wiley

ALERT

FAR Council Kicks Off Rulemaking to Ban Certain Semiconductor Purchases; Seeks Comment from Contractors

May 10, 2024

WHAT: The Federal Acquisition Regulatory Council (FAR Council) issued an advanced notice of proposed rulemaking (ANPR) to implement parts of Section 5949 of the James M. Inhofe National Defense Authorization Act (NDAA) for Fiscal Year 2023. The ANPR is the first step in the FAR Council's process to implement new restrictions on the sale and use of certain technology under paragraphs (a), (b), and (h) of Section 5949. When they take effect in 2027, those provisions will ban agencies from acquiring products or services that incorporate semiconductors produced, designed, or provided by specific Chinese companies or other entities that are considered national security threats.

WHEN: The FAR Council issued the ANPR on May 3, 2024. Comments on the ANPR are due July 2, 2024. The FAR Council must issue a final rule implementing Section 5949 by December 23, 2025. And the semiconductor prohibitions will take effect on December 23, 2027. Products procured by the Government before the effective date will not be subject to the prohibitions.

WHAT DOES IT MEAN FOR INDUSTRY: The ANPR is the start of the FAR Council's process to implement the semiconductor restrictions created by paragraphs (a), (b), and (h) of Section 5949. The final rule will require contractors at all levels to provide new certifications for covered semiconductor products or services and scrutinize any electronic parts, products, or services provided to the Government. Given the rule's likely far-reaching impacts and potential for contractors to incur substantial costs, the FAR Council is prudently soliciting industry comments on the potential scope and impact of

Authors

Tracye Winfrey Howard
Partner
202.719.7452
twhoward@wiley.law

Megan L. Brown
Partner
202.719.7579
mbrown@wiley.law

Jonathan C. Clark
Associate
202.719.4731
jcclark@wiley.law

Practice Areas

Government Contracts
National Security
Privacy, Cyber & Data Governance

implementing Section 5949's prohibitions before it issues a proposed rule.

Section 5949 of the FY 2023 NDAA

Section 5949 of the FY 2023 NDAA prohibits agencies from procuring or obtaining products or services that contain or use "covered semiconductor products or services" – those designed, produced, or provided by Chinese companies SMIC, CXMT, or YMTC, or their subsidiaries or affiliates.

Relevant to the ANPR, Section 5949(a)(1)(A) prohibits executive agencies from directly procuring or obtaining electronic products or electronic services that use covered semiconductor products or services. Section 5949 (a)(1)(B) prohibits executive agencies from contracting with an entity to procure or obtain electronic parts or products that use any electronic parts or products that include covered semiconductor products or services. Unlike Section 889 of the FY 2019 NDAA (prohibiting the purchase and use of covered telecommunications equipment and services), Part B does not prohibit contractors from using covered semiconductor products or services for their internal operations. Instead, it focuses on whether the procured electronic products or services use other products that include covered semiconductor products or services.

Section 5949's restrictions reflect Congress's broader focus on countering China's growing semiconductor capabilities. The Intelligence Community has identified significant economic and national security risk from U.S. adversaries' disruption of semiconductors through potential "backdoors" that could be built into American defense, telecommunications, and energy systems, or other malicious firmware and software that could be introduced during the semiconductor production process. By banning the use of certain semiconductors in government-procured products and services, Congress attempted to mitigate this significant national security and economic risk. *See* Wiley's Section 5949 Alert for more details.

The ANPR's Approach to Implementing Section 5949

The ANPR summarizes Section 5949 and explains how the FAR Council intends to implement its prohibitions. The described approach is broad and would require contractors to collect detailed information throughout their entire supply chain. Key defined terms include:

- **Covered entities**: Broadly covers domestic and foreign entities that design semiconductors using U.S.-origin technology or software and that purchase Secretary of Defense or Commerce-designated products or services or semiconductor products or services from Semiconductor Manufacturing International Corporation (SMIC).
- **Covered semiconductor product or service:** A semiconductor, semiconductor product, a product that incorporates a semiconductor product, or a service that uses such a product if:
  - Designed, produced, or provided by Semiconductor Manufacturing International Corporation (SMIC) or its affiliates;
  - Designed, produced, or provided by ChangXin Memory Technologies (CXMT), Yangtze Memory Technologies Corp (YMTC), or their affiliates; or

  - Determined by the Secretary of Defense or Secretary of Commerce (in consultation with intelligence agencies) to be produced or provided by an entity owned, controlled, or connected to the government of a foreign country of concern, and that determination is published in the Federal Register.
- **National security system:** Encompasses government telecommunications/information systems used for intelligence, cryptological activities relating to national security, military command and control, weapons systems components, or critical military/intelligence functions.

Notably, the ANPR does not clarify the definition of "critical systems" provided in Section 5949 and does not define "use."

Contractors Must Conduct a Reasonable Inquiry

Borrowing from the Section 889 regulations, the FAR Council is considering a requirement that contractors conduct a "reasonable inquiry" to detect and avoid the use of covered semiconductor products and services. The ANPR provides the following definition of a reasonable inquiry:

Reasonable inquiry means an inquiry designed to uncover any information in the entity's possession about whether any electronic products or electronic services that are provided to the Government – (1) Include covered semiconductor products or services; or (2) Use electronic products that include covered semiconductor products or services.

The ANPR adds that contractors can "rely on the certifications of compliance from covered entities and subcontractors who supply electronic products or services." Although a reasonable inquiry would not require independent audits or formal reviews, the FAR Council suggests other due diligence mechanisms may be necessary depending on the situation.

The Proposed Rule May Have Broad Scope of Application

The FAR Council anticipates the semiconductor restrictions applying to all solicitations and all contracts, including those at or below the simplified acquisition threshold, at or below the micro-purchase threshold (currently $10,000 for most procurements), and those for commercial products or services, including commercially available off-the-shelf (COTS) items. The FAR Council notes that Section 5949 does not exempt micro-purchases, and many critical products/services are procured in transactions below the micro-purchase threshold. Thus, agencies would include in all solicitations a provision that requires offerors to certify, after conducting a reasonable inquiry, that they will not use covered semiconductor products or services in electronic products or services provided to the Government. The semiconductor restrictions would also apply to contracts through a mandatory contract clause included in all government contracts, which would need to be flowed down to subcontractors at every level.

The heads of executive agencies would have limited authority to waive the restrictions in some cases, such as when the agency determines compliant products or services are unavailable or only available at prohibitively expensive prices. Consistent with Section 5949, the FAR Council also reiterates that agencies need not replace

products or services procured prior to the December 2027 effective date of the prohibition and may continue to use non-compliant semiconductors through the end-of-life of existing equipment.

The final rule's potentially broad application will thus affect government contractors at all levels. Even contractors providing electronic products and services through small purchases and those supplying COTS items will need to comply with the semiconductor restrictions and certification requirements.

FAR Council Considering Requiring Provenance and Supply Chain Information for Every Chip

The FAR Council also notes that it is "considering requiring offerors to identify the provenance of the supply chain for the semiconductor components for each electronic product provided to the Government." Provenance information might include, but not be limited to, "identification of vendors and facilities responsible for the design, fabrication, assembly, packaging, and test of the product, manufacturer codes used for the product, and distributor codes used for the product." This potential requirement seems at odds with the limited "reasonable inquiry" discussed elsewhere in the ANPR. Requiring offerors to identify the entire supply chain provenance for each semiconductor in electronics provided to the Government goes far beyond a reasonable inquiry and would likely impose a substantial burden on contractors.

Modern electronics often contain many semiconductors sourced globally, making it incredibly complex to trace the complete path of each component. This is especially true when contractors have multiple subcontractors, each with their own supplier networks. Gathering this information would be extremely time-consuming and resource intensive, and contractors would need to obtain detailed information from their own suppliers and each subcontractor's suppliers. Considering the FAR Council's estimate that 75% of contractors will have affected products or services, and the number of semiconductors that could be incorporated into a single product or service sold to the Government, the effort required to track the provenance of every single semiconductor could be immense.

Report from Commerce About Covered Products/Services

The FAR Council is considering creating a website or report, in collaboration with the U.S. Department of Commerce, to identify electronic products and services that include covered semiconductor products or services. This list could assist offerors and contractors in identifying prohibited products or services. That said, the rapidly changing semiconductor manufacturing landscape means the list likely would not be exhaustive. While contractors could use it to identify definitively prohibited products and services, they would still need to conduct reasonable inquiries to determine whether unlisted items might contain covered semiconductor products or services. The effectiveness of such a list thus would depend on how often the Department of Commerce updates it and how quickly Commerce can identify new affected products and services. Even with a robust list, however, contractors should be wary of relying on it solely and assuming that unlisted items are automatically suitable for government contracts.

FAR Council Anticipates Substantial Impacts on Contractors

The FAR Council anticipates the rule will have broad-ranging impacts on contractors, including additional education and training on the new requirements, updated business policies, investigation of contractor and subcontractor semiconductor usage and supply chains, and significant time spent by contractors completing certifications and ensuring compliance. The FAR Council estimates that 75% of new awardees will provide electronic products and services impacted by Section 5949's prohibitions. It also estimates that, on average, new contracts will have between 5 and 15 covered products and that 10-20% of the semiconductors in those products will be noncompliant. And finally, the FAR Council estimates contractors would incur around $10,000 each to replace or update a noncompliant semiconductor. Although the FAR Council did not provide an estimated total impact, given that electronics can contain numerous semiconductors, the potential cost impact of these regulations on contractors will be substantial.

Section 5949(g)

The FAR Council expects to address Section 5949(g), related to mitigating supply chain risks for non-prohibited semiconductor products and services, in a separate rulemaking. This future rulemaking will likely address ongoing efforts to increase and secure the domestic supply chain for semiconductors, such as those funded by the CHIPS and Science Act of 2022.

FAR Council's Questions and Request for Feedback

In addition to general feedback about the rule, the FAR Council has 18 specific questions it hopes to receive input on. These questions generally fall into the following categories: (1) clarifying the rule's scope and definitions; (2) details about implementation; (3) supply chain visibility/contractors' ability to comply with restrictions and certification obligations; (4) accuracy of the FAR Council's impact assessment; (5) waivers; and (6) anticipated guidance and compliance best practices.

Feedback during the ANPR process can help shape the final regulations. Accordingly, contractors with views and information about these topics should take advantage of this opportunity to influence the rule's ultimate form and ensure the FAR Council understands the potential effect on their operations. The FAR Council is statutorily obligated to release the final rule by December 23, 2025, so this rule will be moving forward regardless of industry involvement. But its proposed and final forms remain to be seen. Comments on the ANPR are due by July 2, 2024.

Wiley's Government Contracts, Telecom, Media & Technology, National Security, and Privacy, Cyber & Data Governance practices will continue to monitor these issues and keep contractors apprised of new developments.