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National Security Update - Commerce Department Releases Proposed Rule Implementing the Information and Communications Technology Supply Chain Executive Order

November 27, 2019

I. Summary

The Department of Commerce ("the Department") has issued a proposed rule implementing the May 15, 2019 Executive Order entitled "Securing the Information and Communications Technology and Services Supply Chain," which we previously analyzed here. Once finalized and effective, the regulations will govern the process and procedures that the Secretary of Commerce ("Secretary") will use to determine whether certain transactions involving information and communications technology or services ("ICTS") should be prohibited or otherwise restricted.

This proposed rule follows other U.S. Government supply chain security initiatives, including the regulations implementing the manufacturer-specific prohibitions of Section 889 of the John S. McCain National Defense Authorization Act for Fiscal Year 2019 ("Section 889"), the enactment of the Foreign Investment Risk Review Modernization Act ("FIRRMA"), which reformed the jurisdiction and authorities of the Committee on Foreign Investment in the United States ("CFIUS"). Underlying these efforts is the U.S. Government's concern that foreign adversaries may be able to expropriate valuable technologies, engage in espionage with regard to sensitive U.S. Government or commercial information, and exploit vulnerabilities in products or services. As currently drafted, the proposed rule goes further than other legal authorities available to the U.S. Government in that it allows the government to prohibit or otherwise restrict a broad range of wholly commercial transactions that it determines present national security risks. The proposed rule leaves significant uncertainty for companies in the ICTS sector, as well as companies that procure ICTS, as to the types of transactions that may undergo review and be prohibited or otherwise restricted.

Comments on the proposed rule are due to the Department of Commerce by December 27, 2019. Further information on specific elements of the proposed rule is discussed below.

II. Principal Elements of the Proposed Rule

Under the proposed rule, the Secretary may review, and require mitigation, prohibition, or an unwinding of transactions that: (1) are conducted by any person subject to the jurisdiction of the United States or involve property subject to the jurisdiction of the United States; (2) involve any property in which any foreign country or a national thereof has an interest (including through an interest in a contract for the provision of the technology or service); ***and*** (3) were initiated, pending, or completed after May 15, 2019 (regardless of when agreements relating to those transactions were entered into, dated, or signed or when any license, permit, or authorization applicable to the transaction was granted). The Secretary would also have the ability to review, and potentially prohibit, mitigate, or unwind transactions involving "ongoing" activities, even if a contract was entered into prior to May 15, 2019. The proposed rule specifically calls out "managed services, software updates, or repairs" as among such transactions that may be reviewed.

The proposed rule does not specify the considerations upon which the Secretary would rely to determine whether a transaction should be mitigated, prohibited, or unwound. Instead, the Department would utilize a "case-by-case, fact-specific approach" for its reviews. According to the proposed rule, this approach is intended to provide the Department with the flexibility to target those transactions that present "undue risks to the infrastructure or digital economy of the United States" or "unacceptable risk to national security or the safety of U.S. persons" without unintentionally prohibiting other transactions that may not present similar levels of risk. However, the proposed rule specifically invites comments as to whether "categorical" determinations are appropriate, either to "exempt certain classes of transactions from the Executive Order's restrictions" or to "prohibit transactions as a class" if those transactions pose an "undue or unacceptable" risk.

The Secretary would have broad discretion under the proposed rule to initiate, conduct, and resolve an investigation. The Secretary (or a designee) could commence the evaluation of a covered transaction: (1) at the Secretary's own discretion; (2) upon request from department heads or agency, governmental body, or the Federal Acquisition Security Council (FASC) as appropriate; or (3) based on information submitted by private parties to the Secretary that the Secretary deems credible via a secure portal. This third prong could allow business competitors to submit information triggering a review.

The proposed rule lists a number of factors that the Secretary, in consultation with designated senior government officials, would be required to consider when determining the effect of a transaction. Among those factors is whether the transaction involves ICTS designed, developed, manufactured, or supplied, by persons owned by, controlled by, or subject to the jurisdiction or direction of a foreign adversary. The Secretary also would be required to consider whether the transaction: (1) poses an undue risk of sabotage to or subversion of the supply chain of ICTS in the United States; (2) poses an undue risk of catastrophic effects on the security or resiliency of United States critical infrastructure or the digital economy of the United States; or (3) otherwise poses an unacceptable risk to the national security of the United States or the security and safety of United States persons. In evaluating these factors, the Secretary may rely on information from a broad range of sources, including publicly available information, business or confidential information, or classified information.

Notice Requirement and Lack of Advisory Opinions

Under the proposed rule, the Secretary would be required to notify parties to a transaction that the Secretary has determined a transaction is subject to the rule and to provide written notice to the parties of a preliminary determination as to whether the transaction may proceed, along with an explanation of the basis for that determination. The parties would then have 30 days to submit an opposition to the preliminary determination or to provide information on proposed measures to mitigate any identified concerns. While the proposed rule specifies that business confidential or other trade secret information submitted as a part of this process will not be made available for public inspection except as otherwise required by law, it does not prescribe specific confidentiality procedures for this process. The Secretary would be required to make a final written determination within 30 days of receiving any information sent by the parties in response to the preliminary determination. Such final determinations by the Secretary will be made publicly available in the Federal Register. In the final determination, the Secretary may determine that the transaction is prohibited, the transaction is not prohibited, or the transaction is prohibited, but could be mitigated.

Notably, the proposed rule specifies that the Secretary would not issue advisory opinions or declaratory rulings with respect to any proposed transaction. Thus, unless a party receives notice that its transaction is subject to the rule, it is uncertain what mechanism, if any, a private entity may have to obtain guidance about whether a transaction may be subject to review or a requirement to mitigate, prohibit, or unwind the transaction.

Key Definitions

The proposed rule would define a number of key terms, although many of these definitions are broad and leave significant discretion with the Secretary in the exercise of this authority. For example, the proposed rule defines a foreign adversary as "any foreign government or foreign non-government person determined by the Secretary to have engaged in a long-term pattern or serious instances of conduct significantly adverse to the national security of the United States or security and safety of United States persons for the purposes of Executive Order 13783." However, the rule does not identify particular governments or entities, noting only that the determination of a "foreign adversary" is a matter of Executive Branch discretion.

The proposed rule would adopt the same broad definition of ICTS that is in the Executive Order, namely, "any hardware, software, or other product or service primarily intended to fulfill or enable the function of information or data processing, storage, retrieval, or communications by electronic means, including through transmission, storage, or display." In determining whether a transaction involves ICTS designed, developed, manufactured, or supplied, by persons "owned by, controlled by, or subject to the jurisdiction or direction of a foreign adversary," the proposed rule would require the Secretary to consider numerous factors, including, but not limited to the laws and practices of the foreign adversary, equity interest, access rights, seats on the board of directors, contractual arrangements, voting rights, and control over design plans, operations, hiring decisions, or business plan development. The combination of these factors and the broad definition of ICTS would leave the Secretary with significant discretion for determining whether a transaction may be subject to review or a requirement to mitigate, prohibit, or unwind the transaction.

Similarly, the proposed rule adopts the broad definition of "transaction" from the Executive Order, capturing "any acquisition, importation, transfer, installation, dealing in, or use of any information and communications technology or service." This definition includes private sector

procurement of technology or services that could include certain licensing arrangements, permits, and/or other authorizations to use covered ICTS. Moreover, the incorporation of "dealing in" and "use of" in the definition, if interpreted broadly, could encompass commercial activity that only indirectly relates to ICTS.

Businesses Likely to Be Affected

While the definition of ICTS in the proposed rule is broad, the Department in its Regulatory Flexibility Act assessment identifies three general categories of entities that could be directly affected by the proposed rule. The enumeration of these categories may provide some guidance as to the types of providers of ICTS that could be affected by this proposed rule. The categories are:

1. Telecommunications and Information Technology Equipment and Service Providers
   - Incumbent Local Exchange Carriers (LECs)
   - Interchange Carriers (IXCs)
   - Competitive Access Providers
   - Operator Service Providers (OSPs)
   - Local Resellers
   - Toll Resellers
   - Wired Telecommunications Carriers
   - Wireless Telecommunications Carrier (except Satellite)
   - Common Carrier Paging
   - Wireless Telephony
   - Satellite Telecommunications
   - All Other Telecommunications
2. Internet and Digital Service Providers
   - Internet Service Providers (Broadband)
   - Internet Service Providers (Non-Broadband)
   - Cloud Providers/Data Center Service Providers
   - Managed Security Service Providers
   - Internet Application Operators/Developers
   - Software Providers (platform as a service, software as a service, etc.)
3. Vendors and Equipment Manufacturers
   - Vendors of Infrastructure Development or "Network Buildout"
   - Telephone Apparatus Manufacturing
   - Radio and Television Broadcasting and Wireless Communications Equipment
   - Information Technology Equipment Manufacturers

- Connected Device Manufacturers (e.g., connected video cameras, health monitoring devices)
- Other Communications Equipment Manufacturing

Evaluation Process

While conducting the evaluation of the effect of a transaction, the Secretary would be permitted to utilize information from a broad array of sources. This may include the classified threat assessment prepared by the Office of the Director of National Intelligence and the initial vulnerabilities assessment created by the Department of Homeland Security as required under Section 5(b) of the Executive Order to inform the initial analysis of risk.

During the evaluation, the Secretary would consult with relevant agency heads to make a decision for action or inaction regarding adjustment of a transaction. Action regarding adjustment of a transaction could include prohibiting the transaction or approval of the transaction provided measures are taken to mitigate the risks associated with the transaction. As noted above, the proposed rule calls for two 30-day periods: one for a party to respond to a notice of the Department's concern, and the next for the Secretary to issue a final determination. Although those time frames are relatively compressed (compared, for instance, to the review and investigation periods of a CFIUS review), the Secretary may extend deadlines in the Secretary's discretion. Depending on how Commerce exercises that discretion, it could create significant uncertainty for parties awaiting a determination about a pending transaction.

Emergency Exception to Procedures

Given the significant national security issues at stake in these determinations, the proposed rule also authorizes the Secretary to "vary or dispense with any or all of the procedures" if public harm would likely occur or if national security interests require a deviation. The Secretary must then provide the reason for engaging in the emergency action, to the extent it is possible to do so in a manner that is consistent with national security interests, in the final written determination.

Penalties

The proposed rule carries significant penalties for false or misleading statements made in connection with a proposed transaction, amounting to either a civil penalty up to $302,584, or twice the value of the transaction. Failure to comply with any mitigation measures imposed by the Secretary also may be subject to a civil penalty up to $302,584 or the value of the transaction.

III. Next Steps

The Department's action is a notice of proposed rulemaking, not an interim or final rule. As such, it invites parties to submit comments to the proposed rule. The Department specifically has invited comment on a number of issues, including:

- Whether the Secretary should consider categorical exclusions or prohibitions, whether based on types or classes of ICTS or parties to the transaction;
- Questions related to the implementation of mitigation measures, such as a need to take account of future technology developments;

- The definition of “transaction” and how “dealing in” and “use of” any ICTS should be interpreted;
- Whether the Secretary should impose additional recordkeeping requirements.

These questions suggest that the Department recognizes the breadth and uncertainty in the scope of transactions that may trigger review. Based on the feedback it receives, the Department could issue the rule in a form largely similar to the proposed rule, or it could make significant revisions.

Although the proposed rule is not yet final, companies in the ICTS sector may wish to take account of the proposed rule in considering potential transactions, especially those involving countries that the U.S. Government considers to present national security concerns, such as China and Russia. This includes, for instance, attention to the allocation of risk between contracting parties related to this review process, including potential delays or other uncertainties that may arise from this new process.

The Department of Commerce is accepting comments on all aspects of the rule by December 27, 2019. Comments may be submitted here.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

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