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Guest Article
June 9, 2025

New Restrictions on Investments into Chinese Entities: Key Considerations for Advisers, Funds, and Investors

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Background

Certain foreign investments into the United States have long been subject to review and possible restriction by the Committee on Foreign Investment in the United States (CFIUS), which consists of a group of national security and economic agencies including the Departments of Treasury, Defense, State, Justice, Commerce, Energy, and Homeland Security. However, the U.S. has not broadly restricted outbound investments into foreign countries outside of traditional economic sanctions or export control programs.

That changed on January 2, 2025, when a rule adopted by the Treasury Department (the "Rule") took effect that limits investments by U.S. persons made into sensitive economic sectors of certain defined "countries of concern." The only country of concern identified in the Rule is China, including Hong Kong and Macau. The Rule (31 CFR Part 850) implements the directives of an executive order issued by then-President Biden on August 9, 2023, and is intended to prevent U.S. investments from accelerating or enhancing the military, intelligence, surveillance, or cyber-enabled capabilities of China.

In general, the Rule – popularly known as the "Outbound Investment Security Program" – limits investments into Chinese-located or -controlled companies engaged in the semiconductor and microelectronic, quantum information technology, and artificial intelligence (AI) sectors. The Rule restricts U.S. persons from "knowingly" investing in the defined sectors, whether directly or through U.S. or offshore funds. The knowledge element is a "should have known" standard requiring due diligence, which can be satisfied when a fund makes certain representations to a U.S. person investor, usually in a side letter.

As explained below, the limitations in the Rule require notification to the government of certain investments in the covered sectors and outright prohibit other kinds of investments. These limitations present challenges and ambiguities to advisers, funds, and investors, and may necessitate changes in the investment strategies and governance of (i) funds advised by U.S. investment advisers and (ii) offshore funds with U.S. person investors.

Summary of Key Features of the Rule

Scope of the Rule's Coverage

The Rule imposes investment restrictions on U.S. citizens (wherever residing), U.S. lawful permanent residents, persons located in the U.S., U.S.-organized or -domiciled entities, and "controlled foreign entities" of which any of the foregoing is a "parent." U.S.-domiciled funds are captured, as are offshore funds advised by U.S. managers. Likewise, a U.S. person investor into an offshore fund advised by a non-U.S. manager is also subject to the Rule.

An investment by a person subject to the Rule may be prohibited or subject to notification requirements if the investment is knowingly made into:

- An entity with a principal place of business in or incorporated in China (including Hong Kong and Macau); or
- An entity (wherever located) that is 50% or more owned or controlled, directly or indirectly, by:
    - The Chinese government;
    - An entity with a principal place of business in or incorporated in China; or
    - A Chinese citizen or permanent resident of China (excluding U.S. citizens in China).

A non-Chinese person or entity is captured if it (i) has a board seat on, holds any interest in, or exerts control over, a Chinese entity and (ii) 50% or more of its revenue, net income, capital expenditure, or operating expenses are attributable to a Chinese entity.

Covered Industries

Currently, the prohibitions or notification requirements in the Rule apply to only three "covered industries":

- *Semiconductors* and *microelectronics*, including supercomputers, certain software and equipment, and the design or fabrication of certain integrated circuits;
- *Quantum information technologies*, such as quantum computer technology; and
- *AI systems* designed for or intended to be used for military, government intelligence, or mass-surveillance end uses or that are trained using a specified quantity of computing power.

Investments into Chinese entities engaged in certain activities in the specified industries are prohibited (as defined at 31 CFR 850.224), while other kinds of activities (defined at 31 CFR 850.217) merely require advance notification to the Treasury Department.

The activities of a Chinese entity's subsidiaries are likely relevant in assessing the propriety of an investment (the regulation is unclear), but the activities of a Chinese entity's parent or affiliates are irrelevant.

Covered Transactions

The Rule applies to "Covered Transactions," which include, directly or indirectly:

1. Acquiring equity interests, options, warrants, convertible debt, or debt providing equity-like rights;
2. Acquiring, leasing, or other development of operations, land, property, or other assets in China;
3. Entering a joint venture; and
4. Acquiring a "limited partner or equivalent" interest in a non-U.S. investment vehicle if the investor knows at the time of the investment that the vehicle "likely will invest in" a Chinese entity in a restricted industry.

Equity that is publicly traded (in any market) and any equity issued by an SEC-registered investment company is excluded if the U.S. person investor does not acquire affirmative or

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blocking rights of any kind other than standard minority protections. These prohibited rights expressly include the right to make a shareholder proposal, which can arise under Chinese law with an exceedingly small shareholding interest, which effectively imposes an equity cap. In fact, under China's New Company Law, effective as of July 1, 2024, the threshold for permission to make shareholder proposals in joint stock limited companies has been lowered from 3% to 1%. Carried interest is excluded.

Covered Transactions are either "**prohibited**" or "**notifiable**."

Prohibited Transactions
There are 12 different components within the definition of a "prohibited" transaction in the regulations, and, generally speaking, the Rule prohibits investments in the aforementioned technologies that *significantly* enhance the military, intelligence, surveillance, or cyber-enabled capabilities of China or pose an acute national security risk to the U.S. For investments in *semiconductors and microelectronics* and *AI systems*, the Rule describes certain technological specifications that would cause an investment in those technologies to be prohibited. *All* investments in *quantum information technologies* are prohibited unless the investment fits into a relevant safe harbor.

Notifiable Transactions
Investments into *semiconductors and microelectronics* and *AI systems* that do not meet the Rule's technological specifications are notifiable transactions. A person subject to the notification requirement is required to file a notice with Treasury that includes information related to the transaction no later than 30 days after the relevant transaction is completed or 30 days after the person knows of such transaction. Notice filers should be aware that there is little guidance from Treasury around the difference between a prohibited and a notifiable transaction in practice.

Knowledge and Due Diligence Requirements

The Rule only restricts investments when the U.S. person (or foreign entity controlled by a U.S. person) has "knowledge" that the investment target is a Chinese or Chinese-controlled entity active in one of the specified industries. Knowledge is broadly defined as (i) actual knowledge that a fact or circumstance exists or is substantially certain to occur; (ii) an awareness of a high probability of a fact or circumstance's existence or future occurrence; or (iii) reason to know of a fact or circumstance's existence.

A U.S. person is responsible for knowledge they had or could have had through a "reasonable and diligent inquiry." A reasonable and diligent inquiry refers to a person's efforts to obtain relevant information about a transaction as part of a pre-transaction due diligence process. The Treasury Department will consider the totality of the relevant facts and circumstances in assessing whether an inquiry was undertaken. This assessment will consider several factors, including:

- The inquiry a U.S. person has made regarding an investment target or other relevant transaction counterparty;
- 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;
- 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 publicly available information;
- Whether the U.S. person purposefully avoided learning or seeking relevant information;
- The presence or absence of warning signs; and
- The use of available public and commercial databases to identify and verify relevant information of an investment target or other relevant transaction counterparty.

Consequently, neither U.S. managers nor U.S. investors in offshore funds may bury their heads in the sand. A U.S. person will violate the Rule if they know or should have known their money would flow into a Covered Transaction. Given the uncertainty of the Rule's applicability, some firms are requesting representations and warranties that an investee is not a Covered Foreign Person or engaged in a Covered Transaction. While loans are exempt, lenders may be including such provisions if they become subject to the Rule. Firms are also preparing due diligence checklists or memos to the file to demonstrate compliance with the Rule.

For secondary transactions, advisers may receive questions from limited partners about whether the fund plans to engage in a Covered Transaction. Buyers may also request closing conditions around Rule compliance. For seller agreements, forward looking covenants may be requests in the transfer agreement or in a side letter agreement but could trigger most favored nation provisions.

Investor Side Letter Requests

Since both a U.S.-domiciled fund and an offshore fund advised by a U.S. manager are directly subject to the Rule, a U.S. person investor into such funds can reasonably rely on the fund to perform the required due diligence. However, an offshore fund advised by a non-U.S. manager is not directly subject to the Rule and a U.S. person investor must take additional steps to avoid knowingly making a problematic investment.

The Rule provides two **safe harbors** for such investors. First, an investor may limit their total investment to $2 million in a fund (*i.e.,* the limited partner or equivalent's committed capital must be not more than $2 million when aggregated across any investment and co-investment vehicles of the fund). The final version of the Rule thus focuses on a bright line for overall committed capital rather than a more complex inquiry, such as a limited partner's percentage of assets under management. Second, an investor seeking to invest more than $2 million may obtain, as a pre-condition to their investment, a "binding contractual assurance" in which the fund represents that it will not use the investor's money to invest in any Covered Transaction. To qualify for the second safe harbor, the investor cannot receive investment returns from any Covered Transaction.

Additionally, investors may request side letter representations that (i) give them the opportunity to review fund investments in advance of execution and (ii) provide such investor with an opt-out option. However, this active approach of complying with the safe harbor would likely only be feasible for large institutional clients investing in closed end funds, and it is more likely to see investors request confirmations that their investments will not be pooled into any Covered Transactions.

Other Exceptions

The Rule also identifies certain kinds of investments as "excepted transactions," which fall outside the scope of the prohibitions. These include most kinds of passive investments in publicly traded securities; U.S.-registered securities issued by index funds, mutual funds or ETFs, and securities issued by regulated business development companies; limited partner investments that comply with one of the safe harbor provisions set out above; and certain kinds of derivatives. The exceptions also cover acquisitions of a "covered foreign person" that results, for example, in a new non-Chinese entity within the meaning of the Rule; certain inter-company transactions; historical binding, uncalled capital commitments; certain kinds of debt financing; and certain kinds of employment compensation. There is also a national interest exemption, based on certain circumstances.

Effective Date

Transactions with a completion date on or after January 2, 2025, are subject to the Rule, including the prohibition and the notification requirement, as applicable. The Treasury

Department issued Frequently Asked Questions with further guidance.

Penalties

Under the International Emergency Economic Powers Act (IEEPA), penalties for non-compliance – on a per transaction basis – can reach up to the greater of double the value of the violating trans-action, or $377,700. For criminal violations of the IEEPA, penalties may reach up to $1 million in criminal fines and up to 20 years' imprisonment.

Potential Expansion of the Rule

On January 20, 2025, President Trump issued a memorandum directing several members of his cabinet and other economic advisers to conduct a review of E.O. 14105 and the Rule, and an initial review of the Rule was completed on or about April 1, 2025, in which the administration stated that it "plans to evaluate . . . whether the scope of outbound investment restrictions should be expanded to be responsive to developments in technology and the strategies of countries of concern." This suggests that there may be further changes to the policy that could expand the Rule.

In a more fulsome statement of administration priorities, in February 2025 the administration stated in the America First Investment Policy that it was actively considering "new or expanded restrictions" in sectors such as "semiconductors, artificial intelligence, quantum, biotechnology, hypersonics, aerospace, advanced manufacturing, directed energy, and other areas implicated by the PRC's national Military-Civil Fusion strategy." Multiple U.S. agencies have also been tracking China's efforts on these fronts, with one prominent example being the Department of Defense's list of "Chinese Military Companies." The Department of Defense list already includes over 100 companies including entities such as COSCO, CNOOC, Tencent, and Huawei. These statements reflect that the Treasury Department could expand the Rule to additional sectors and companies in the future.

Conclusion

The outbound investment security program is of a piece with other national security initiatives that are being rapidly advanced by different elements of the U.S. government, most of which are focused on China and other notable "countries of concern," including Venezuela, Russia, Iran, Cuba, and North Korea. This includes companion programs – such as the recently implemented "Data Security Program" advanced by the National Security Division of the Department of Justice – as well as sector-specific legislative and regulatory initiatives, such as the U.S. Trade Representative's advancement of proposed fees targeting the Chinese shipbuilding industry in connection with the U.S. maritime, logistics and shipbuilding sectors, and its ongoing investigation in the semiconductor sector. Firms need to adopt policies and procedures for compliance with the Rule. It is expected that further changes will be afoot.

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