Commerce Department's New Export-Related Restrictions Inhibit Semiconductor Design by and Manufacturing for Huawei

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05 / 18 / 20

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In response to the announcement on Friday by the U.S. Department of Commerce of new export-related restrictions targeting Huawei Technologies Co., Ltd. and several of its non-U.S. affiliates (collectively, Huawei), Sen. Ben Sasse (R-NE) publicly advocated that the United States "strangle" Huawei. Although the interim final rule is not nearly as draconian as Sen. Sasse might prefer, the changes to the so-called foreign direct product rule made by the Bureau of Industry and Security (BIS) will greatly inhibit Huawei's ability to design semiconductors and to procure chipsets produced by non-U.S. foundries to Huawei's design specifications if such activities implicate certain manufacturing equipment, software or technology that is subject to the U.S. Export Administration Regulations (EAR). The approach adopted by BIS seemingly spares U.S. chipmakers — which also routinely make use of non-U.S. foundries — but over time potentially could accelerate efforts by non-U.S. semiconductor manufacturers to source necessary manufacturing equipment from non-U.S. suppliers.

The interim final rule will formally be published in the *Federal Register* by BIS on May 19, 2020, but will be effective as of May 15, 2020. Comments on the rule are due to BIS by July 14, 2020.

Background on the Application of US Export Controls to Huawei

The United States long has perceived Huawei to be a national security risk and has taken a number of increasingly aggressive actions in recent years to investigate the company for alleged sanctions violations and to thwart the use of Huawei equipment in U.S. and allied telecommunications networks, as detailed in our December 12, 2019, client alert "Commerce Department Takes Steps To Thwart Use of Information and Communications Technology and Services Associated With Foreign Adversaries." Arguably, however, the most consequential of these actions was the addition of Huawei, effective May 16, 2019, to the Entity List,[1] a restricted party list maintained by BIS. The Entity List restrictions essentially are limited to a prohibition on the export, reexport or in-country transfer of items, whether hardware, software or technology, that are "subject to the EAR" to Huawei absent a license. The licensing policy for Huawei is presumptive denial and none of the usual license exceptions set forth in Part 740 of the EAR apply to transactions involving Huawei.[2]

[1] At that time, Huawei Technologies Co., Ltd. and 68 of its non-U.S. affiliates were added to the Entity List. In August 2019, an additional 46 non-U.S. Huawei affiliates were added to the Entity List.

[2] BIS issued a limited, 90-day temporary general license, effective May 20, 2019, that authorized certain categories of transactions with Huawei that otherwise would be prohibited absent a license. BIS has repeatedly extended the validity of the temporary general license, including most recently on May 15, 2020. *See* 85 Fed. Reg. 29610 (May 18, 2020). BIS also announced that the temporary general license, which now runs through August 13, 2020, may be revised or possibly eliminated altogether at the conclusion of the current validity period and encouraged persons who have been relying on these authorizations to "begin preparations to determine the specific, quantifiable impact of elimination ... ."

The temporary general license currently permits: (i) certain transactions necessary to maintain and support existing and currently fully operational networks and equipment; (ii) certain transactions necessary to provide service and support — including software for bug fixes, security vulnerability patches and other changes to existing versions of the software — to existing Huawei personal consumer electronic devices; and (iii) the disclosure to Huawei and/or to its listed non-U.S. affiliates of information regarding security vulnerabilities in items owned, possessed or controlled by Huawei or any of its non-U.S. affiliates when related to the process of providing ongoing security research critical to maintaining the integrity and reliability of existing and currently fully operational network and equipment. BIS also has provided guidance regarding interactions with Huawei in the context of participation in standards-setting or development groups or bodies and reportedly is nearing a decision on a rulemaking intended to allow engagement in standards-setting for next generation 5G wireless networks.

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For an item to be "subject to the EAR" it generally must be: (i) of U.S. origin, wherever it might be located; (ii) physically present in the United States; (iii) developed or manufactured outside the United States and incorporate a greater than *de minimis* percentage by value of controlled U.S.-origin content (the so-called *de minimis* rule);[3] or (iv) developed or manufactured outside the United States based on national security-controlled U.S.-origin technology or software (the so-called foreign direct product rule) or within a plant or major component of a plant that is a direct product of national security-controlled U.S.-origin technology or software.

While the appearance of Huawei on the Entity List effectively stanched the flow of U.S.-origin items to Huawei, many suppliers to Huawei rely upon globally dispersed supply chains. As a consequence, the correct application of the *de minimis* and foreign direct product rules to items manufactured or developed outside the United States resulted in determinations that certain items to be supplied to Huawei were not, in fact, subject to the EAR and, therefore, were beyond the jurisdictional reach of the Entity List restrictions.

For several months, BIS has been rumored to be considering changes to both the *de minimis* and foreign direct product rules to close what erroneously were being characterized as loopholes in the application of U.S. export controls to Huawei. The May 15, 2020, interim final rule represents the first step in that direction, but it may not be the last.

Interim Final Rule Strategically Targets Huawei, While Minimizing Collateral Damage

Using a two-pronged approach, the interim final rule broadens the scope of the foreign direct product rule with respect to Huawei by capturing within the scope of the EAR:

i. items that are produced or developed by Huawei that are derived from certain technology or software that are subject to the EAR; and

ii. items that are produced or developed by non-U.S. entities (a) using certain manufacturing and test equipment that is derived from certain technology or software that are subject to the EAR, and (b) that are based on technology or software produced or developed by Huawei.

Specifically, the interim final rule adds a footnote to Supplement No. 1 to Part 744 of the EAR (the Entity List), which, as detailed below, draws two new categories of foreign-produced or -developed items within the scope of the EAR and imposes a license requirement on the export from abroad, reexport or in-country transfer of such items when there is "knowledge"[4] that the items are destined for a listed entity with this footnote designation in the license requirement column of the Entity List. Each of the Huawei entities appearing on the Entity List now carry this designation.

The First Prong. The first category of items that now are subject to the EAR and require a license to be supplied to Huawei are those that: (i) are produced or developed by Huawei; and (ii) are the direct products of certain technology or software pertaining to integrated circuits and microprocessors, digital computers and telecommunications equipment that are subject to the EAR.[5]

To illustrate the practical effects of this prong of the rule, BIS explained that "if an entity with a footnote 1 designation on the Entity List produces or develops an integrated circuit design utilizing specified Category 3, 4 or 5 'technology' or 'software' such as Electronic Design Automation software, whether the 'technology' or 'software' is U.S.-origin or foreign-produced and made subject to the EAR pursuant to the de minimis or foreign-produced direct product rule, that foreign-produced integrated circuit design is subject to the EAR." In the case of Huawei, this integrated circuit design would require a license to be shared with another listed Huawei entity. Presumably, if Huawei possessed the requisite manufacturing capabilities, any items manufactured by Huawei that are the direct products of specified technology or software that is subject to the EAR also would be treated as subject to the EAR.

[3] The *de minimis* threshold for non-embargoed countries, such as China, is 25%. For purposes of applying the so-called *de minimis* rule, the term "controlled U.S.-origin content" means content that itself would require an export license to be exported to the end destination (*e.g.*, China) based on its export classification, *i.e.*, its Export Control Classification Number (ECCN). ECCNs are five-digit alphanumeric designators that are compiled into the Commerce Control List.

[4] For purposes of the EAR: "Knowledge of a circumstance (the term may be a variant, such as 'know,' 'reason to know,' or 'reason to believe') includes not only 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. Such awareness is 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."

[5] Specifically, the items produced or developed by Huawei must be the direct product of: (i) technology or software subject to the EAR and specified in ECCNs 3E001, 3E002, 3E003, 4E001, 5E001, 3D001, 4D001 or 5D001; (ii) technology subject to the EAR and specified in ECCNs 3E991, 4E992, 4E993 or 5E991; or (iii) software subject to the EAR and specified in ECCNs 3D991, 4D993, 4D994 or 5D991.

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The Second Prong. The second category of items that now are subject to the EAR and require a license to be supplied to Huawei are those that both: (i) are the direct products of a plant or major component of a plant located outside the United States when the plant or major component[6] itself is a direct product of U.S.-origin technology or software classified in one of the ECCNs described above; and (ii) are the direct products of technology or software produced or developed by Huawei. Thus, as BIS explained:

> ... if a foreign company produces integrated circuits outside the United States in a foundry containing U.S.-origin or foreign-produced equipment (which itself is a direct product of U.S.-origin 'technology' or 'software' in specified Category 3, 4, or 5 ECCNs) that is essential to the 'production' of the integrated circuit to meet the specifications of their design, including testing equipment (i.e., a major component of a plant), and the design for the integrated circuit was produced or developed from 'software' or 'technology' by an entity specified in footnote 1 to the Entity List, whether or not such design is subject to the EAR, then that foreign-produced integrated circuit is subject to the EAR.

This prong of the rule is directed squarely at non-U.S. foundries, such as Taiwan Semiconductor Manufacturing Company Limited (TSMC), that produce chips for Huawei based on Huawei designs, often using U.S.-origin manufacturing and test equipment.[7] The rule does not affect U.S. and non-U.S. chipmakers other than Huawei that utilize the services of non-U.S. foundries, as had been feared; however, potential further changes to the foreign direct product or *de minimis* rule that we understand have been considered by BIS — but which have not gained sufficient traction with other agencies, notably the Department of Defense, or the White House — may have such an effect. Nevertheless, over time the rule is likely to constrain the ability of U.S. equipment makers from supplying such foundries.

Recognizing the potential adverse impacts on non-U.S. foundries, the rule states that any items that were in production prior to May 15, 2020, that would be captured by the EAR by virtue of the second prong of the rule may be exported, reexported or transferred (in-country) before September 14, 2020.

China Threatens Retaliation

With the "Phase 1" trade deal with China already on shaky footing, these latest actions targeting Huawei, a Chinese national champion, threaten to further destabilize the bilateral trade relationship, particularly if China opts to retaliate. Specifically, as has been reported, China may add major U.S. companies to its "unreliable entities" list or otherwise impose purchasing or other restrictions on, or initiate regulatory investigations of, significant U.S. participants in the Chinese market.

[6] BIS has clarified that a "major component of a plant located outside the United States means equipment that is essential to the 'production' of an item, including testing equipment, to meet the specifications of a design ... ."

[7] Unrelatedly, TSMC recently announced plans to invest approximately $12 billion to construct a new 5-nanometer semiconductor production facility in Arizona, a decision that was applauded by the secretary of commerce.