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Client Insight: Biden Administration Finalizes Regulations Restricting Outbound U.S. Investment into China

Insights
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The U.S. has finalized a new regulatory program governing investments by U.S. persons in PRC-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 in companies in these three technology sectors. Here is a detailed look at the final rules and their potentially significant impact on the activities of U.S. venture capital funds, corporate venture capital, private equity funds, and other investors.

On August 9, 2023, the Biden Administration issued an Executive Order ("EO") [Fn 1] to regulate U.S. outbound investment in certain technologies and products in the People's Republic of China, including Hong Kong and Macao (collectively, the "PRC"). The EO 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 ("Treasury") in consultation with other agencies, including the U.S. Department of Commerce. Concurrently, Treasury issued an Advance Notice of Proposed Rulemaking ("ANPRM") to provide an overview and solicit comments on the scope of the new program. After receiving comments on these proposed regulations, on June 21, 2024 Treasury issued a Notice of Proposed Rulemaking ("NPRM") to implement the rules. [Fn 2] On October 28, 2024, Treasury issued final rules (the "Final Rules") implementing the program effective January 2, 2025. [Fn

3] The program defines certain “covered transactions” that would either: (1) require U.S. persons to provide notification to Treasury of the same, or (2) prohibit U.S. persons from undertaking certain transactions, in either case involving certain PRC entities engaged in activities related to subsets of the following three advanced technology areas: (i) semiconductors and microelectronics, (ii) quantum information technologies and (iii) artificial intelligence systems.

The Final Rules are not solely concerned with limiting certain PRC-related companies’ access to U.S. capital, but are instead principally focused on the intangible benefits to such PRC-related companies that are often provided by U.S. venture capital funds, corporate venture capital, private equity funds, and other investors. As described by Treasury, the program seeks to deny affected PRC-related companies access to “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.”

The U.S. already prohibits or restricts the export to the PRC of many of the technologies and products under consideration for the new program. The new program adds technology categories and complements the President’s earlier Executive Order from June 3, 2021, as later supplemented, that prohibits investments in approximately one hundred named Chinese companies due to their suspected ties to defense or surveillance technology sectors. [Fn 4]

According to Treasury, this new program will prevent U.S. investments from helping accelerate the indigenization within the PRC of technologies that threaten U.S. national security. Treasury states that this indigenization undermines the effectiveness of existing U.S. export controls and inbound investment screening programs (i.e., Committee on Foreign Investment in the United States (CFIUS) review), which also seek to protect U.S. national security.

Takeaways:

- **The Final Rules go into Effect January 2, 2025 for Investors and Chinese Companies.** The program enjoys bi-partisan support in the US, so is unlikely to be affected by the recent US election results. This January 2, 2025 effective date represents a change from the earlier proposed August 9, 2023 effective date for certain aspects of the program.

- **No New Filing and Approval Process for Covered Foreign Investments.** To the relief of many, the new program does not set up a “reverse CFIUS” filing process

for the review of each prospective "covered investment." In other words, the new program will not create a case-by-case review of individual investments.

- **Certain Investments in PRC-Related Companies Active in Semiconductors and Microelectronics, Quantum Information Technologies, and Artificial Intelligence Systems will be Banned When the Final Rules Become Effective.** The program will prohibit investment in PRC-related companies active in certain semiconductors and microelectronics, quantum information technologies, and artificial intelligence systems that exceed certain parameters or are critical for the military, intelligence, surveillance, or cyber-enabled capabilities of the PRC. The regulations narrowly define the subcategories of these technologies subject to prohibition; however, as explained below, many normal commercial applications of artificial intelligence by PRC-related companies may no longer remain available for investment.

- **Certain Investments in PRC-related Companies Active in Semiconductors and Microelectronics and Artificial Intelligence Systems will be Allowed Subject to Post-Closing Notification to Treasury**. The program will allow all investments in semiconductors and microelectronics and artificial intelligence systems that are not otherwise specifically prohibited by the Final Rules, with certain investments subject to a post-closing notice within 30 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 to inform the future development and implementation of the program.

- **Existing PRC Investments are Not Subject to Prohibition or Notice.** The program does not have a retroactive effective date and, accordingly, all investments made prior to January 2, 2025 are grandfathered in. However, the Final Rules will not allow subsequent follow-on investments in affected companies with prohibited technology after January 2, 2025.

- **US limited partners or equivalents ("LPs") that Invest In Funds Should Require Funds to Agree Not to Invest in Covered Transactions.** The Final Rules provide an exception to allow most LPs to invest in a pooled investment fund without being subject to the Final Rules where either: (a) the committed capital of the LP is less than $2 million; or (b) the LP secures a binding contractual assurance that its capital in the fund will not be used by the fund to engage in a transaction that would be prohibited or notifiable if engaged in by a U.S. person.

- **The Program Includes Non-Circumvention 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.

Which Investors are Covered by the Final Rules?

The program requires U.S. persons, wherever they are located, to bear responsibility for adhering to the investment prohibition and the notification requirement. A U.S. person includes any U.S. citizen, lawful permanent resident, entity organized under the laws of the U.S. or any jurisdiction within the U.S., "including any foreign branches of any such entity, and any person in the U.S." The definition also applies to a foreign person temporarily present in the U.S.

What Types of Transactions are Covered by the Final Rules?

The program focuses on U.S. persons undertaking certain types of transactions that could convey intangible benefits, which specifically include: acquisition of equity interests (e.g., via mergers and acquisitions, private equity investments, venture capital investments, and other arrangements); greenfield investments; joint ventures; and certain debt financing transactions that are convertible to equity.

In order to minimize unintended consequences of the new regulations, the Final Rules provide exceptions for certain types of passive and other investments that may pose a lower likelihood of conveying intangible benefits. For example, the Final Rules allow certain U.S. investments into publicly-traded securities, derivatives, index funds, mutual funds, exchange-traded funds, certain investments made as a limited partner, committed but uncalled capital investments, and certain intracompany transfers of funds from a U.S. parent company to its subsidiary.

Treasury decided not to provide other exclusions that were introduced in earlier proposals, as it believe the scope of transactions provided in the Final Rules does not apply to the transactions that it was considering exempting.

Which Companies are Covered by the Final Rules?

The Final Rules apply to companies in named "countries of concern," which is currently only one country—the PRC (including Hong Kong and Macao). It is possible that additional countries may be added in the future. Therefore, initially, the program will apply to investments in companies that are organized under the laws of the PRC, have a principal place of business in the PRC, or are majority-owned by PRC individuals or entities.

Unlike the existing sanctions framework, the new program will identify certain technologies for coverage, rather than banning or blacklisting specific PRC-related companies. Accordingly, U.S. investors will need to determine whether a company in

which they plan to invest develops technology that would constitute a “covered transaction.”

The Final Rules describe the affected technology categories that will be subject to prohibition, and those subject to post-closing notification. A chart summarizing the affected technologies is provided below:

Technology Category	Prohibited	Allowed Subject to Post-Closing Notice
Semiconductors and Microelectronics	PRC entities engaged in: 1. the development of electronic design automation software or advanced packaging design for integrated circuits; 2. the development of semiconductor fabrication equipment; 3. the design, fabrication, or packaging of certain advanced integrated circuits; or 4. the installation or sale of supercomputers.	PRC entities engaged in the design, fabrication, and packaging of integrated circuits not included within the “prohibited” integrated circuit activities.
Quantum Information Technology	PRC entities engaged in: 1. the production of quantum computers and certain components; 2. the development of certain quantum sensors; or 3. the development of certain quantum networking and quantum communication systems.	None.
Artificial Intelligence	PRC entities engaged in:	PRC entities engaged in developing AI systems that are not “prohibited” and that are (a)

	1. developing certain AI systems designed to be exclusively used for, or which the relevant covered foreign person intends to be used for, any military end use or government intelligence or mass surveillance end use; 2. developing certain AI systems trained using a quantity of computing power greater than 10^25 computational operations; or 3. developing certain AI systems trained using 10^24 computational operations using primarily biological sequence data.	designed to be used for certain end uses (e.g., government intelligence or mass-surveillance, military), (b) intended to be used for cybersecurity applications, digital forensics tools, penetration testing tools, or control of robotic systems, or (c) trained using a quantity of computing power greater than 10^23 computational operations.

What is the Impact on Existing Investments?

The program does not provide for retroactive application with respect to transactions and investments completed prior to January 2, 2025. However, Treasury may, after the effective date of the Final Rules, request information about transactions by U.S. persons that were completed or agreed to after the date of the issuance of the 2023 EO to better inform the development and implementation of the program. While the ANPRM suggested that Treasury might allow additional pro-rata or minimal investment without further restrictions or notification requirements, it declined to provide any such allowance for follow-on investments in the Final Rules.

What is the Potential Impact on New Investments?

Starting January 2, 2025, U.S. investors will need to assess whether a company in which they intend to invest is a PRC-related company and whether it is engaged in either a prohibited technology or a technology that requires notification. Pursuant to the knowledge standard adopted, 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 the willingness of the company receiving the investment to represent that it is not a PRC-controlled company involved in the relevant technologies. U.S. investors will need to conduct their own assessment to

meet the knowledge standard, and it is advisable to preserve a record of this diligence in case Treasury later has questions or investigates a particular transaction.

As with CFIUS, there is no minimum percentage or dollar value of investment threshold required for an investment to be a "covered transaction" under the new program. Thus, U.S. investors will need to assess every transaction potentially affected by the Final Rules, including early investments in seed rounds or early stage funding involving small dollar amounts. U.S. investors will need to assess the present and likely future intentions of the company in order to determine whether the proposed investment will qualify as a "covered transaction" that is prohibited or subject to notice. The budget and time needed for adequate diligence will need to be factored into the investment negotiation process.

If the "covered transaction" is prohibited, then the U.S. investor will not be able to make the investment. If the "covered transaction" is subject to notification, the U.S. investor will be able to make the investment and will be required to make a notification within an expected 30 days of initial closing. In addition, a U.S. person who acquires actual knowledge following the completion date of a transaction of a fact or circumstance such that the transaction would have been a "covered transaction" had the fact or circumstance been known by the U.S. person at the time of the transaction will also be required to submit a notification within 30 days of acquiring such knowledge. (See details below.)

How do the Final Rules Affect Fund Investors?

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

> *Exclusion for Certain Limited Partnership Investments.*
>
> The Final Rules define a covered transaction to include the acquisition of a limited partner interest in a non-U.S. venture capital fund, private equity fund, fund of funds, or other pooled investment fund that a U.S. LP knows at the time of the acquisition of such limited partner interest (and not each time the fund makes an investment) likely will invest in a company of a country of concern that is in the semiconductors and microelectronics, quantum information technologies, or artificial intelligence sectors, and such fund undertakes a transaction that would be a covered transaction if undertaken by a U.S. person.

The Final Rules do exclude a *de minimis* limited partner investment into VC funds, PE funds, or funds of funds that invest in "covered transactions." The exclusion will apply to LPs that do not have the ability to influence or participate in the fund's management, funding of any covered investment, or the applicable portfolio company's decision-making or operations and whose committed capital is not more than $2 million aggregated across all investment and co-investment vehicles of the fund. Note that this exclusion is for LPs and does not extend to the investment fund itself.

In addition, if a LP that has secured a binding contractual assurance prior to 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, then such transaction will be considered an "Excepted Transaction" and will not be subject to the Rule's prohibition or notification requirements with respect to the LP obtaining such assurance, even if the fund later makes such acquisitions.

Finally, with respect to transactions in which a LP has made a binding capital commitment to a fund prior to the January 2, 2025 effective date of the Final Rule, and the capital is called after the effective date, such transaction shall also be considered an "Excepted Transaction" and shall not be subject to such prohibition and notification requirements.

Prohibitions on Avoidance Relevant to US Persons Managing Non-US 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 exercises that authority to direct, order, decide upon, or approve a transaction. Such authority is presumed to exist where the US person is an officer or director of, 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:

> (1) Participate in formal approval and decision-making related to the transaction, including making a recommendation;

(2) Review, edit, comment on, approve, or sign relevant transaction documents; or

(3) 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. In determining whether a U.S. person took all reasonable steps to prohibit and prevent such transaction, Treasury will consider: (1) the execution of agreements with respect to compliance between the subject 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; (3) the 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 Rules; (4) the implementation of 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.

What Would a Post-Closing Notice Require?

Treasury will require that notifications be filed via a portal hosted on its website no later than 30 days following the closing of a "covered transaction," and that any information submitted would not be made public other than under limited exceptions required by law.

U.S. persons will be required to furnish information for applicable "covered transactions" in semiconductors and microelectronics and AI systems that includes, but is not limited to:

(i) the identity of the person(s) engaged in the transaction and nationality (for individuals) or place of incorporation or other legal organization (for entities);

(ii) basic business information about the parties to the transaction, including name, location(s), business identifiers, key personnel, and beneficial ownership;

(iii) the relevant or expected date of the transaction;

(iv) the nature of the transaction, including how it will be effectuated, the value, its status, a post-transaction organizational chart, and a brief statement of business rationale;

(v) a description of the basis for determining that the transaction is a “covered transaction” – including identifying the covered national security technologies and products of the covered foreign person;

(vi) transaction information including transaction documents, any agreements or options to undertake future transactions, partnership agreements, integration agreements, or other side agreements relating to the transaction with the covered foreign person and a description of rights or other involvement afforded to the U.S. person(s);

(vii) detailed information about the covered foreign person, which could include products, services, research and development, business plans, and commercial and government relationships with a country of concern; and

(viii) a description of due diligence conducted regarding the investment, including information to allow Treasury to determine if it was reasonable and sufficiently diligent.

In addition, the Final Rules require filers to maintain a copy of the notification and supporting documentation for a period of ten years. Supporting documentation includes pitch decks, marketing letters, and offering memorandums; transaction documents including side letters; and diligence materials related to the transaction. This documentation must be provided to Treasury upon request.

What are the Penalties for Non-Compliance?

Under the EO, Treasury can “nullify, void, or otherwise compel the divestment of any prohibited transaction entered into after the effective date” of the implementing regulations. The Final Rules do not specific the nature of any potential divestment process and whether ordering the divestment of a prohibited transaction will be tailored to the size, type, or sophistication of the U.S. person or to the nature of the violation. Treasury has noted that it would not use this authority to unwind a transaction that was not prohibited at the time it was completed.

Treasury is also authorized to impose civil penalties up to the maximum allowed under 50 U.S. Code § 1705(b), namely, the greater of $250,000 (as adjusted for inflation) or twice the value of the transaction, for: (i) material misstatements or omissions from information submitted to Treasury; (ii) the undertaking of a prohibited transaction; or (iii) the failure to timely notify a transaction where required. A person who willfully commits a violation of the Final Rules may be fined up to $1,000,000 and/or be imprisoned up to 20 years.

What Happens Next?

The Final Rules go into effect January 2, 2025.

How Can GD Help?

If you have questions or concerns regarding the application of the Final Rules to any outbound investment to the PRC that you are considering, or want to know how best to prepare in advance for addressing the impact of the Final Rules going forward, please contact your Gunderson attorney.

[Fn 1] Original Executive Order

[Fn 2] Treasury's Notice of Proposed Rule Making

Treasury's Advance Notice of Proposed Rule Making

[Fn 3] The Final Rules

[Fn 4] Executive Order from June 3, 2021

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