

Winston's Takeaways from the Final Outbound Investment Rule

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On October 28, 2024, the U.S. Department of the Treasury's (Treasury) Office of Investment Security published the final text of the Outbound Investment Security Program ([the Final Rule](#)). The Final Rule will become **effective January 2, 2025**. Any "Covered Transaction" entered into on or after that date will be subject to the prohibitions and affirmative legal requirements applicable to "U.S. persons" under the Final Rule. As background, the Final Rule is designed to prevent (or in some cases require notification of) U.S. investments in businesses that could benefit a Country of Concern's semiconductor-manufacturing, artificial intelligence (AI), or quantum-computing capabilities, with a particular focus on investments that would typically be accompanied by intangible benefits such as access to investment and talent networks, enhanced access to additional financing, enhanced standing and prominence, or managerial assistance. Currently, the only designated "Country of Concern" is the People's Republic of China, including the Special Administrative Regions of Hong Kong and Macau (collectively, China).

We provided [a comprehensive explainer of the Outbound Investment Security Program](#) (the Explainer) when the proposed text (the Proposed Rule) was released. The now Final Rule will have jurisdiction over U.S. person outbound direct and indirect investments through:

- acquisition of an equity interest or contingent equity interest in a person, with "knowledge" that the person is a "covered foreign person" (CFP), including where the interest is acquired through a lender's foreclosure on collateral;
- provision of a loan or other debt that is convertible into equity to a person, with "knowledge" the person is a CFP;
- conversion of a contingent equity interest in, or debt to, a person into an equity interest, with "knowledge" that the person is a CFP (note that a single investment could be a "Covered Transaction" more than once because of the later conversion of the convertible investment in an equity interest);
- provision of a loan or other debt that gives the U.S. person certain control rights over or relating to a person, with "knowledge" that the person is a CFP, such as the right to appoint board members or make management decisions;
- acquisition, lease, or development of operations, land, property, or other assets (e.g., greenfield or brownfield investments) in a "Country of Concern" (CC) that the U.S. person "knows" will, or "intends" to result in, the

establishment of a CFP or the engagement of a “Person of a Country of Concern” (PCC) in a “Covered Activity” (collectively, PCC-CA);

- entrance into a joint venture (JV), wherever located, with a PCC where the U.S. person “knows” or “intends” that the JV will engage in a “Covered Activity”; and
- acquisition of a limited partnership interest in a non-U.S. person private fund, fund of funds, or other pooled investment fund, with “knowledge” that the fund will likely invest in a PCC, and where the fund in fact then invests in a PCC, in which case the original acquisition is the “Covered Transaction.”

Collectively, we refer to these investments as “Covered Transactions.”

In the Explainer, we expanded on the jurisdictional boundaries; illustrated the concepts of CFEs and CFPs; and explained the proposed prohibitions, requirement to take “all reasonable steps to prohibit and prevent” transactions by CFEs that would be prohibited if undertaken by a U.S. person, and transaction notification requirements. The Final Rule remains largely the same as the Proposed Rule. Below is a list of the noteworthy updates and other items we identified in the Final Rule text or in the accompanying Treasury responses to public comments.

1. Treasury Built a De Minimis Aspect into Part of the “Covered Foreign Person” Definition

All “Covered Transactions” involve the investment into or creation of a CFP. CFPs consist of:

- PCC-CAs;
- PCCs that are joint venturers in a JV that the U.S.-person joint venturer knows at the time of entrance into the JV that it will be or plans to be engaged in a “Covered Activity”; and
- persons holding a board seat, voting or equity interest, or a contractual power to direct the management in/of a PCC-CA and that are sufficiently connected to the PCC-CA through one or more of revenue, net income, capital expenditures, and operating expenses.

The last category determined through financial metrics opens the door to potentially many businesses, both Chinese and non-Chinese, ultimately being considered CFPs because of the financial metrics connection. Under the Proposed Rule, all that was required was for the *potential* CFP to receive or incur at least 50% of its annual revenue, net income, capital expenditures, or operating expenses from one or more PCC-CAs.

Now under the Final Rule, for a *potential* CFP holding a board seat, equity, or contractual power over a PCC-CA, the 50% measure is moderated by a requirement that each respective PCC-CA, to be counted toward the 50%, meet the minimum threshold of \$50,000 contributed to or received from the would-be CFP in one of the four annual financial metrics. For example, consider a *potential* CFP with the right to appoint one board seat each on the boards of PCC-CA No. 1 and PCC-CA No. 2. When combined, both entities constitute 55% of the *potential* CFP’s annual revenue (\$220,000 of \$400,000), but while No. 1 provides \$180,000 (45%) and No. 2 provides 10% (\$40,000), the revenue generated by No. 2 is inapplicable, and therefore the *potential* CFP’s connection to PCC-CAs through annual revenue is insufficient to cause it to be an actual CFP.

Confused about what a CFP (covered foreign person) or a PCC-CA (person of a country of concern engaged in a covered activity) is? Please see our [Explainer](#).

2. U.S. Companies That Will Incur the “All Reasonable Steps” Requirement for Covered Foreign Entities’ Investments Should Begin Preparing Now for the January 2, 2025 Effective Date

U.S. person entities will be required to take “all reasonable steps to prohibit and prevent” transactions by their CFEs that would be prohibited if engaged in directly by the U.S. entity as described above. Treasury offers no definitive safe-harbor mechanism and simply provides a **non-exhaustive list** of measures it will consider when examining whether a U.S. person entity complied with this requirement:

- the execution of agreements with respect to compliance with the Final Rule between the U.S. person and its CFE;

- the existence and exercise of governance or shareholder rights by the U.S. person with respect to the CFE, where applicable;
- the existence and implementation of periodic training and internal reporting requirements by the U.S. person and its CFE with respect to compliance with the Final Rule;
- 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 CFE; and
- implementation of a documented testing and/or auditing process of internal policies, procedures, or guidelines.

If there is a possibility that a CFE of your company will engage in “Covered Transactions,” implementation of these and any other necessary measures to prohibit and prevent the CFE from doing so should start now so they are fully in effect by January 2, 2025.

Confused about what a CFE (covered foreign entity) is? Please see our [Explainer](#).

3. Limited Partners Exception Materially Increased in Scope Under Final Rule

Limited partner investors (LPs) are better off under the Final Rule than under the Proposed Rule. Treasury indicated in the Proposed Rule that for the LP exception to the definition of “Covered Transaction” to apply, Treasury was considering:

- a lengthy list of non-capital contribution activities that a LP holding a minority of assets under management in a pooled investment fund could not participate in to preserve the LP exception to the “Covered Transaction” definition;
- a \$1M committed capital limit across all co-investment vehicles; and/or
- requiring, in transactions where the fund is not a U.S. person or CFE, that the LP secure a binding contractual assurance from the foreign fund preventing the foreign fund from engaging in what would otherwise be a prohibited transaction if undertaken by the LP.

In the Final Rule, Treasury ditched the cumbersome activities-based approach and now presents LPs with a choice:

- either ensure that (the LP’s) committed capital across all co-investment vehicles will be under a higher threshold of \$2M (instead of the original \$1M); or
- (if the fund is not a U.S. person or CFE) obtain a contractual assurance that the LP’s capital invested will not be used to engage in an indirect prohibited transaction or notifiable transaction.

4. Other Excepted Transactions Categories Largely Remain Unchanged

Most exceptions announced in the Proposed Rule remain substantially the same. For example, some commenters pointed out that some foreign jurisdictions provide relatively small shareholders (as a percentage of total equity) a right to cause a shareholder vote on whether to nominate new directors, which the commenters posited should fall under the scope of the standard minority-shareholder protections exception. However, Treasury declared these proposal rights are not minority-shareholder protections. Treasury also declined to expand the scope of exceptions pertaining to investments in publicly traded securities, registered investment company securities, buyouts by U.S. persons of persons of a country of concern, and foreclosure on voting interests by lending syndicates where the U.S. person is a passive, non-leading bank lender.

However, there are two limited windows of increased scope with respect to activity taking place between now and the effective date of January 2, 2025. Specifically:

- U.S. companies hoping to use the intracompany exception must ensure the relevant covered activities begin no later than January 1, 2025, to avoid “Covered Transaction” status (under the Proposed Rule, the cutoff date was August 9, 2023, the date of the President’s executive order “Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern” ([the Outbound Order](#))); and

- the Final Rule moves the cutoff date back from August 9, 2023, to January 2, 2025, for the binding uncalled capital commitments exception, which prevents such uncalled capital investments, when called, from causing a “Covered Transaction,” so long as the commitment was made prior to the cutoff date.

The Final Rule also adds two exceptions for:

- investments by U.S. persons in derivatives; and
- the receipt of employment compensation by an individual in the form of stock or stock options, as well as for the exercise of those compensatory stock options.

5. The Lack of Clear Due Diligence Standards or a Safe Harbor Will Necessitate That Investors (or Their Legal Advisors) Contemporaneously Document Their Analysis Regarding “Covered Transactions”

LPs, like other classes of investors, are not left unscathed with respect to a lack of clarity on due diligence expectations. In response to the Proposed Rule, many commenters expressed great discomfort with the question of what diligence would be sufficient for a U.S. person to confirm they undertook a “reasonable and diligent inquiry” with respect to a transaction. In the Final Rule, Treasury has done little to nothing to assuage industry concerns. Besides the most minor tweaks to the “knowledge” standard section, Treasury added language indicating that the assessment of whether the U.S. person’s inquiry was sufficiently “reasonable” and “diligent” will be based on “the totality of the relevant facts and circumstances.” Treasury declined to establish a safe-harbor provision and declined to prescribe what red flags or warning signs to look for, stating only that “a U.S. person may wish to obtain representations and warranties from the relevant transaction counterparty regarding pertinent information such as the investment target or counterparty’s ownership, investment, and activities.” LPs, as with others, are left with broad statements from Treasury such as: “[I]t may be possible for [an] LP to know, through a ‘reasonable and diligent inquiry,’ the country and general sector in which the pooled investment fund is likely to invest.” In the supplemental information section of the Final Rule, Treasury noted it anticipates posting additional information online regarding application of the knowledge standard.

U.S. person investors that will engage in “Covered Transactions” not qualifying for an exception should carefully and contemporaneously document the diligence performed. The animating statute for the Final Rule—the International Emergency Economic Powers Act (IEEPA)—has a 10-year statute of limitations. The contemporaneous documentation will become particularly helpful if the U.S. person subsequently attains the “knowledge” that the transaction was a “Covered Transaction” and therefore incurs a 30-day deadline to inform Treasury of that “knowledge.”

6. The Final Rule Is Part of an Increasing Trend in Regulations on International Trade and Investment Where the Regulated Persons Are Asked to Determine What Parties Are Prohibited or Restricted

The U.S. government is increasingly pushing sanctions and restricted-party determinations onto the regulated persons themselves. In the case of the Final Rule, U.S. person investors must determine whether businesses receiving the investments are CFPs. Commenters requested that Treasury issue a list, and it flatly declined (though some preexisting list-based sanctions and restricted-party lists are automatically added to the definition of CFPs). Compare Treasury’s approach with the Export Administration Regulations’ use of “military end user” and “military-intelligence end user” definitions to impose restricted-party prohibitions without providing exhaustive lists. Though not a sanctioned-party definition, the Committee on Foreign Investment in the United States (CFIUS) part 800 regulations also ask regulated persons to do a fair bit of work assessing whether a U.S. business meets the definition of a “TID U.S. business” for mandatory-declaration purposes.

7. Investment Banks Can Potentially Engage in a Covered Transaction When Underwriting a Newly Issued Security

Investment banks underwriting an initial public offering (IPO) often purchase a sizable portion of the issuer’s shares to help “make the market” and to subsequently sell at a profit. Treasury states in the Final Rule that such purchases of equity in a CFP prior to public trading for purposes of facilitating the IPO are nonetheless “Covered Transactions” if they meet the definitions of a “prohibited” or “notifiable” transaction. Treasury further emphasizes that these types of circumstances are precisely why the Final Rule has been issued, because underwriting an IPO by U.S. persons

tends to “transfer intangible benefits, including enhanced standing and prominence, managerial assistance, access to investment and talent networks, market access, and enhanced access to additional financing.” Contrast this with the CFIUS regulations, which exclude acquisitions of securities by securities underwriters in the process of underwriting.

8. Non-U.S. Investment Firms Employing U.S.-Person Managers Now Have Clearer Criteria for the Scope of Required Recusal from a “Covered Transaction”

The Final Rule’s “U.S. person” definition also captures individuals who are U.S. citizens, lawful permanent residents, or any individuals located in the United States. Such individuals must also comply with the Final Rule, including its prohibition on knowingly directing a prohibited transaction by a non-U.S. person, even if the individual is employed by a non-U.S. firm. The Final Rule now clarifies exactly what activities U.S. persons must recuse themselves from for the recusal to be effective:

- participation 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).

This concept is not dissimilar to the recusal process the Office of Foreign Assets Control has long encouraged for U.S. persons employed by foreign entities with sanctions exposure.

9. Investors in Contingent Equity Interests May Seek to Avoid Future Jurisdiction over a Conversion by Obtaining Contractual Assurances on Future Activities

Treasury’s commentary accompanying the Final Rule suggests that U.S. person investors in contingent equity interests could consider obtaining contractual assurances regarding an investment target’s future business activities to avoid circumstances where the U.S. person would be unable to convert because the conversion would constitute a “prohibited transaction.” Investment managers will likely begin to see large U.S. person investors, such as institutional investors, seeking such contractual assurances for transactions closing on January 2, 2025, or beyond.

10. Watch Out for Conflict-of-Interest Decision-Making Authority Delegated to Committees

The Final Rule keeps the proposed restrictions on U.S. persons, wherever located, from knowingly directing prohibited transactions by making or substantially participating in the investment decision. Many entities and organizations may delegate investment authority to a committee when a conflict of interest exists at the manager or general partner level. U.S. persons participating in such committees, while usually unable to make or participate in investment decisions, could be able to do so in limited circumstances involving conflicts of interest and would need to properly recuse themselves from such decisions.

11. Variable Interest Entities Are No Longer Mentioned by Name, but Contractual Authorities to Control Them Can Still Create a “Covered Foreign Person” Status

Variable-interest entities (VIEs) are Chinese entities owned by Chinese individuals or entities without foreign investment or foreign equity ownership (the operating company). VIEs are controlled by a multinational-enterprise structure (the control company) that will have both Chinese and foreign investment and shareholders. An edit in the text of the CFP definition eliminated the VIE reference, but Treasury’s supplement information to the Final Rule “emphasizes that ‘contractual power to direct or cause the direction of the management or policies’ can be granted through variable interest entities.”

You can read more about VIEs in our previous article [“Understanding China’s Variable-Interest Entities.”](#)

12. Sensible Additions to the Final Rule Will Avoid a Scorched-Earth Search for Internal AI System Modifications at Covered Foreign Persons

Much like other software, “AI systems” are developing incrementally, with specific business applications built upon foundation models (such as GPT) and incorporated into other systems, software, hardware, applications, tools, or utilities. Many businesses will achieve incredible efficiency through the design of proprietary modifications to foundation models. With the addition of Notes 2 and 3 to the definitions of “prohibited” and “notifiable” transactions, businesses that do not sell or otherwise provide their internal AI systems externally, nor develop them for a limited set of problematic end uses (intelligence, mass-surveillance, military end use, digital forensics, penetration testing tools, or the control of robotic systems), will not be engaging in a “covered activity.”

13. Don't Forget About Recordkeeping

The Final Rule contains a 10-year recordkeeping requirement with respect to documents related to any transaction where a notification was required to be filed. Such supporting documentation includes pitch decks, marketing letters, offering memoranda, transaction documents, and due diligence materials. This 10-year recordkeeping requirement is consistent with the underlying IEEPA's recently updated 10-year statute of limitations.

Please contact the authors or your Winston & Strawn relationship attorney if you have any questions or need further information.

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