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Commerce Department Amends Foreign-Produced Direct Product Rule, Further Restricting Transfers to Huawei

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International Trade Controls

In an effort to curtail access by China's Huawei Technologies Co., Ltd. to products made using U.S. semiconductor software and technology, the Commerce Department's Bureau of Industry and Security ("BIS") on May 15, 2020, released an Interim Final Rule[1] expanding and extending U.S. export controls jurisdiction to certain non-U.S. items when destined for Huawei or its affiliates that have been designated on the BIS Entity List.

Specifically, the Interim Final Rule amends the Export Administration Regulations ("EAR") to restrict the knowing reexport, export from abroad, or transfer (in-country) to Huawei Technologies Co., Ltd. and its non-U.S. affiliates designated on the Entity List (collectively, "Huawei"[2]) of non-U.S. items when those items are (1) produced using certain equipment that is the "direct product" of specified U.S.-origin software or technology and (2) the "direct product" of software or technology produced or developed by Huawei. The Interim Final Rule also restricts the knowing reexport, export from abroad, or transfer (in-country) to Huawei of certain items produced or developed by Huawei that are the direct product of EAR-controlled software or technology.

Since Huawei was designated on the BIS Entity List on May 16, 2019, with additional affiliates added on August 19, 2019, persons already were prohibited from exporting, reexporting, or transferring (in-country) to Huawei most items subject to U.S. export controls without a BIS license. The new rule expands the scope of non-U.S. items subject to U.S. export controls pursuant to the preexisting "foreign-produced direct product rule," but limits that expanded scope to the reexport, export abroad, or transfer (in-country) of certain semiconductor-related items to Huawei.

Although the Interim Final Rule was effective immediately (i.e., beginning on May 15, 2020), it includes a "savings clause" for items already in transit as of its publication, and for items already in production that will be exported from abroad, reexported, or transferred (in-country) before

[1] *See Amendments to General Prohibition Three (Foreign-Produced Direct Product Rule) and the Entity List*, 85 Fed. Reg. 29,849 (May 19, 2020).

[2] Not all Huawei subsidiaries and affiliates are designated on the Entity List. As used here, "Huawei" refers only to those entities that are so designated.

September 14, 2020. BIS published the Interim Final Rule in the Federal Register on May 19, 2020, and will accept public comments through July 14, 2020.

Separately, on May 15, 2020, BIS further extended—apparently for the last time—the Temporary General License in effect since Huawei was first designated on the Entity List in 2019. This Temporary General License permits certain activities, including those necessary for the continued operation of existing networks and equipment as well as the support of existing mobile services, through August 13, 2020.

Background

In light of Huawei's designation on the Entity List in 2019, items subject to U.S. export controls generally could not be exported, reexported, or transferred (in-country) to Huawei without prior specific licensing from BIS.

In addition to all items in the United States and U.S.-origin items anywhere in the world, items subject to U.S. export controls (i.e., "subject to the EAR") include:

- Foreign-made items incorporating more than a *de minimis* percentage of controlled U.S.-origin content (or *any* controlled U.S. content for certain specific items for which there is no *de minimis* level[3]);
- When destined to certain countries, foreign-made items that are the direct product of U.S.-origin technology or software released pursuant to certain written assurances (generally required because they are controlled for "national security" reasons on the Commerce Control List ("CCL")), and the resulting items are classified in CCL entries controlled for "national security" reasons; and
- When destined to certain countries, foreign-made items that are the direct product of a complete plant or any major component of a plant, when that plant (or component) is the direct product of U.S.-origin technology or software released pursuant to certain written assurances (generally required because it is controlled for "national security" reasons on the CCL), and the resulting items are classified in CCL entries controlled for "national security" reasons.[4]

With respect to the latter two categories, "'direct product' means the immediate product (including processes and services) produced directly by the use of technology or software."[5]

[3] *See* 15 C.F.R. § 734.4(a) (May 15, 2020).

[4] *See id.* § 734.3(a).

[5] *Id.* § 734.3(a)(4).

New EAR Provisions

The Interim Final Rule does not alter the underlying principles that the United States applies in asserting jurisdiction over the export, reexport, and transfer of items.

Instead, the new rule expands the reach of the "foreign-produced direct product rule"—which generally has been limited to the direct products of U.S.-origin technology or software controlled for "national security" reasons and specific destination countries—to certain items manufactured to Huawei specifications using less sensitive EAR-controlled technology and software, including technology or software controlled only for "antiterrorism" reasons, provided that the reexporter, exporter from abroad, or transferor (in-country) knows that the item is destined for Huawei. It also restricts the knowing export from abroad, reexport, or transfer (in-country) to Huawei of items that are developed or produced by Huawei and are the "direct product" of specified EAR-controlled technology or software. The Interim Final Rule imposes these new requirements through the addition of two new substantive provisions to the EAR.

First, the Interim Final Rule amends the EAR's General Prohibition Three, known as the Foreign-Produced Direct Product Rule,[6] to specify that reexports, exports from abroad, or transfers (in-country) of any foreign-produced item described in new footnote 1 to the Entity List, with knowledge that the item is destined for an Entity List-designated party subject to footnote 1, requires BIS authorization.[7]

Second, the Entity List itself also is amended by adding new footnote 1, which provides that specified items may not be knowingly reexported, exported from abroad, or transferred (in-country) to "footnote 1" entities without BIS authorization.[8] The only Entity List entries tagged with the "footnote 1" designation are Huawei and each of its Entity List-designated affiliates. One part of footnote 1 controls non-U.S. items when the items are:

- Produced by a plant or major component of a plant that is a direct product of specified "U.S.-origin" technology or software, *and*
- The direct product of technology or software produced or developed by a "footnote 1" entity, i.e., Huawei.[9]

Footnote 1 specifies that a "major component of a plant" means "equipment that is essential to the 'production' of an item, including testing equipment, to meet the specifications of a design specified" by a "footnote 1" entity, i.e., Huawei.[10] This restriction would reach many types of semiconductor production and testing equipment.[11] The new provision thus requires BIS

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[6] *See id.* § 736.2(b)(3).

[7] *See id.* § 736.2(b)(3)(vi).

[8] *See* footnote 1 to Supp. No. 4 to EAR Part 744.

[9] *Id*. paragraph (b)(1) of footnote 1.

[10] *Id.* note to paragraph (b)(1) of footnote 1.

[11] In particular, the covered software includes ECCNs 3D001, 3D991, 4D001, 4D993, 4D994, 5D001, and 5D991; and the covered technology includes ECCNs 3E001, 3E002, 3E003, 3E991, 4E001, 4E992, 4E993, 5E001, and 5E991.

authorization for the knowing provision to Huawei of items manufactured outside the United States to Huawei specifications using semiconductor-related equipment that is the "direct product" of U.S.-origin technology.

Footnote 1 also requires BIS authorization for the knowing reexport, export from abroad, or transfer (in-country) to "footnote 1" entities, i.e., Huawei, of non-U.S. items that are the "direct product" of technology or software subject to the EAR and controlled under one of the specified ECCNs noted above, when the items are produced or developed by "footnote 1" entities.[12] This measure may implicate additional scenarios not described by the provision above, such as when a non-U.S. foundry operates without covered U.S. tools or machinery, but is provided with a design by Huawei that is the direct product of relevant EAR-controlled technology or software, and is asked to transfer the resulting items to Huawei. It also restricts the transfer among Huawei affiliates of items based on specified EAR-controlled technology or software. Notably, unlike the measure above, which is triggered by "U.S.-origin" technology or software, this provision is triggered by technology or software that is "subject to the EAR," in theory capturing a broader set of items that would include non-U.S. technology or software that includes more than *de minimis* controlled U.S. content (or *any* controlled U.S. content for certain items).

Knowledge Requirement

Under the EAR, "knowledge" means "positive knowledge that the circumstance exists or is substantially certain to occur," but also "an awareness of a high probability of its existence or future occurrence," which may be "inferred from evidence of the conscious disregard of facts known to a person and is also inferred from a person's willful avoidance of facts."[13]

The "knowledge" requirement in the Interim Final Rule governs only whether the reexporter, exporter from abroad, or transferor (in-country) knows that the item is destined for Huawei; the rule is *not* limited to situations in which the reexporter, exporter from abroad, or transferor (in-country) "knows" the U.S.-origin or EAR-controlled status of the relevant item or the plant (or major component of a plant) at which it was manufactured.

Importantly, the new rule applies not only to items supplied directly to Huawei, but also to items supplied to third parties, provided that the person supplying items to the third party knows those items are destined for Huawei. However, it does not apply to any items that are supplied to third parties and not destined for Huawei, even where the items are being supplied at Huawei's direction (e.g., where a company makes a Huawei-branded item based on a Huawei design and supplies the item to Huawei customers).

[12] *See* footnote 1(a) to Supp. No. 4 to EAR Part 744. We note that there is significant ambiguity in the phrasing of this provision; the above analysis is based upon statements that Administration officials have made regarding their understanding of this provision.

[13] 15 C.F.R. § 772.1.

Savings Clause

The Interim Final Rule includes two savings provisions for items subject to control under footnote 1:

- Items newly captured by footnote 1(a) "that were on dock for loading, on lighter, laden aboard an exporting or transferring carrier, or en route aboard a carrier to a port of export or to the consignee/end-user, on May 15, 2020, pursuant to actual orders for exports, reexports and transfers (in-country) to a foreign destination or to the consignee/end-user, may proceed to that destination under the previous license exception eligibility or without a license."
- Items newly captured by footnote 1(b) that "started 'production' prior to May 15, 2020 . . . may proceed as not being subject to the EAR, if applicable, or under the previous license exception eligibility or without a license so long as they have been exported, reexported or transferred (in-country) before [midnight on] September 14, 2020."

Items in either category not meeting these safe-harbor criteria require licensing from BIS.

Looking Ahead

This action represents the Trump Administration's latest attempt to curtail Huawei's access to U.S. technologies and software, which the Administration views as presenting a U.S. national security threat. It also demonstrates the apparent limits of traditional export control authorities—including even the authority to designate parties on the Entity List—to achieve the Administration's policy goals over the past year. In announcing the new rule, BIS stated that "Huawei has continued to use U.S. software and technology to design semiconductors, undermining the national security and foreign policy purposes of the Entity List by commissioning their production in overseas foundries using U.S. equipment."

As noted in a prior client alert, the Administration also has considered other responses, such as changes to the EAR's *de minimis* rules with respect to Huawei, but those efforts apparently are not proceeding at this time as they are considered unlikely to have a significant impact.

Looking ahead, companies engaged in the manufacture abroad of items designed to Huawei specifications using equipment that is the direct product of specified U.S.-origin software or technology may require BIS authorization to knowingly provide those items to Huawei. Each analysis would be highly fact-specific.

For the semiconductor industry, determining whether an item built to Huawei specifications qualifies as the "direct product" of software or technology produced or developed by Huawei, or if the machines or tools involved are the "direct product" of the relevant U.S.-origin software or technology, may prove challenging. Beyond the EAR definition noted above, BIS has provided limited guidance on when an item qualifies as the "direct product" of controlled U.S. technology or software, and may be motivated to interpret the term broadly in the Huawei context. Industry participants may wish to seek guidance on, for example, what level of involvement in the production or design of an item Huawei would need to have to trigger the new controls. Members of the public also have until July 14, 2020, to provide public comments on the new Interim Final Rule.

The Chinese government has expressed its opposition to the new measure, and various sources have quoted Chinese state media in reporting that China may take retaliatory actions against U.S. companies.[14] We will continue to monitor these developments closely.

We also understand that the Commerce Department has drafted a rule to facilitate companies' participation in standards-development organizations where Huawei is a participant; the rule is currently under inter-agency review.

Thus far, only the Huawei entities designated on the Entity List have received a "footnote 1" designation. However, this designation could in theory be applied to other parties, or it may signal BIS's willingness to use similar approaches to target specific entities or industry sectors for more restrictive export controls in the future.

Extension of Temporary General License

In addition to issuing the Interim Final Rule, BIS also issued a Final Rule extending through August 13, 2020, a Huawei-related temporary general license, a version of which has been in effect (with various amendments over time) since Huawei was first designated on the Entity List in 2019.[15]

As described in greater detail in a prior client alert, the Temporary General License has two main prongs. The first prong authorizes exports, reexports, and transfers to Huawei for the continued operation of existing networks and equipment, pursuant to legally binding contracts and agreements executed between Huawei and third parties on or before May 16, 2019. The second prong authorizes exports, reexports, and transfers for service and support of Huawei "personal consumer electronic devices" (including phones and personally-owned equipment such as tablets, smart watches, and mobile hotspots) and "customer premises equipment" (such as network switches and home networking adapters that enable consumers to access network communication services and distribute them within their home or small business), provided the devices were available to the public on or before May 16, 2019. In both cases, the authorized exports, reexports, or transfers may not enhance the functional capacities of the equipment or software being supported.

The Temporary General License also continues to authorize the disclosure to Huawei of certain information regarding security vulnerabilities in items owned, possessed, or controlled by Huawei or any of its non-U.S. affiliates.

Even as BIS again extended the Temporary General License, BIS officials advised that they do not intend to renew it following its next expiration. Instead, BIS intends for users of Huawei equipment to use the remaining time until the expiration of the Temporary General License to transition to other equipment, or seek licensing from BIS, as necessary.

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[14] See, e.g., *China says it's opposed to latest U.S. rules against Huawei*, CNBC (May 17, 2020), https://www.cnbc.com/2020/05/17/china-says-its-opposed-to-latest-us-rules-against-huawei.html.

[15] The Temporary General License appears at Supp. 7 to EAR Part 744.

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Covington has deep experience advising clients on the legal, policy, and practical dimensions of U.S. export controls. We will continue to monitor developments in this area, and we are well positioned to assist clients in understanding how these developments may affect their business operations.

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