

# Locke Lord QuickStudy: Final Rule Issued Regarding U.S. Outbound Investments in Certain Chinese National Security Technologies and Products

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On October 28, 2024, the U.S. Department of the Treasury (the “Treasury”) released final regulations (the “Final Rule”) to implement Executive Order 14105, titled “Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern” (“EO 14105” or the “Outbound Order”) issued by President Biden on August 9, 2023.

The Outbound Order is intended to restrict U.S. investments that could enhance the development of sensitive technologies deemed to threaten U.S. national security, specifically prohibiting certain investments flowing to entities within “countries of concern” listed on Annex A to the Outbound Order. Currently, Annex A lists only the People’s Republic of China, along with the Special Administrative Region of Hong Kong and the Special Administrative Region of Macau (collectively, “China”); the President may in the future update the Annex to the Outbound Order to add additional countries of concern. Please see also our August 15, 2023 QuickStudy titled “President Biden Issues Executive Order Banning Certain Technology Sharing with China.”

## Executive Summary

The Final Rule, which takes effect on January 2, 2025, requires U.S. persons to provide notification to the Treasury regarding transactions involving Chinese businesses that develop or produce national security technologies and products that may threaten U.S. national security and prohibits U.S. persons from investing in Chinese businesses that are engaged in activities involving certain other national security technologies and products that pose a particularly acute national security threat to the U.S. The Outbound Order grants the Secretary of the Treasury (the “Secretary”) authority to block those transactions that are determined to negatively impact the national security of the U.S. by directly or indirectly supporting the military or intelligence capabilities of countries of concern.

The Final Rule also introduces new requirements on U.S. persons to conduct certain due diligence and notify the Secretary of investments in a “Covered Foreign Person” engaged in “Covered Activities” pertaining to specified categories of technologies and products. As you can see, there is a lot to unpack in that simple sentence. The overarching goal of the Outbound Order and related Final Rule is to protect critical technologies while preserving the U.S.’s commitment to open and secure investments. The Final Rule covers some 297 pages and is intricately drafted. The Treasury anticipates making additional information available on its Outbound Investment Security Program (the “Program”) website regarding topics such as the application of the knowledge standard.

The Outbound Order identifies three sectors of national security technologies and products to be covered by the Program: (i) semiconductors and microelectronics, (ii) quantum information technologies, and (iii) artificial intelligence. The President promulgated the Outbound Order based upon concerns that China has been exploiting or has the ability to exploit U.S. outbound investments and may gain certain intangible benefits that often accompany U.S. investments and that help companies succeed.

## **The Outbound Order**

The Outbound Order has two related parts addressing the President's objective. First, the Outbound Order requires U.S. persons to notify the Secretary prior to investing in a "Covered Foreign Person" who is engaged in "Covered Activities" in specified categories of technologies and products. The second prong requires the Secretary to block investment by a U.S. person in a Covered Foreign Person if the investment would advance such person's military or intelligence capabilities, particularly in sensitive areas.

Covered Activities (described in greater detail below) include the development of semiconductors and microelectronics technology, equipment, and capabilities that enable the production and certain uses of integrated circuits that underpin current and future military innovations or that improve the speed and accuracy of military decision-making, planning, and logistics, among other things; as well as that enable mass surveillance or other cyber-enabled capabilities.

Specifically, the Outbound Order:

- requires U.S. persons to submit information to the Treasury regarding Notifiable Transactions (see definition below) and prohibit U.S. persons from engaging in Prohibited Transactions (see definition below).
- requires the Secretary to investigate violations of the Outbound Order or the Final Rule and pursue civil penalties for such violations. The Secretary also has the power to refer acute violations of the Outbound Order to the U.S. Attorney General for criminal prosecution. U.S. persons who believe they may have violated the Final Rule can submit a voluntary self-disclosure, which the Treasury may take into account when determining penalties.
- introduces a due diligence requirement to the knowledge standard. U.S. persons are required to take action if they are aware, or should have been aware, of facts related to a transaction that involve sensitive national security technologies or entities in countries of concern. This standard requires U.S. persons to undertake reasonable due diligence to ascertain whether a transaction is covered by the Final Rule. A U.S. person may also be involved in a Covered Transaction if they have a significant influence over a foreign entity of concern.

## **Prohibited Transactions**

Subpart C of the Final Rule prohibits U.S. persons from engaging in a Prohibited Transaction unless an exemption for that transaction has been granted under section 850.502.

## **Notifiable Transactions**

Subpart D of the Final Rule requires U.S. persons (and their controlled foreign subsidiaries) to notify the Treasury in any of the following circumstances:

- If it undertakes a Notifiable Transaction (section 850.401);

- If its Controlled Foreign Entity undertakes a transaction that would be notifiable if undertaken by a U.S. person (section 850.402); or
- If the U.S. person acquires actual knowledge following the completion date of a transaction that the transaction would have been a Covered Transaction if the U.S. person had known of relevant facts or circumstances as of the completion date (section 850.403).

Pursuant to the above circumstances, a U.S. person is required to follow the Treasury's procedures to timely submit detailed information to the Treasury and to certify as to the completeness and accuracy of the submission, and to maintain certain records. The U.S. person has an ongoing duty to promptly update any submission if it later discovers a material omission or inaccuracy about any information so provided.

## **Covered Sectors – National Security Technologies and Products**

The Final Rule outlines specific technologies and products that fall under its scope, focusing primarily on those with military or intelligence applications. These include:

- *Semiconductors and Microelectronics*: Prohibited transactions related to the development of advanced integrated circuits, supercomputers, and critical electronic design automation software.
- *Quantum Information Technologies*: Prohibited transactions involving the development of quantum computers, critical components for quantum computing, and certain quantum communication systems.
- *Artificial Intelligence ("AI") Systems*: Transactions related to AI systems that are intended for use in military or intelligence operations are prohibited, particularly those requiring significant computational power or involving biological sequence data.

## **Exceptions and Exemptions**

While the Final Rule imposes many restrictions, it also includes several exceptions for specific types of transactions. These include investments in publicly traded securities, certain limited partner investments in venture or private equity funds, and intracompany transactions. Additionally, U.S. persons may apply for a national interest exemption if they believe a transaction is critical to U.S. interests. The Final Rule clarifies that not all investments in countries of concern are subject to the Outbound Order; only those related to sensitive technologies with potential national security risks. For instance, investments related to semiconductors, quantum technologies, and certain AI systems may be heavily regulated, but only certain transactions are prohibited.

## **Importance of Compliance and the Final Rule's Impact**

The Final Rule marks a significant shift in U.S. foreign investment policy, and is a direct response to growing national security concerns about foreign adversaries leveraging U.S. investments to gain access to sensitive technologies. U.S. persons, whether individual investors or corporate entities, must pay close attention to comply. As compliance requirements come into effect in January 2025, U.S. businesses and investors will need to develop compliance programs and conduct due diligence on their foreign transactions to avoid potential violations. The Final Rule's emphasis on national security technologies highlights the U.S. government's commitment to safeguarding critical technologies from exploitation while maintaining a secure and open investment environment. By adhering to these regulations, U.S. persons can continue to engage in international investments with the assurance that their actions are aligned with national security priorities.

## Key Defined Terms

**Controlled Foreign Entity** means an entity incorporated in, or organized under the law of, a country other than the United States of which a U.S. person is a parent.

**Covered Activity** means, in the context of a transaction, any of those activities included in the definition of Notifiable Transaction in section 850.217 or Prohibited Transaction in section 850.224.

**Covered Foreign Person.** The Final Rule describes three sets of circumstances that will cause a person to be a Covered Foreign Person:

- section 850.209(a)(1), a person is a Covered Foreign Person if it is a person of a country of concern that is engaged in a Covered Activity;
- section 850.209(a)(2), a person is a Covered Foreign Person even if it is not itself a person of a country of concern or engaged in a Covered Activity but has a particular relationship with a person of a country of concern that is engaged in a Covered Activity; and
- section 850.209(a)(3), a person of a country of concern will be a Covered Foreign Person by virtue of its participation in a joint venture with a U.S. person if such joint venture is engaged in a Covered Activity.

**Covered Transactions** are transactions that are either notifiable or prohibited, and include a U.S. person's direct or indirect:

- Acquisition of an equity interest or contingent equity interest (including convertible debt) in a Covered Foreign Person;
- Provision of debt financing that affords the lender certain management or governance rights in a Covered Foreign Person that are characteristic of an equity investment but not typical of a loan;
- Conversion of a contingent equity interest (including convertible debt) in a Covered Foreign Person where the contingent equity interest was acquired on or after the effective date of the Final Rule; and
- Acquisition, leasing, or other development of land, property or other assets that will result in or the U.S. person plans to result in the establishment of a Covered Foreign Person, or the engagement of an existing person of a country of concern in a Covered Activity.

**Excepted Transaction.** Below is a summary of ten categories of Excepted Transactions (subject to conditions, in some instances):

- An investment by a U.S. person in a publicly traded security;
- An investment by a U.S. person in a security issued by a registered investment company, such as an index fund, mutual fund, or exchange traded fund, or issued by any company that has elected to be a business development company;
- An investment of a certain size by a U.S. person limited partner in a pooled investment fund;
- An investment by a U.S. person in a derivative;
- A U.S. person's 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 ongoing operations, including ongoing Covered Activities;
- 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 a country or territory outside the United States that has been designated by the Secretary in accordance with provisions set forth in section 850.501(g) of the Final Rule.

**Knowledge.** A U.S. person is responsible for knowledge the U.S. person had or could have had through a “reasonable and diligent inquiry.” The Treasury expects a U.S. person to make a reasonable effort, taking into account the context of a given transaction and any warning signs, among other factors.

**Notifiable Transaction** is a transaction by a U.S. person or its Controlled Foreign Entity with or resulting in (1) the establishment of a Covered Foreign Person that engages in a Covered Activity that may contribute to the threat to the national security of the United States identified in the Outbound Order, or (2) the engagement of a person of a country of concern in a Covered Activity that the Secretary has determined may contribute to the threat to the national security of the United States identified in the Outbound Order. The Final Rule also requires a U.S. person to provide prompt notice to the Treasury upon acquiring actual knowledge after the completion date of a transaction of facts or circumstances that would have caused the transaction to be a Covered Transaction if the U.S. person had such knowledge on the completion date.

**Parent** means a U.S. person that, directly or indirectly, (1) holds more than 50 percent of the outstanding voting interest or voting power of the board of the entity; (2) is a general partner, managing member, or equivalent of the entity; or (3) if the entity is a pooled investment fund, is an investment adviser to any such fund.

**Prohibited Transaction** means a transaction by a U.S. person with or resulting in (1) the establishment of a Covered Foreign Person that engages in a Covered Activity that poses a particularly acute national security threat because of its potential to significantly advance the military, intelligence, surveillance, or cyber-enabled capabilities of a country of concern, or (2) engagement of a person of a country of concern in a Covered Activity that poses a particularly acute national security threat because of its potential to significantly advance the military, intelligence, surveillance, or cyber-enabled capabilities of a country of concern. Additionally, the Final Rule prohibits a U.S. person from knowingly directing a transaction that the U.S. person knows would be a Prohibited Transaction if engaged in by a U.S. person. The Final Rule also requires a U.S. person to take all reasonable steps to prohibit and prevent any transaction by its Controlled Foreign Entity that would be a Prohibited Transaction if undertaken by a U.S. person.

**U.S. person** means 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.

## Conclusion

This paper is intended as a guide only and is not a substitute for specific legal or tax advice. Please reach out to the authors for any specific questions. We expect to continue to monitor the topics addressed in this paper and provide future client updates when useful.

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