THE GOVERNMENT CONTRACTOR®

THOMSON REUTERS

Information and Analysis on Legal Aspects of Procurement

Vol. 62, No. 36 **September 30, 2020**

Focus

¶ 269

FEATURE COMMENT: Don't Overlook 889(b): The Chinese Telecom Prohibition's Implications For Federal Grant Recipients

An important development in federal assistance programs has been the recent Aug. 13, 2020 implementation of the "Section 889" restrictions on grantees (and sub-recipients) concerning the use of certain Chinese-made or -provided telecommunications equipment and services. See 85 Fed. Reg. 49506 (Aug. 13, 2020). This rule change has been somewhat overshadowed by the relatively greater attention paid to similar prohibitions regarding Government contractors under Federal Acquisition Regulation procurements. However, Section 889's grant restrictions have the same if not greater ramifications because the change impacts the hundreds of billions of dollars that are directly administered every year by federal agencies or by state and local governments on a pass-through basis. In addition, the restrictions on the use of "covered" equipment and services may present a number of practical challenges, because in many of the countries where overseas work is performed, such products or services may be the dominant or even the only viable sources of supply.

This Feature Comment addresses the new restrictions placed on grant recipients, examines the key implications that all recipients should be considering, and suggests the actions that recipients can and should take now to best prepare and mitigate the impact of the rule change.

Section 889 of the John S. McCain 2019 National Defense Authorization Act—In Section 889 of the John S. McCain 2019 National Defense Authorization Act, Congress introduced several prohibitions and funding restrictions on the procurement and use of telecommunications equipment and services produced or provided by certain Chinese entities. Section 889 defined these "covered telecommunications equipment or services" as follows:

> (A) Telecommunications equipment produced by Huawei Technologies Company or ZTE Corporation (or any subsidiary or affiliate of such entities).
>
> (B) For the purpose of public safety, security of government facilities, physical security surveillance of critical infrastructure, and other national security purposes, video surveillance and telecommunications equipment produced by Hytera Communications Corporation, Hangzhou Hikvision Digital Technology Company, or Dahua Technology Company (or any subsidiary or affiliate of such entities).
>
> (C) Telecommunications or video surveillance services provided by such entities or using such equipment.
>
> (D) Telecommunications or video surveillance equipment or services produced or provided by an entity that the Secretary of Defense, in consultation with the Director of the National Intelligence or the Director of the Federal Bureau of Investigation, reasonably believes to be an entity owned or controlled by, or otherwise connected to, the government of a covered foreign country.

Section 889(f)(3).

Section 889 contained two key prohibitions: one governing federal procurement (Section 889(a)) and one governing federal grants (Section 889(b)). With regard to federal grants, Congress stated that as of Aug. 13, 2020, agencies would be prohibited from "obligat[ing] or expend[ing] loan or grant funds to procure or obtain, extend[ing] or renew[ing] a contract to procure or obtain, or enter[ing] into a contract (or extend or renew a contract) to procure or obtain" covered telecommunications equipment

and services. See Section 889(b)(1). In other words, Section 889 prohibited executive agencies from using federal funds in connection with any grant in which the recipient or sub-recipient used "covered telecommunications equipment or services," i.e., equipment and services (including those relating to video surveillance) produced or provided by the Chinese entities listed above, as well as their affiliates and subsidiaries. The prohibition also extends to such "covered" technology incorporated into any nonbranded products or systems.

Regulatory Implementation of Section 889's Grant Provisions—Pursuant to Section 889(b)(1), on Aug. 13, 2020, as part of its five-year update to the Uniform Guidance, the Office of Management and Budget issued a new rule at 2 CFR § 200.216, which took effect immediately. Under § 200.216(a), grant recipients, and any sub-recipients, are now prohibited from spending federal loan or grant funds to "(1) procure or obtain; (2) extend or renew a contract to procure or obtain; or (3) enter into a contract (or extend or renew a contract) to procure or obtain" covered telecommunications equipment and services. In other words, recipients may no longer use federal funds to purchase covered products and services or to extend or renew any contracts to purchase or use the same. OMB also added a new cost provision, 2 CFR § 200.417, to specify that covered telecommunications equipment and services will be considered an unallowable cost and therefore not reimbursable as a direct or indirect cost.

Key Implications for Recipients—To the relief of many in industry, the final rule narrowed the scope of the prohibition as initially provided in OMB's Jan. 22, 2020 proposed rule, which prohibited any use of covered telecommunications equipment or services by grant recipients or sub-recipients. See 85 Fed. Reg. 3766 (Jan. 22, 2020). The final rule narrowed the scope to prohibit only the *use of federal funds* to finance the purchase or use of covered equipment and services. While less expansive than the proposed rule, the final rule nevertheless requires prompt action on the part of federal grant recipients and sub-recipients. Not only must such entities cease the use of federal funds to purchase new equipment and services, they must also review whether federal funds are being used to support any covered products, services, or systems that are currently in place or that will be used for any planned acquisitions of such technology. These inquiries are time-sensitive not only for compliance reasons but because of the financial assistance that may be available from the Government to help recipients become compliant. In this regard, the rule states that awarding agencies "shall prioritize available funding and technical support to assist affected businesses, institutions and organizations as is reasonably necessary for those affected entities to transition from covered communications equipment and services, to procure replacement equipment and services, and to ensure that communications service to users and customers is sustained." See 2 CFR § 200.216(b).

While there are many similarities between the restrictions placed on Government contractors and those on grantees (and their sub-recipients), a key distinction is that, unlike federal procurements, the grant restrictions in 2 CFR § 200.216 do not prohibit grantees or sub-recipients from using covered telecommunications equipment and services—they just cannot buy those products or services with federal funds.

Although this may appear to be helpful flexibility for recipients, the rule will likely raise significant audit challenges involving compliance and cost accounting issues. That is, regardless of whether recipients want to procure covered telecommunications equipment and services, which they can still do with private funds, they will likely need to perform a relatively fulsome review of their supply chains to address and mitigate associated audit risks. For example, recipients may need to determine whether they have already purchased and are using covered telecommunications equipment and services, whether they plan on procuring such equipment and services, and, for both, how they plan to identify, segregate, and document the funding sources and related cost treatment for these expenses. To accomplish these tasks, in addition to conducting a self-inventory assessment, recipients (to meet their audit burdens) will probably need to use third-party supply chain certifications, especially for those entities that provide nonbranded products and services that may incorporate proscribed technology.

These will be important undertakings because OMB's Aug. 13, 2020 update to the Uniform Guidance also included a new cost principle at 2 CFR § 200.471, which will make expressly unallowable all costs (whether charged as a direct cost or included in an indirect cost pool) used to procure or obtain covered telecommunications equipment and services. The

new cost principle is slated to have an effective date of Nov. 12, 2020. Not only must all grant recipients affirmatively demonstrate that their costs are generally allowable (i.e., reasonable, allocable, and adequately documented), they also need to demonstrate that the costs are not expressly unallowable under an applicable cost principle. Therefore, the addition of § 200.471 will likely invite scrutiny from auditors and, hence, present the following challenge: any grantee or sub-recipient that does not have adequate records or other reasonable assurances demonstrating that their telecommunications equipment and services costs are for permissible technology (which can be particularly difficult for unbranded products, services, and systems) may have those costs questioned and, absent satisfactory substantiation, ultimately disallowed by the Government.

Under such circumstances, a recipient would have to absorb the costs, which could be an expensive proposition, and in the event of any reckless or willful disregard of the restrictions, the recipient could also face administrative penalties. Indeed, in such a case, a recipient could even face False Claims Act liability due to the 2 CFR § 200.415 certification accompanying cost submissions and reports that the claimed costs, in addition to being "true, complete, and accurate," are consistent with "the terms and conditions of the Federal award," which now include § 200.216's prohibitions. However, given the recency of § 200.216 and the scant guidance presently available for the rule, recipients should have viable, good-faith defenses to any Government challenges so long as they timely exercised reasonable diligence in efforts to comply with the rule.

Unlike the FAR provisions implementing the Section 889(a) prohibitions for federal procurements, which clearly state that the prohibition applies to new or extended contracts, the OMB regulations do not specify whether the grant prohibitions apply to *current* grants. As of the date of this publication, while some agencies have clarified their intentions to only apply the prohibition to new grants, other agencies' guidance has suggested that the prohibition is effective immediately. For instance, the U.S. Agency for International Development's (USAID) guidance confirms that the prohibition only applies to new grants and that assistance awards made prior to August 13 are not subject to the Section 889 prohibitions. See USAID, Section 889 Frequently Asked Questions (FAQs) for Contractors and Recipients of USAID Awards (Sept. 18, 2020), *www.usaid.gov/sites/default/files/documents/Partner_FAQs_09-18-2020.pdf.* In contrast, the Environmental Protection Agency's (EPA) guidance states that as of Aug. 13, 2020, "all EPA assistance agreement recipients must comply with the OMB revised regulation at 2 CFR 200.216." See EPA, RAIN-2020-G05, EPA Implementation of Prohibition on Certain Telecommunication and Video Surveillance Services or Equipment and Termination Provisions from Office of Management and Budget Final Guidance (Aug. 28, 2020), *www.epa.gov/grants/rain-2020-g05*. Recipients should confirm with their awarding agencies whether the prohibition applies to awards made prior to Aug. 13, 2020. Regardless, all recipients should consider taking action now to ensure compliance for future awards.

Five Action Items to Consider Now—Given the potential stakes, and to the extent they are not already underway, grantees should consider the following actions to protect their organization:

1. Unlike the corresponding FAR rule for federal procurements, OMB's grant rule applies to sub-recipients. Accordingly, your institution should incorporate the rule in all sub-awards because as the grantee, your institution is responsible for your sub-recipient's compliance with all applicable terms and conditions of the grant agreement. Your institution's oversight function is thus an important aspect of your compliance responsibilities, and that performance will affect your organization's audit risk.
2. Your institution should work with your auditor now to determine the impact of § 200.216 to your audit plan and process, including current and forward-looking risk assessments depending on all relevant factors, such as: (a) the nature of your organization, of the grant/project, and of any sub-recipients; (b) your institution's internal control environment and level of oversight exerted over sub-recipients and/or contractors; and (c) the appropriate level of supply chain review.
3. To assist in your institution's compliance review, and for audit substantiation purposes, you should request certifications from sub-recipients as to whether they have or have not procured or obtained covered telecommunications equipment or services. Likewise, your institution and its sub-recipients should request certifications from respective contrac-

tors, vendors, or suppliers as to whether they have or have not sold covered equipment and services. Certifications can demonstrate that your institution has conducted a reasonable diligence review, compiled the appropriate support for any audit positions to be taken, and shifted the risk of any inaccuracies to the proper entity. Certifications may also mitigate your institution's audit risk profile, since sub-recipient oversight and purchases of goods or services are important areas of risk assessment.

4. Based on the results of your institution's own supply chain review, and the information obtained from sub-recipients and contractors, you should segregate and treat as unallowable any federal funds that were used to purchase covered telecommunications equipment or services or that you reasonably suspect constitute such technology. Your institution should also adapt its internal controls to identify and preclude any further purchases of covered equipment and services, such as by adding known or suspected products, services, or providers of covered technology (based on presently available records and on any additional information, such as certification responses, that is received) to a list of products, services, and entities that require further review before any transactions may be entered.
5. If your institution has a reasonable basis to believe that it or any sub-recipient has purchased covered equipment and services with federal funds, you should consider early engagement with the awarding agency to see if additional funding is available and can be obligated to cover any potential remediation costs in transitioning to a communications platform that uses noncovered equipment or services. Timing will be important due to the apparent first-come, first-served nature of the relief provided in § 200.216(b).

✦

This Feature Comment was written for THE GOVERNMENT CONTRACTOR by* Amy Conant Hoang *and* David Y. Yang*. Ms. Hoang is a Washington, D.C.-based senior associate and Mr. Yang is a Seattle, WA-based partner in the Government Contracts and Procurement Policy Group of K&L Gates LLP. K&L Gates is a fully integrated global law firm with lawyers located across five continents.