

Preparing For The New Restrictions On Investment Into China

By **Steven Franklin, David Wang and Greg Kinzelman** (December 9, 2024, 7:00 PM EST)

The U.S. recently finalized a new regulatory program governing investments by U.S. persons in China-related companies involved in three technology sectors of national security concern — semiconductors and microelectronics, quantum information technologies and artificial intelligence systems.

This new program will in some cases require post-closing reporting and in other cases outright prohibit investments by U.S. persons, including private investment funds, in companies in these three technology sectors.

On Aug. 9, 2023, the Biden administration **issued an executive order** to regulate U.S. outbound investment in certain technologies and products in China.[1]

The order provided for the establishment of a new and targeted national security program to be implemented and administered by the U.S. Department of the Treasury in consultation with other U.S. agencies. On Oct. 28, the Treasury **issued final rules** implementing the program effective Jan. 2, 2025.[2]

The program defines certain covered transactions that would either: (1) require U.S. persons to notify the Treasury of the same, or (2) prohibit U.S. persons from undertaking certain transactions, in either case involving certain Chinese entities engaged in activities related to subsets of the three advanced technology areas. These subsets include the sensitive technology areas of (1) semiconductors and microelectronics, (2) quantum information technologies and (3) artificial intelligence systems.

The final rules are not solely concerned with limiting certain China-related companies' access to U.S. capital, but are instead principally focused on the "intangible benefits that often accompany United States investments and that help companies succeed ... [such as] enhanced standing and prominence, managerial assistance, investment and talent networks, market access and enhanced access to additional financing" that are often provided by U.S. venture capital funds, corporate venture capital, private equity funds, and other investors.

According to the Treasury, this new program will prevent U.S. investments from helping China localize the production of sophisticated technologies that threaten U.S. national security.

Key Insights

The final rules go into effect on Jan. 2, 2025, for investors and Chinese companies.

The program enjoys bipartisan support in the U.S., so it is unlikely to be affected by the recent U.S. election results. The Jan. 2 effective date represents a change from the earlier proposed Aug. 9, 2023, effective date for certain aspects of the program.

The final rules do not create a new filing and approval process for covered foreign investments.

The new program does not set up a reverse filing process for the Committee on Foreign Investment in the United States to review each prospective covered transaction. In other words, the new program will not create a case-by-case review of individual investments.

Certain investments in China-related companies active in sensitive technology areas will be banned when the final rules become effective.

The program will prohibit investment in China-related companies active in sensitive technology areas that exceed certain parameters or are critical for the military, intelligence, surveillance, or cyber-enabled capabilities of China.[3] Importantly, many normal commercial applications of artificial intelligence by China-related companies may no longer be available for investment.

Certain investments in China-related companies active in semiconductors and microelectronics, and artificial intelligence systems will be allowed, subject to post-closing notification to the Treasury.

The program will allow all investments in semiconductors, microelectronics and artificial intelligence systems that are not otherwise specifically prohibited by the final rules. Certain investments will be subject to a post-closing notice within 30



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days of the closing of the investment. This post-closing notification requirement appears to be motivated primarily by the desire of the U.S. government to gather information regarding cross-border investment flows.

Existing Chinese investments are not subject to the prohibitions or notice requirements.

The program does not have a retroactive effective date, and accordingly, all investments made prior to Jan. 2, 2025, are grandfathered in.

U.S. limited partners, or their equivalents, that invest in funds should require funds to agree not to invest in covered transactions.

The final rules provide an exception to allow most limited partners to invest in pooled investment funds without being subject to the final rules where either: (1) the committed capital of the limited partner is less than \$2 million; or (2) the limited partner secures a binding contractual assurance that the fund will not use its capital in the fund to engage in a transaction that would be prohibited or notifiable if engaged in by a U.S. person.

The program includes noncircumvention rules.

The final rules include prohibitions on U.S. persons circumventing the investment restrictions, including through the use or direction of non-U.S. entities.

Impact on Existing Investments

The program does not provide for retroactive application with respect to transactions and investments completed prior to Jan. 2, 2025. However, the Treasury may request information after the effective date about transactions by U.S. persons that were completed or agreed to after the date on which the 2023 executive order was issued, to better inform the development and implementation of the program.

While prior iterations of the final rules suggested that the Treasury might allow additional pro-rata or minimal investment without further restrictions or notification requirements, the Treasury ultimately declined to provide any such allowance for follow-on investments.

Potential Effect on New Investments

Starting Jan. 2, U.S. persons will need to assess whether a company in which they intend to invest is a China-related company, and whether the prospective transaction is prohibited or notifiable. The term "U.S. persons" includes U.S. citizens, U.S. entities, permanent residents and foreign persons temporarily present in the U.S.

Pursuant to the knowledge standard adopted in the final rules, to be covered by the regulations, a U.S. person would need to know — or reasonably should know based on publicly available information and other information available through a reasonable and appropriate amount of due diligence — that it is undertaking a transaction involving a covered foreign person, and that the transaction is a covered transaction.

Accordingly, more diligence will be required than simply obtaining a representation from the relevant company that it is not a Chinese-controlled company involved in the relevant technologies. U.S. investors will need to conduct their assessment so that it meets the knowledge standard, and it is advisable to preserve a record of this diligence in case the Treasury later has questions or investigates a particular transaction.

As with CFIUS, there is no minimum percentage or dollar-value investment threshold required for an investment to be a covered transaction under the new program. U.S. investors will need to assess the company's present and likely future intentions to determine whether the proposed investment will qualify as a covered transaction that is prohibited or subject to notice, and budget in the requisite time and money for such diligence.

Effect on Fund Investors

The final rules specifically reference fund investors in the discussion related to exclusions for certain limited partner investments and circumvention rules. Given the concern for "intangible benefits that often accompany United States investments" in formulating the final rules, the Treasury was focused on how these benefits could be avoided by eliminating loopholes and unintended consequences.

Exclusion for Certain Limited Partnership Investments

The final rules define a covered transaction to include the acquisition of a limited partnership interest in a non-U.S. pooled investment fund that a U.S. limited partner knows, at the time of the acquisition of the interest (and not each time the fund makes an investment), is likely to invest in a company of a country of concern that is in the sensitive technology areas, and such fund undertakes a transaction that would be a covered transaction if undertaken by a U.S. person.

The final rules exclude certain excepted transactions — limited partner investments into private investment funds that invest in covered transactions, if:

- The limited partnership's committed capital is not more than \$2 million aggregated across all investment and coinvestment vehicles of the fund — note that this exclusion is for limited partnerships and does not extend to the

investment fund itself; or

- A limited partnership has secured a binding contractual assurance before its investment into a fund that its capital in such fund will not be used to engage in a transaction that would be a prohibited transaction or notifiable transaction, if engaged in by a U.S. person — even if the fund later makes such acquisitions.

In either case, in order to qualify as excepted transactions, the limited partnership must not obtain rights beyond standard minority shareholder protections — i.e., those that are typically defensive in nature and are to protect against fund manager or majority investors actions — as part of its investment.

Finally, with respect to transactions in which a limited partnership has made a binding capital commitment to a fund prior to the Jan. 2, 2025, effective date, and the capital is called after the effective date, such transaction will also be considered an excepted transaction, and will not be subject to the prohibition and notification requirements.

Prohibitions on Avoidance Relevant to US Persons Managing Non-U.S. Funds

Under the final rules, a U.S. person is prohibited from knowingly directing a transaction by a foreign entity 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.

U.S. persons knowingly direct a transaction if they have authority, individually or as part of a group, to make or substantially participate in decisions on behalf of a non-U.S. entity, and exercise that authority to direct, order, decide upon or approve a transaction. Such authority is presumed to exist where the U.S. person is an officer or director of a foreign, or otherwise possesses executive responsibilities with respect to a foreign entity.

However, the final rules allow U.S. persons who recuse themselves to avoid being considered to have directed a transaction if they do not:

- Participate in formal approval and decision-making related to the transaction, including making a recommendation;
- Review, edit, comment on, approve or sign relevant transaction documents; or
- Engage in negotiations with the relevant transaction counterparty.

In addition, the program will require U.S. persons to take all reasonable steps to prevent any transaction by a foreign entity controlled by a U.S. person that would be prohibited if engaged in by a U.S. person.

Such steps may include executing agreements containing the governance and shareholder rights of the U.S. person with respect to the controlled foreign entity, and implementing policies, procedures, reporting, auditing and training programs in respect thereof.

Post-Closing Notice

The Treasury will require that notifications be filed via a portal hosted on its website no later than 30 days after the closing of a covered transaction. Any information submitted will not be made public, with certain limited exceptions.

U.S. persons will be required to furnish information for applicable covered transactions in sensitive technology areas, including details about the U.S. person, the covered foreign person, the covered transaction, and the relevant national security technologies and products.

In addition, the final rules require filers to maintain a copy of the notification and supporting documentation — including marketing, and due diligence materials and transaction documents — for a period of 10 years, to be provided to the Treasury upon request.

Penalties for Noncompliance

Under the EO, the Treasury can "nullify, void, or otherwise compel the divestment of any prohibited transaction entered into after the effective date" of the implementing regulations.

The Treasury is also authorized to impose civil penalties up to the maximum allowed under Title 50 of the U.S. Code, Section 1705(b), namely, the greater of \$250,000 (as adjusted for inflation) or twice the value of the transaction.

A person who willfully commits a violation of the final rules may be fined up to \$1 million and imprisoned up to 20 years.

What Happens Next

After the final rules go into effect on Jan. 2, we expect the Treasury will set up a filing portal, and issue more detailed guidance and FAQs as the program gets underway.

Assuming the final rules remain materially intact in 2025, we expect that before U.S. persons make new commitments to

venture capital and private equity funds, they will require that those funds agree not to invest in covered transactions.

Additionally, all U.S. persons involved in investing in China — including U.S. individuals participating in the Chinese investment activities of their employers — will need to ensure that they (1) do not make prohibited transactions, (2) do not knowingly direct prohibited investments to be made on behalf of others, and (3) comply with any applicable notice requirements.

Accordingly, all U.S. entities, as well as non-U.S. entities that have U.S. individuals participating in their investment processes, will need to:

- Adopt policies and procedures to identify prospective investments that may constitute covered transactions;
- Insulate U.S. employees, officers and directors from knowingly directing prohibited investments; and
- Ensure that any new investments comply with any contractual arrangements designed to avoid deploying their capital into covered transactions.

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[1] The original executive order is at: <https://www.whitehouse.gov/briefing-room/presidential-actions/2023/08/09/executive-order-on-addressing-united-states-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern/>.

[2] The final rules are at: https://home.treasury.gov/system/files/206/TreasuryDepartmentOutboundInvestmentFinalRuleWEBSITEVERSION_0.pdf.

[3] For a more detailed summary of the final rules, including a chart summarizing the affected technologies, see: <https://www.gunder.com/en/news-insights/insights/client-insight-biden-administration-finalizes-regulations-restricting-outbound-us-investment-into-china>.

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