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Treasury Department Issues Final Rule to Implement Outbound Investment Executive Order

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On October 28, 2024, the U.S. Department of the Treasury ("Treasury") issued its final rule (the "Final Rule") to implement Executive Order 14105, "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" issued by President Biden on August 9, 2023 (the "Outbound Order"). As we described in our analysis of Treasury's advance notice of proposed rulemaking (the "ANPRM") last August and our analysis of Treasury's notice of proposed rulemaking ("NPRM") in June, the Outbound Order marks the first time that the United States, or any other major Western democratic economy, has sought to regulate and control outbound capital flows and other investments for national security reasons.

While it will take time for the practical effects of the Final Rule to come into focus, the following are initial observations on the likely implications for industry:

1. **The United States is the first Western economy to regulate outbound investment in China but may not be the last.** We expect the U.S. government will press ally and other friendly governments to adopt similar mechanisms to stop the flow of capital and "intangible benefits" to Chinese companies that are developing technologies that present U.S. national security concerns.
2. **The Final Rule will have broad extraterritorial effect.** It applies not just to transactions undertaken by U.S. companies, but also to transactions undertaken by non-U.S. entities to the extent that certain "U.S. persons" are involved in directing the transaction. Non-U.S. companies will either need to screen U.S. persons from decision-making related to investments or else establish procedures to ensure compliance with the Final Rule.
3. **While framed as regulation of outbound investment, the Final Rule goes much further, effectively regulating through its coverage of "greenfield" and "brownfield" investment and "joint ventures" what activities companies can and cannot undertake in China.** Companies that operate in China and that undertake activities related to semiconductor manufacturing, quantum computing, and artificial intelligence ("AI") will likely need to implement internal policies to ensure they do not inadvertently engage in prohibited or notifiable activities.
4. **Given the broad scope of transactions covered by the Final Rule, compliance with the Outbound Order will need to become a deal checklist item for transaction parties.** The Final Rule does not just regulate transactions with Chinese parties, as it may also apply to transactions with non-Chinese companies that are under majority Chinese

ownership or that have Chinese subsidiaries. Determining whether a counterparty is a "covered foreign person" will in some cases be challenging and time consuming.

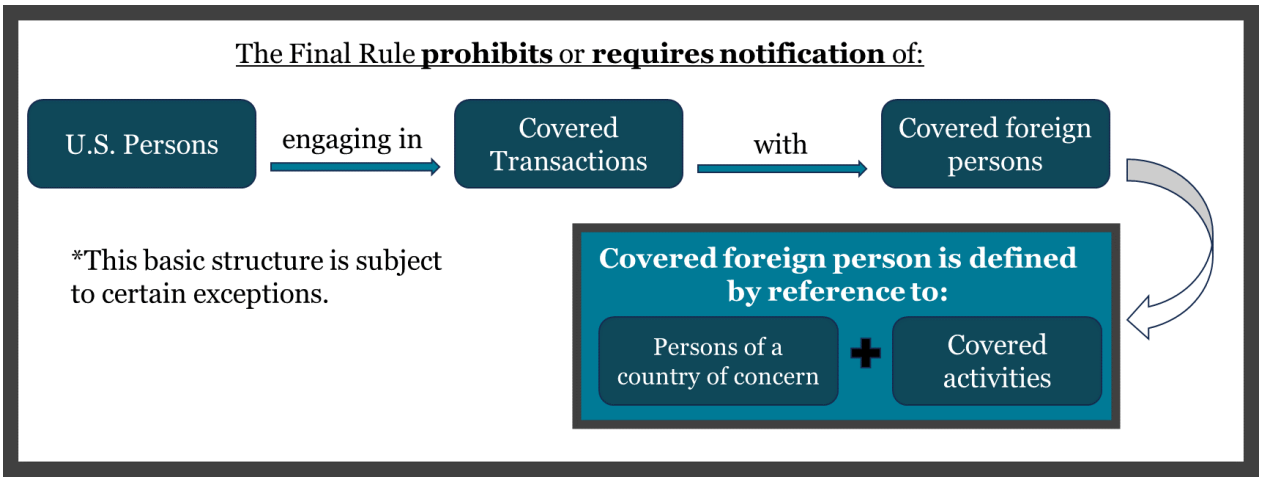
5. **The Final Rule will have significant implications for non-U.S. investment funds that receive capital from U.S. persons.** Such non-U.S. funds will likely need to either exclude all U.S.-person investors from the fund, or else commit not to undertake any investments in companies that would be prohibited or notifiable.

The Final Rule provides for civil money penalties of up to $368,136 (adjusted regularly for inflation) or twice the value of the relevant transaction, and criminal violations may be referred to the Department of Justice. ***Accordingly, companies who may be implicated by the Final Rule will want to establish a plan for how to comply before it comes into effect on January 2, 2025.***

Executive Summary

The Final Rule largely tracks the rule as proposed in the NPRM. Treasury has not made any structural changes in the Final Rule or fundamentally altered any key definitions or other provisions. Instead, Treasury has made certain modest adjustments to accommodate comments on the NPRM, which were largely focused on increasing the clarity of the Final Rule and carving out certain types of transactions that Treasury assessed to present a lower likelihood of presenting national security risk. With that said, Treasury dedicated nearly 250 pages to addressing comments submitted in response to the NPRM, including clarifying in some areas how the Final Rule is intended to apply, while in other areas declining to provide additional clarity or further muddying the waters (in particular as it relates to brownfield investments, as we discuss further below).

As in the NPRM, the Final Rule prohibits or requires notification for **covered transactions**, which are certain types of transactions undertaken by **U.S. persons** involving—directly or indirectly—**covered foreign persons**. Covered foreign persons include **persons of a country of concern** (generally Chinese and Chinese-owned entities) engaged in certain **covered activities**, as well as entities that attribute more than 50 percent of their revenue, net income, capital expenditure, or operating expenses to persons of a country of concern engaged in covered activities. Whether a covered transaction is prohibited or notifiable depends on the specific covered activity undertaken by the covered foreign person involved in the transaction. Covered activities include certain specified **activities related to (i) semiconductors and microelectronics, (ii) quantum information technologies, and (iii) AI**.



The Final Rule also requires U.S. persons to prevent their **controlled foreign entities** from engaging in **prohibited transactions**, and U.S. persons are required to submit notifications to Treasury when their controlled foreign subsidiaries undertake **notifiable transactions**. U.S. persons likewise are prohibited from **knowingly directing** a non-U.S. person to undertake a transaction that would be prohibited if undertaken by a U.S. person.

For the Final Rule to apply to a transaction undertaken by a U.S. person, it generally requires that the U.S. person **know** that its counterparty is a covered foreign person. In determining whether a U.S. person violated the rule—e.g., by undertaking a prohibited transaction or failing to file a required notification—the rule provides that Treasury will assess whether, at the time of the transaction, the U.S. person knew or could have known of a given fact or circumstance based on a reasonable and diligent inquiry. The rule sets out certain factors that Treasury will assess in determining whether the U.S. person undertook a reasonable and diligent inquiry.

If a U.S. person is required to submit a notification with respect to a transaction, such notification must be submitted no later than 30 days following the completion date of the transaction. The notification itself would be required to include information about the U.S. person, the covered foreign person (including the reasons the entity is a covered foreign person), and the transaction.

Questions and Answers Regarding the Final Rule

What is the scope of "U.S. persons" subject to the Final Rule's restrictions?

The Final Rule maintains the NPRM's broad definition of a U.S. person, which includes "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 definition and the related provisions described below lead the Final Rule to have broad extraterritorial effects, including for foreign subsidiaries of U.S. companies, U.S. persons serving in executive roles for foreign companies outside the United States, and foreign executives temporarily located in or simply transiting through the United States.

Controlled Foreign Entities

The Final Rule, like the NPRM, requires U.S. persons to take "all reasonable steps" to prevent their controlled foreign entities from undertaking transactions that would be prohibited if undertaken by a U.S. person, and U.S. persons must notify Treasury of any transactions undertaken by their controlled foreign entities that would be notifiable if undertaken by a U.S. person. The Final Rule defines a "controlled foreign entity" as any "entity incorporated in, or otherwise organized under the laws of, a country other than the United States of which a U.S. person is a parent." Under the Final Rule, "parent" means, with respect to a particular entity:

> "(a) A person who or which directly or indirectly holds more than 50 percent of:
>
> (1) The outstanding voting interest in the entity; or
>
> (2) The voting power of the board of the entity;
>
> (b) The general partner, managing member, or equivalent of the entity; or
>
> (c) The investment adviser to any entity that is a pooled investment fund, with 'investment adviser' as defined in the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11))."

Treasury confirmed in the Final Rule that it will assess a U.S. person's compliance with the requirements with respect to its controlled foreign entities "in light of the relevant facts and circumstances," including:

1. the execution of agreements with respect to compliance with the Final Rule between the U.S. person and its controlled foreign entity;
2. the existence and exercise of governance or shareholder rights by the U.S. person with respect to the controlled foreign entity, where applicable;
3. the existence and implementation of periodic training and internal reporting requirements by the U.S. person and its controlled foreign entity with respect to compliance with the Final Rule;
4. the implementation of appropriate and documented internal controls, including internal policies, procedures, or guidelines that are periodically reviewed internally, by the U.S. person and its controlled foreign entity; and
5. implementation of a documented testing and/or auditing process of internal policies, procedures, or guidelines.

"Knowingly Directing"

The Final Rule prohibits U.S. persons from "knowingly directing" any non-U.S. person to undertake a transaction that would be prohibited if undertaken by a U.S. person. As in the NPRM, a U.S. person "knowingly directs" a transaction when the U.S. person has authority, individually or as part of a group, to make or substantially participate in decisions on behalf of a non-U.S. person, and exercises that authority to direct, order, decide upon, or approve a transaction. The Final Rule clarifies that such authority exists when a U.S. person is an officer, director, or otherwise possesses executive responsibilities at a non-U.S. person. The Final Rule also provides that a U.S. person can recuse himself or herself from certain activities to avoid liability for knowingly directing a transaction:

- Participating in formal approval and decision-making processes related to the transaction, including making a recommendation;
- Reviewing, editing, commenting on, approving, and signing relevant transaction documents; and
- Engaging in negotiations with the investment target (or, as applicable, the relevant transaction counterparty, such as a joint venture partner).

A U.S. person that recuses himself or herself from these activities will not be considered to have knowingly directed a transaction undertaken by a foreign person (e.g., a non-U.S. business in which they serve as an executive).

Treasury has confirmed that the obligation to comply with the Final Rule, and liability for violations thereof, fall on the relevant U.S. person, rather than their foreign employer (e.g., if the U.S. person is an executive at a non-U.S. organization).

"Any Person in the United States"

As indicated above, the definition of "U.S. person" includes "any person in the United States." In response to comments expressing concern with this aspect of the definition, including that it could reach non-U.S. executives simply in transit through the United States, Treasury explained that "the circumstance of a non-U.S. citizen or permanent resident individual in transit through the United States who wishes to enter into a transaction that could trigger coverage under the Final Rule, while possible, is not likely to be a frequent occurrence and can be reasonably managed with advance planning." However, this hand-waving seems to ignore that non-U.S. executives frequently visit the United States to meet with clients, advisors, governments, and branches of their own companies, during which time they may be required to participate in decision-making their companies undertake, which involvement could constitute "knowingly directing" an otherwise prohibited transaction. Non-U.S. companies therefore may need to implement processes to ensure that decision-making regarding such transactions does not take place while relevant executives are present in the United States or that such executives are recused from the decision-making. Given the breadth of the recusal provisions and the reality of executives' travel schedules, these circumstances may not be so infrequent or reasonably managed as Treasury believes.

What transactions are covered?

The definition of covered transactions in the Final Rule generally follows the definition in the NPRM. As defined in the Final Rule, "covered transaction" means a U.S. person's direct or indirect:

- Acquisition of an equity interest or contingent equity interest in a person that the U.S. person knows at the time of the acquisition is a covered foreign person;
- Provision of a loan or a similar debt financing arrangement to a person that the U.S. person knows at the time of the provision is a covered foreign person, where such debt financing affords or will afford the U.S. person an interest in profits of the covered foreign person, the right to appoint members of the board of directors (or equivalent) of the covered foreign person, or other comparable financial or governance rights characteristic of an equity investment but not typical of a loan;

- Conversion of a contingent equity interest into an equity interest in a person that the U.S. person knows at the time of the conversion is a covered foreign person, where the contingent equity interest was acquired by the U.S. person on or after January 2, 2025;
- Acquisition, leasing, or other development of operations, land, property, or other assets in a country of concern that the U.S. person knows at the time of such acquisition, leasing, or other development will result in, or that the U.S. person plans to result in:
  - The establishment of a covered foreign person; or
  - The engagement of a person of a country of concern in a covered activity;
- Entrance into a joint venture, wherever located, that is formed with a person of a country of concern, and that the subject U.S. person knows at the time of entrance into the joint venture that the joint venture will engage, or plans to engage, in a covered activity; or
- 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) that a U.S. person knows at the time of the acquisition likely will 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.

As noted in the introduction, while the Final Rule is framed as addressing outbound U.S. investment, it covers far more, effectively regulating through its coverage of "greenfield" and "brownfield" investment what activities companies can and cannot undertake in China. We address certain clarifications and ambiguities related to these concepts below. We also address Treasury's note regarding "indirect" covered transactions.

Greenfield, Brownfield, and Joint Venture Investments

The scope of "covered transactions" subject to the Final Rule includes the acquisition, leasing, or other development of operations, land, property, or other assets in a country of concern that the U.S. person knows at the time of such acquisition, leasing, or other development will result in, or that the U.S. person *plans* to result in, (i) the establishment of a covered foreign person (i.e., a greenfield investment) or (ii) the engagement of a person of a country of concern in a covered activity (i.e., a brownfield investment). Covered transactions also include entrance into a joint venture, wherever located, that is formed with a person of a country of concern, and that the subject U.S. person knows at the time of entrance into the joint venture that the joint venture will engage, or *plans* to engage, in a covered activity.

Under the NPRM, the foregoing transactions would be covered to the extent that a U.S. person "*intends*" the resulting entity to engage in a covered activity. In the Final Rule, Treasury substituted the word "plans" for "intends" to address concerns regarding the subjective nature of "intent." Treasury noted in its commentary on the Final Rule that, in assessing whether a transaction is covered, indicators relevant to a U.S. person's plans would include, for example, correspondence with the investment target or relevant government, business plans, and presentations to potential investors. Treasury also clarified in its commentary that "development" in the context of greenfield and brownfield investments is intended to refer to activities such as build-out, expansion, or retrofitting of facilities or land.

Ambiguities Related to the Scope of Brownfield Investments

The NRPM applied to "brownfield" investments—i.e. the acquisition, leasing, or other development of operations, land, property, or other assets in a country of concern resulting in "the engagement of a person of a country of concern in a covered activity *where it was not previously engaged in such covered activity*." Commentors asked Treasury to clarify whether engagement by a covered foreign person in a new covered activity in this context would refer to engagement in a new *category* of covered activity (e.g., designing integrated circuits vs. fabricating integrated circuits) or engagement in a new type of covered activity within the same category (e.g., fabricating an integrated circuit manufactured from one gallium-based compound semiconductor vs. fabricating an integrated circuit manufactured from a different gallium-based compound semiconductor). Treasury did not directly respond to these comments or offer clarification. Treasury stated only:

> *"In addition, the Treasury Department responds to the comments through modification to section 850.210(a)(4)(ii) of the Final Rule to specify that it relates to the 'engagement of a person of a country of concern in a covered activity.' The Final Rule's coverage of a 'brownfield' investment is intended to capture a U.S. person's acquisition, leasing, or other development of operations that the U.S. person knows will result in, or the U.S. person plans to result in, an existing person of a country of concern engaging in a covered activity."*

In line with these comments, Treasury removed "where it was not previously engaged in such covered activity" from the brownfield investment provision. However, neither Treasury's commentary nor this change to the text of the rule seems to shed light on when an entity would be considered to engage in a new covered activity for purposes of this provision.

The uncertainty around the scope of the Final Rule's brownfield investment provision is further complicated by Treasury's commentary in its discussion of the exception for "intracompany" transactions. Specifically, Treasury seems to suggest that a "transfer" from a U.S. person to a person of a country of concern to support new covered activities would constitute a brownfield investment, and therefore a covered transaction. However, the definition of a brownfield investment, as noted above, does not appear to cover "transfers" (e.g., the mere transfer of funds) without the "acquisition, leasing, or other development of operations, land, property, or other assets in [China]," unless Treasury is construing this language extremely broadly. In fact, Treasury clarified that "development" in this context, which otherwise could be understood very broadly, means the build-out, expansion, or retrofitting of facilities or land. This suggests that brownfield investments would not include a mere "transfer" (e.g., of funds) from a U.S. person to a Chinese entity that supports new covered activities, unless it also involved the acquisition, lease, build-out, expansion, or retrofitting of facilities or land. However, absent further guidance from Treasury, U.S. persons may need to exercise caution around transfers or other transactions with Chinese entities that could support new covered activities.

Ambiguities Related to the Scope of Joint Ventures

Treasury acknowledged that several commenters requested further guidance on the meaning of "joint venture," which was not defined in the NPRM. Specifically, commenters advocated that the term "joint venture" should include only the acquisition of an equity interest or the establishment of a new legal entity, and exclude other forms of commercial cooperation, relationships, or activities that could be collaborative in nature but generally are understood not to rise to the level of a "joint venture."

Treasury declined to define the term "joint venture." Instead, Treasury referred in its commentary to the plain English meaning of the term "joint venture" as "involving the contribution of capital and/or assets by two parties and the sharing of profits and losses," and suggested that a joint venture would not "ordinarily" result simply where there is a licensing agreement, the sale or barter of goods and services, or resale of goods and services. While Treasury's commentary on the Final Rule clarifies that it does not necessarily intend to capture ordinary commercial arrangements and relationships (e.g., licensing arrangements) as joint ventures, Treasury's refusal to adopt a clear definition leaves it with discretion to apply the term potentially broadly to capture relationships and activities that may not fall neatly under the conventional notion of "investment" or "transaction." This is one additional reason that U.S. persons will need to exercise caution in interacting with their Chinese subsidiaries, given the uncertainty around the scope of the intracompany transaction exception (discussed above), to the extent an arrangement between a U.S. parent and its Chinese subsidiary could constitute a joint venture that supports the Chinese subsidiary undertaking a new covered activity.

"Indirect" Covered Transactions

As in the NPRM, the Final Rule covers both direct and "indirect" covered transactions. With respect to "indirect" covered transactions, Treasury added a note to the Final Rule to clarify that an "indirect" covered transaction includes a U.S. person's use of an intermediary to engage in a transaction that would be a covered transaction if engaged in directly by a U.S. person. In its discussion of this note, Treasury indicates, for example:

> *"if a U.S. person owned a special purpose vehicle organized in a non-U.S. jurisdiction, that in turn acquired an equity interest in a covered foreign person, and the U.S. person knew at the time of its transaction that the special purpose vehicle would be acquiring an equity interest in a covered foreign person, that transaction would have been a covered transaction."*

It is not clear, however, how this scenario would differ from any other scenario in which a U.S. person had a controlled foreign entity because the Final Rule still would require the U.S. person to take all reasonable steps to prevent its controlled foreign entity from undertaking a prohibited transaction, and the Final Rule would require the U.S. person to submit a notification to Treasury if its controlled foreign entity undertook a notifiable transaction. Treasury claims that the inclusion of "indirect" in the definition of "covered transaction" is intended to address a potential loophole, but it is not clear what the loophole is. The presence of the word "indirect" therefore introduces further ambiguity into the definition of "covered transaction." With that said, Treasury indicated that it anticipates making further information available on its website regarding this provision.

What is the scope of "covered foreign persons" with whom transactions would be prohibited or notifiable?

As with the other key definitions in the Final Rule, the definition of "covered foreign person" has remained largely the same from the NPRM, and there have been no substantive changes to the definition of "person of a country of concern."

The definition of "covered foreign person" has three prongs:

1. A person of a country of concern that engages in a covered activity; or
2. A person that directly or indirectly holds a board seat on, a voting or equity interest (other than through securities or interests that would satisfy the conditions in § 850.501(a) if held

by a U.S. person) in, or any contractual power to direct or cause the direction of the management or policies of any person or persons described in paragraph (a)(1) of this section from or through which it:

a. Derives more than 50 percent of its revenue individually, or as aggregated across such persons from each of which it derives at least $50,000 (or equivalent) of its revenue, on an annual basis;

b. Derives more than 50 percent of its net income individually, or as aggregated across such persons from each of which it derives at least $50,000 (or equivalent) of its net income, on an annual basis;

c. Incurs more than 50 percent of its capital expenditure individually, or as aggregated across such persons from each of which it incurs at least $50,000 (or equivalent) of its capital expenditure, on an annual basis; or

d. Incurs more than 50 percent of its operating expenses individually, or as aggregated across such persons from each of which it incurs at least $50,000 (or equivalent) of its operating expenses, on an annual basis.

3. With respect to a covered transaction described in § 850.210(a)(5), the person of a country of concern that participates in the joint venture is deemed to be a covered foreign person by virtue of its participation in the joint venture.

A "person of a country of concern" means:

(a) Any individual that:

(1) Is a citizen or permanent resident of a country of concern;

(2) Is not a U.S. citizen; and

(3) Is not a permanent resident of the United States;

(b) An entity with a principal place of business in, headquartered in, or incorporated in or otherwise organized under the laws of, a country of concern;

(c) The government of a country of concern, including any political subdivision, political party, agency, or instrumentality thereof; any person acting for or on behalf of the government of a country of concern; or any entity with respect to which the government of a country of concern holds individually or in the aggregate, directly or indirectly, 50 percent or more of the entity's outstanding voting interest, voting power of the board, or equity interest, or otherwise possesses the power to direct or cause the direction of the management and policies of such entity (whether through the ownership of voting securities, by contract, or otherwise);

(d) Any entity in which one or more persons identified in paragraph (a), (b), or (c) of this section, individually or in the aggregate, directly or indirectly, holds at least 50 percent of any of the following interests of such entity: outstanding voting interest, voting power of the board, or equity interest; or

(e) Any entity in which one or more persons identified in paragraph (d) of this section, individually or in the aggregate, directly or indirectly, holds at least 50 percent of any of the following interests of such entity: outstanding voting interest, voting power of the board, or equity interest.

Accordingly, putting these two definitions together, covered foreign persons could include not only Chinese entities, but entities anywhere in the world—including entities that have their place of incorporation and principal place of business in the United States—that are (i) ultimately 50 percent or more Chinese-owned and engaged in covered activities, or (ii) attribute more than 50 percent of their revenue, net income, capital expenditure, or operating expenses to one or more covered foreign persons, directly or indirectly, individually or in the aggregate. This means that the Final Rule will apply not only to investments in China but to investments all over the world, including in the United States.

Meaning of "Engages In"

As noted above, the first prong of the covered foreign person definition applies to a "person of a country of concern that engages in a covered activity." Several comments raised questions about what it means for a legal entity to "engage in" a covered activity, especially in a typical corporate structure with holding companies and operating companies. Treasury did not change the text of the rule but clarified in its commentary how this part of the definition would apply. Specifically, Treasury confirmed that there will be no *de minimis* level of activity below which an entity would not be considered to be engaged in a covered activity. In other words, even if a Chinese or Chinese-owned entity spent only a tiny fraction of its time or resources engaging in a covered activity, it still would be considered a covered foreign person. Treasury did, however, clarify that an entity must itself engage in the covered activity to be considered a covered foreign person, as opposed to a parent entity that might control a subsidiary engaged in a covered activity. Thus, presumably, a holding company or another parent company that controls a subsidiary that is engaged in a covered activity would not itself be considered to be engaged in a covered activity.

Treasury did, however, add a $50,000 *de minimis* threshold to the second prong of the covered foreign person definition, meaning that entities that contribute less than $50,000 to any of an entity's revenue, net income, capital expenditure, or operating expenses on an annual basis will be disregarded for purposes of determining whether the parent entity is a covered foreign person. This change is unlikely to simplify the process of determining whether an entity is a covered foreign person under the second prong of the covered foreign person definition, but it may be helpful in edge cases.

The knowledge standard—what investigation and diligence must investors undertake to determine whether a proposed transaction is notifiable or prohibited?

The Final Rule largely retains the "knowledge standard" introduced in the NPRM without any substantive changes. The knowledge standard outlines the level of awareness a U.S. person must have regarding certain facts and circumstances related to a particular transaction to trigger obligations under the Final Rule. It provides that the U.S. person may be deemed to possess knowledge if the person: (1) has actual knowledge that a fact or circumstance exists or is substantially certain to occur; (2) is aware of a high probability of a fact or circumstance's existence or future occurrence; or (3) could have obtained such information through a reasonable and diligent inquiry.

As under the NPRM, the Final Rule effectively imposes an obligation on U.S. persons and controlled foreign entities to conduct diligence to a reasonable degree to ascertain whether the transaction is prohibited or notifiable. In that regard, the Final Rule sets forth certain factors that Treasury would consider in assessing whether a U.S. person undertook a reasonable and diligent inquiry, including the following:

- The inquiry a U.S. person has made regarding an investment target or other relevant transaction counterparty (such as a joint venture partner), including questions asked of the investment target or relevant counterparty, as of the time of the transaction;
- The contractual representations or warranties the U.S. person has obtained or attempted to obtain from the investment target or other relevant transaction counterparty (such as a joint venture partner) with respect to the determination of a transaction's status as a covered transaction and status of an investment target or other relevant transaction counterparty (such as a joint venture partner) as a covered foreign person;
- The efforts by the U.S. person as of the time of the transaction to obtain and consider available non-public information relevant to the determination of a transaction's status as a covered transaction and the status of an investment target or other relevant transaction counterparty (such as a joint venture partner) as a covered foreign person;
- Available public information, the efforts undertaken by the U.S. person to obtain and consider such information, and the degree to which other information available to the U.S. person as of the time of the transaction is consistent or inconsistent with such publicly available information;
- Whether the U.S. person purposefully avoided learning or seeking relevant information;
- The presence or absence of warning signs, which may include evasive responses or non-responses from an investment target or other relevant transaction counterparty (such as a joint venture partner) to questions or a refusal to provide information, contractual representations, or warranties; and
- The use of available public and commercial databases to identify and verify relevant information of an investment target or other relevant transaction counterparty (such as a joint venture partner).

In response to comments regarding the potential difficulties of undertaking diligence in China, Treasury added to the Final Rule a provision that an "assessment of whether a U.S. person has undertaken a reasonable and diligent inquiry shall be based on a consideration of the totality of relevant facts and circumstances."

What are the "covered activities"?

Whether a covered transaction is prohibited or notifiable depends on the specific covered activity undertaken by the covered foreign person involved in the transaction. Covered activities include certain specified activities related to (i) semiconductors and microelectronics, (ii) quantum information technologies, and (iii) AI. The table below details the prohibited and notifiable activities, which have remained largely the same from the NPRM, with some changes related to AI.

Semiconductors and microelectronics	
Prohibited	**Notification Required**
▪ Develops or produces any electronic design automation software for the design of integrated circuits or advanced packaging;	▪ Designs any integrated circuit that is not described in the prohibited category;

■ Develops or produces any: (1) 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 they are still on the wafer or substrate); (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; ■ Designs 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, or integrated circuits designed for operation at or below 4.5 Kelvin; ■ Fabricates any of the following: (1) Logic integrated circuits using a non-planar transistor architecture or with a production technology node of 16/14 nanometers or less, including fully depleted silicon-on-insulator ("FDSOI") integrated circuits; (2) NOT-AND ("NAND") memory integrated circuits with 128 layers or more; (3) Dynamic random-access memory ("DRAM") integrated circuits using a technology node of 18 nanometer half-pitch or less; (4) Integrated circuits manufactured from a gallium-based compound semiconductor; (5) Integrated circuits using graphene transistors or carbon nanotubes; or (6) Integrated circuits designed for operation at or below 4.5 Kelvin; ■ Packages any integrated circuit using advanced packaging techniques; ■ Develops, installs, sells, or produces 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.	■ Fabricates any integrated circuit that is not described in the prohibited category; ■ Packages any integrated circuit that is not described in the prohibited category.

Quantum information technologies	
Prohibited	**Notification Required**
▪ Develops 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; ▪ Develops or produces 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; ▪ Develops or produces 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. **Definition of "quantum computer" remains unchanged from the NPRM as "a computer that performs computations that harness the collective properties of quantum states, such as superposition, interference, or entanglement."*	▪ None.
AI systems	
Prohibited	**Notification Required**
▪ Develops 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	▪ Develops any AI system that is not in the prohibited category and that is: ● Designed to be used for any (1) 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 nuclear weapons), or combat system

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);
▪ Develops any AI system that is trained using a quantity of computing power greater than:
  ● 10^25 computational operations (e.g., integer or floating-point operations); or
  ● 10^24 computational operations (e.g., integer or floating-point operations) using primarily biological sequence data.
	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);
	● Intended by the covered foreign person or joint venture to be used for any of the following: cybersecurity applications, digital forensics tools, penetration testing tools, the control of robotic systems; or
	● Trained using a quantity of computing power greater than 10^23 computational operations (e.g., integer or floating-point operations).

In the context of covered activities related to AI, the Final Rule defines an "AI system" as:

- (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 (1) uses data inputs to perceive real and virtual environments; (2) abstracts such perceptions into models through automated or algorithmic statistical analysis; and (3) uses model inference to make a classification, prediction, recommendation, or decision; or
- (b) Any data system, software, hardware, application, tool, or utility that operates in whole or in part using a system described in (a).

Treasury has clarified that, while the second prong of the definition may implicate a range of persons who use third-party AI models or machine-based systems, such persons would be considered to engage in a covered activity only to the extent they "develop" the relevant third-party AI model or machine-based system being used, such as through design or substantive modification. For example, a person engaging in substantive modifications of a third-party AI model, such as removing security measures or safeguards, would be developing an AI system.

The Final Rule also clarifies that customizing, configuring, or fine-tuning a third-party AI model or machine-based system strictly for internal, non-commercial use (e.g., not for sale or licensing) would not itself be considered as engaging in a covered activity, unless such activity has a government intelligence, mass-surveillance, or military end use, or is for digital forensics tools, penetration testing tools, or the control of robotic systems. This clarification is intended to address requests from commenters that the Final Rule "distinguish between AI systems with end uses that are offensive in nature from those that are defensive (e.g., the cybersecurity-related applications under section 850.217(d)(2) could include both applications that disrupt another computer network and those that protect one's own network)." The effect of this clarification is that persons

of a country of concern may use third-party AI systems for internal, non-commercial cybersecurity purposes without being considered a covered foreign person solely on this basis.

Treasury declined in the Final Rule to define "design" with respect to covered activities involving AI systems, but noted in its commentary that "the plain English meaning of 'design' should apply, including but not limited to the process of conceiving, defining, or planning a system for a specific function or end use, such as laying out elements, interfaces, and other characteristics in accordance with identified requirements or architecture." Treasury also noted that "assessing a given AI system for 'design' or 'exclusive design' may involve considering an AI developer's source of funding, customer base, nature and extent of model customization, performance indicators from testing and evaluation, and relevant training data, among other factors."

What transactions are exempted?

Consistent with the NPRM, Treasury has included 10 categories of excepted transactions in the Final Rule:

- An investment in a publicly traded security;
- An investment in a security issued by a registered investment company, such as an index fund, mutual fund, or exchange traded fund;
- An investment of a certain size by a U.S. person limited partnership ("LP") in a pooled investment fund;
- An investment in a derivative, so long as such derivative does not confer the right to acquire equity, any rights associated with equity, or any assets in or of a covered foreign person;
- A full buyout of all interests of any person of a country of concern in an entity, such that the entity is not a covered foreign person following the transaction;
- An intracompany transaction between a U.S. person parent and its controlled foreign entity that supports new operations that are not covered activities or that maintains covered activities that the foreign entity was engaged in prior to the effective date;
- Fulfillment of a U.S. person's binding, uncalled capital commitment entered into prior to the effective date of the Final Rule;
- The acquisition of a voting interest in a covered foreign person upon default or other condition involving a loan, where the loan was made by a lending syndicate and a U.S. person participated passively in the syndicate;
- The receipt of employment compensation by an individual in the form of stock or stock options, or the exercise of such options; and
- Certain transactions with or involving a person of another country that has been designated as having sufficient outbound investment controls. No such country has been designated yet.

These largely track the exceptions listed in the NPRM, with some additions and revisions. Specifically, Treasury has revised the scope of the exception for LP investments (discussed below), added an exception for investments in derivatives, revised the intracompany transaction exception (also discussed below), revised slightly the exceptions related to uncalled capital

commitments and lending syndicates, and added an exception for equity compensation awards. We discuss the two most substantive revisions below.

Intracompany Transactions Exception

The NRPM included an exception for "intracompany" transactions—i.e., transactions between U.S. persons and their controlled foreign entities that support ongoing operations or other activities that are not covered activities, provided that the exception would not apply to greenfield, brownfield, or joint venture investments. Commenters voiced significant uncertainty about the scope of this exception and requested that Treasury clarify how it was intended to apply. Treasury indicated in the Final Rule that this exception creates a carve-out for an otherwise covered transaction between a U.S. person parent and a controlled foreign entity that supports new operations that are not covered activities or that maintains ongoing operations (including ongoing covered activities) in which the controlled foreign entity was engaged at the time of the effective date of the Final Rule.

As indicated above in the context of brownfield investments, this still leaves uncertainty regarding what would constitute a new covered activity. Moreover, while Treasury refers to this exception in its commentary on the Final Rule as covering "intracompany *transfers*," it is not clear what type of "transfer" could constitute a covered transaction. Thus, absent further guidance from Treasury on the meaning of "transfer," it is unclear how frequently this exception will apply in practice, though Treasury noted in the NPRM that the definition of a covered transaction would not usually apply to most routine intracompany activities such as the sale or purchase of inventory or fixed assets, the provision of paid services, or the licensing of technology.

Exception for Investments Made as a Limited Partner in Investment Funds

In the NPRM, Treasury proposed two alternatives for exceptions for investments made as an LP in a non-U.S. pooled investment fund. Under Alternate 1, a U.S. person's investment made as an LP in a fund would have constituted an excepted transaction if (i) the LP's rights were consistent with a passive investment, and (ii) the LP's committed capital was not more than 50 percent of the total assets under management of the fund. Under Alternate 2, a U.S. person's investment made as an LP would have constituted an excepted transaction if the LP's committed capital was not more than $1 million.

In the Final Rule, Treasury rejected Alternate 1 and adopted Alternate 2, though doubling the threshold to $2 million. Treasury also adopted a separate exception for LP investments in non-U.S. investment funds where the U.S. person has obtained a binding contractual assurance that its capital in the fund will not be used to engage in a transaction that would be prohibited or notifiable if engaged in by a U.S. person. While this new exception may be helpful under certain circumstances, it seems likely that it will be burdensome to apply in practice because any investment fund that provides the contractual assurance will not know for any given investment whether it can use the capital committed by its U.S. person investors to whom it has provided the contractual assurance until it has performed diligence on the investment target to determine whether it is a covered foreign person.

Can parties request a waiver or prior authorization for a covered transaction?

As in the NPRM, Treasury declined to adopt a formal licensing process where a U.S. person could seek prior authorization for a covered transaction, but the Final Rule affirms that a U.S. person could still seek a "national interest exemption" for a covered transaction on a case-by-case basis.

Treasury additionally affirmed it will detail the process and required information for any national interest exemption request on its website in the future.

For transactions that are required to be notified, when must the notification be made and what information is required to be provided in the notification?

A U.S. person subject to the notification requirement under the Proposed Rule would be required to file a notification with Treasury that includes information related to the transaction such as details about the U.S. person, the covered transaction, relevant national security technologies and products, and the covered foreign person, and maintain the notification and "supporting documentation" for 10 years from the date of the filing, including, as applicable, "pitch decks, marketing letters, offering memorandums, and due diligence materials related to the transaction." The Final Rule requires that a notification must be filed no later than 30 calendar days after a transaction is completed. Other required information for notifications include: the full legal names and titles of each officer, director, and other member of management of the covered foreign person and a brief description of the known end use(s) and end user(s) of the covered foreign person's technology, products, or services.

For any required information the U.S. person is not able to provide, the U.S. person is required to provide sufficient explanation for why the information is unavailable or otherwise cannot be obtained and explain the U.S. person's efforts to obtain such information. If such information subsequently becomes available, the U.S. person shall provide such information to Treasury promptly, and in no event later than 30 calendar days following the availability of such information.

Once a notification has been submitted, the Final Rule provides that Treasury may follow up with additional questions or document requests with deadlines specified by Treasury. The Final Rule also provides that once a notification has been submitted, it is possible the U.S. person will receive no communication from Treasury other than an electronic acknowledgement of receipt.

What happens if parties find out after the fact that a transaction was notifiable or prohibited?

As in the NPRM, the Final Rule requires a U.S. person to submit a notification to Treasury if the U.S. person "acquires actual knowledge after the completion date of a transaction of a fact or circumstance such that the transaction would have been a covered transaction if such knowledge had been possessed by the relevant U.S. person at the time of the transaction." This requirement would apply to both notifiable and prohibited transactions. The U.S. person would be required to submit the "post-transaction knowledge" notification no later than 30 calendar days after acquiring such knowledge, and it would be required to include:

- Identification of the fact or circumstance of which the U.S. person acquired knowledge post-transaction;
- The date upon which the U.S. person acquired such knowledge;
- A statement explaining why the U.S. person did not possess or obtain such knowledge at the time of the transaction; and
- A description of any pre-transaction diligence undertaken by the U.S. person, including, as applicable, any steps described in § 850.104(c).

What are the penalties for engaging in a prohibited transaction or failing to make a required notification?

The penalties for non-compliance include both civil and criminal penalties, as well as a divestment order. A violation (e.g., missed notification) will be subject to civil penalties not to exceed $368,136 (adjusted regularly for inflation) or twice the amount of the transaction, whichever is greater, as set forth in the International Economic Emergency Powers Act ("IEEPA"). A violation could also be subject to criminal penalties not to exceed $1,000,000 and/or 20 years in imprisonment as set forth in IEEPA. Under the Final Rule, the Secretary of the Treasury may take any action authorized under IEEPA to nullify, void, or otherwise require divestment of any prohibited transaction. The Final Rule also provides a process for U.S. persons to submit a voluntary self-disclosures to Treasury regarding violations. Treasury indicates in its commentary that it "anticipates providing additional information regarding compliance with the program at a later date."

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