2025 or
 - (b) transactions between a U.S. person and its controlled foreign entity that maintains covered activities that the controlled foreign entity was engaged in prior to January 2, 2025.

Can the program change?

Treasury cannot unilaterally extend the outbound investment program to cover new sectors outside of the three sectors already covered or define new countries of concern. Treasury can, however, recommend that the President modify the EO to make these changes.

Treasury can decide to add or remove technologies and products in the three sectors already controlled by the program by itself. It would need to take such action through a rulemaking procedure, which typically involves releasing draft changes and soliciting public comments. Treasury is committed to assessing whether to add or remove technologies in the semiconductors and microelectronics, quantum information technologies, and AI sectors within one year of the program's January 2, 2025, effective date.

In addition, the incoming Trump administration could issue a new EO to change the scope of the program, and Congress could require changes through legislation.

Treasury has promised to release additional guidance on its enforcement practices as the program matures. Sidley attorneys are closely monitoring Treasury’s development of this outbound investment program and are available to answer your questions.

Attachments

Attachment 1: Covered Transactions

(A covered transaction requires both the investment in the first column and the knowledge in the second column).

TYPE OF DIRECT OR INDIRECT INVESTMENT	KNOWLEDGE REQUIREMENT
EQUITY INTEREST: acquisition of an equity interest or a contingent equity interest (or equivalent) (i.e., a financial instrument that currently does not constitute an equity interest but is convertible into, or provides the right to acquire, an equity interest upon the occurrence of a contingency or defined event).	The U.S. person knows at the time of the acquisition that the target is a “covered foreign person.”
LOAN / DEBT: provision of a loan or a similar debt financing arrangement that affords or will afford the U.S. person (a) an interest in profits of the covered foreign person, (b) the right to appoint members of the board of directors (or equivalent), or (c) other comparable financial or governance rights characteristic of an equity investment but not typical of a loan.	The U.S. person knows at the time of the provision that the recipient is a “covered foreign person.”
CONVERSION OF CONTINGENT EQUITY INTEREST: conversion of a contingent equity interest to an equity interest, where the contingent equity interest was acquired by the U.S. person on or after January 2, 2025.	The U.S. person knows at the time of the conversion that the target is a “covered foreign person” (note that the acquisition of the convertible interest and the conversion of the interest may each be a “covered transaction”).
ASSET DEVELOPMENT: acquisition, leasing, or other development of operations, land, property, or other assets in a “country of concern.”	The U.S. person knows at the time of the acquisition etc. that the transaction will result in (or the U.S. person intends for it to result in) (a) the establishment of a “covered foreign person” or (b) the engagement of a “person of a country of concern” in a covered activity where it had not previously engaged in such covered activity.
JOINT VENTURE: entrance into a JV, wherever located, with a “person of a country of concern.”	The U.S. person knows at the time of entrance into the JV that the JV will engage in, or the U.S. person intends the JV to engage in, a covered activity.

LIMITED PARTNER INTEREST: acquisition of a limited partner or equivalent interest in a venture capital fund, private equity fund, fund of funds, or other pooled investment fund (in each case where the fund is not a U.S. person).	The U.S. person knows at the time of its investment in the fund that the fund is likely to invest in a “person of a country of concern” that is in the semiconductors and microelectronics, quantum information technologies, or AI sectors, and such fund undertakes a transaction that would be a “covered transaction” if undertaken by a U.S. person.
---	---

Attachment 2: Covered Activities

SECTOR	PROHIBITED TRANSACTIONS	NOTIFIABLE TRANSACTIONS
Semiconductors and Microelectronics	<p>Development or production of any electronic design automation software for the design of integrated circuits or advanced packaging;¹</p> <p>Development or production of any</p> <ul style="list-style-type: none"> (a) front-end semiconductor fabrication equipment designed for performing the volume fabrication of integrated circuits, including equipment used in the production stages from a blank wafer or substrate to a completed wafer or substrate (i.e., the integrated circuits are processed but still on the wafer or substrate); (b) equipment for performing volume advanced packaging; or (c) commodity, material, software, or technology designed exclusively for use in or with extreme ultraviolet lithography fabrication equipment; <p>Design of any integrated circuit that meets or exceeds the performance parameters in Export Control Classification Number 3A090.a in supplement No. 1 to 15 CFR part 774,</p>	Design, fabrication, or packaging of any integrated circuit that is not described in the prohibited category of semiconductors and microelectronics.

¹ The term “advanced packaging” means to package integrated circuits in a manner that supports the two-and-one-half-dimensional (2.5D) or three-dimensional (3D) assembly of integrated circuits, such as by directly attaching one or more die or wafer using through-silicon vias, die or wafer bonding, heterogeneous integration, or other advanced methods and materials.

	<p>or integrated circuits designed for operation at or below 4.5 Kelvin;</p> <p>Fabrication of any integrated circuit that meets any of the following criteria:</p> <ul style="list-style-type: none"> (a) logic integrated circuits using a nonplanar transistor architecture or with a production technology node of 16/14 nanometers or less, including fully depleted silicon-on-insulator integrated circuits; (b) NOT-AND (NAND) memory integrated circuits with 128 layers or more; (c) dynamic random-access memory integrated circuits using a technology node of 18 nanometer half-pitch or less; (d) integrated circuits manufactured from a gallium-based compound semiconductor; (e) integrated circuits using graphene transistors or carbon nanotubes; or (f) integrated circuits designed for operation at or below 4.5 Kelvin; <p>Packaging of any integrated circuit using advanced packaging techniques; or</p> <p>Development, installation, sale, or production of 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.</p>	
Quantum Information Technologies	Development of a quantum computer ² or production of any of the critical components required to produce a quantum computer such as a dilution	None.

² The term “quantum computer” means a computer that performs computations that harness the collective properties of quantum states, such as superposition, interference, or entanglement. This definition is unchanged from the NPRM.

	<p>refrigerator or two-stage pulse tube cryocooler;</p> <p>Development or production of any quantum sensing platform designed for, or that the relevant “covered foreign person” intends to be used for, any military, government intelligence, or mass-surveillance end use; or</p> <p>Development or production of any quantum network or quantum communication system designed for, or which the relevant “covered foreign person” intends to be used for</p> <ul style="list-style-type: none"> (a) networking to scale up the capabilities of quantum computers, such as for the purposes of breaking or compromising encryption; (b) secure communications, such as quantum key distribution; or (c) any other application that has any military, government intelligence, or mass-surveillance end use. 	
AI Systems	<p>Development of any AI system³ designed to be exclusively used for, or which the relevant “covered foreign person” intends to be used for, any</p> <ul style="list-style-type: none"> (a) military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapon control, military decision-making, weapons design, or combat system logistics and maintenance) or (b) government intelligence or mass surveillance end use (e.g., through mining text, audio, or video; image recognition; 	<p>Development of any AI system that is not described in the prohibited category of AI systems and that is:</p> <ul style="list-style-type: none"> (a) designed to be used for any 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) or military end use (e.g., for weapons targeting, target identification, combat simulation, military vehicle or weapons control, military decision-making, weapons design (including chemical, biological, radiological, or

³ The term “AI system” means (a) a machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations, or decisions influencing real or virtual environments — i.e., a system that uses data inputs to (1) perceive real and virtual environments; (2) abstract such perceptions into models through automated or algorithmic statistical analysis; and (3) use model inference to make a classification, prediction, recommendation, or decision; (b) any data system, software, hardware, application, tool, or utility that operates in whole or in part using a system described in (a).

	<p>location tracking; or surreptitious listening devices); or</p> <p>Development of any AI system that is trained using a quantity of computing power greater than</p> <p>(a) 10^{25} computational operations (e.g., integer or floating-point operations); or</p> <p>(b) 10^{24} computational operations (e.g., integer or floating-point operations) using primarily biological sequence data.</p>	<p>nuclear weapons), or combat system logistics and maintenance);</p> <p>(b) intended by the “covered foreign person” to be used for cybersecurity applications, digital forensics tools, and penetration testing tools, or the control of robotic systems; or</p> <p>(c) trained using a quantity of computing power greater than 10^{23} computational operations (e.g., integer or floating-point operations).</p>
--	--	--

CONTACTS

James Mendenhall , Partner	+1 202 736 8141, jmendenhall@sidley.com
Carys Golesworthy , Senior Managing Associate	+1 202 736 8539, cgolesworthy@sidley.com
Lloyd Lyall , Associate	+1 202 736 8618, lloyd.lyall@sidley.com

Sidley Austin LLP provides this information as a service to clients and other friends for educational purposes only. It should not be construed or relied on as legal advice or to create a lawyer-client relationship. Readers should not act upon this information without seeking advice from professional advisers. In addition, this information was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding any U.S. federal, state or local tax penalties that may be imposed on such person.

Attorney Advertising—Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Sidley Austin refer to Sidley Austin LLP and affiliated partnerships, as explained at www.sidley.com/disclaimer.

© Sidley Austin LLP