

## INTERNATIONAL TRADE ALERT

### NEW U.S. GOVERNMENT PROPOSALS FOR EXPANDING EXPORT CONTROLS ON DUAL-USE ITEMS



In recent months the Commerce Department's Bureau of Industry and Security (BIS) and the Department of Defense (DoD) have proposed three significant changes to their regulations, which would (1) tighten rules on the release of controlled technology to foreign nationals, (2) increase controls on items intended for "military end-use" in countries, like China, that are subject to U.S. arms embargoes and (3) require defense contractors to maintain effective export control compliance programs that include procedures regarding the release of controlled technology to foreign nationals. While none of the rules have been adopted yet, changes are imminent and potential implications for companies subject to U.S. export controls are considerable. Specifically, as proposed, the new rules – which, in part, appear to arise from the same overarching concern within the U.S. government regarding the transfer of dual-use technology and commodities to China – could require the dedication of substantial new resources to augment existing export control compliance programs in order to maintain compliance.

#### DEEMED EXPORTS: CHANGING REQUIREMENTS FOR THE RELEASE OF TECHNOLOGY TO FOREIGN NATIONALS

In March 2005 BIS solicited comments regarding a report by the Commerce Department's Office of Inspector General (OIG) regarding releases of technology to foreign nationals.<sup>1</sup> The report had recommended the following changes to the U.S. Export Administration Regulations (EAR), which control the release of technology related to dual-use items:

- using a foreign national's country of birth, instead of his country of current citizenship or permanent residency, to determine if an export license is required
- amending the definition of "use" of equipment by foreign nationals to clarify that it includes any of the following activities: operating, installing, maintaining or repairing controlled equipment in the United States

<sup>1</sup> OIG's recommendations and the potential impact of these recommendations were previously discussed in detail in our March 31, 2005, Alert, available at <http://www.akingump.com/docs/publication/734.pdf>.

- clarifying Supplement 1 to the EAR, which provides guidance for government-sponsored and university research, to ensure consistency with the proposed definition of “use” and current BIS policy.

The OIG recommendations elicited over 300 hundred comments. For U.S. companies, a significant focus of the comments was the administrative burdens associated with the proposed change in identifying the country associated with a foreign national. For example, General Electric stated that the estimated direct costs to implement this requirement for just a small set of its operations would total “nearly \$1 million” and that number would “increase by several multiples considering the effect on non-employees, global operations and other GE businesses.” Moreover, commentators were also concerned that the change would have a detrimental impact on recruiting, hiring and retaining knowledgeable and skilled foreign nationals, which could further stifle innovation and injure U.S. competitiveness.

The next step in the regulatory process is the issuance of a proposed rule by BIS, which is anticipated by the end of 2005. The exact form of the rule could be shaped by interagency discussion on the issue, which has not suggested a uniform position on the language and extent of the rule based on public reports to date, and the extensive public comments. BIS officials have been intimating in meetings with industry groups that it will not propose the “country of birth” recommendation. Nevertheless, it appears that other agencies support this change, or a reasonable facsimile, so there may well be a proposal to amend the test for determining a person’s nationality under the deemed export rule, at least with respect to persons affiliated in some manner with U.S.-embargoed countries. After the issuance of the proposed rule, the public will have a second opportunity to comment on the proposed changes.

#### **CONVENTIONAL ARMS CATCH-ALL RULE: HEIGHTENING RESTRICTIONS ON EXPORTS TO ARMS-EMBARGOED COUNTRIES**

At the same time, BIS has been exploring a proposal to implement a “Conventional Arms Catch-All Control” rule under the Wassenaar Arrangement (WA) to require licenses for the exportation of “non-listed dual-use” items when an exporter knows that they will be put to a “military end use.” The United States has pushed for a conventional arms “catch-all” control for a number of years and, in 2003, the participating states of the WA issued the “Statement of Understanding on Control of Non-Listed Dual-Use Items.” BIS asserts that other treaty member-states have adopted laws in accordance with the 2003 SOU and that the Conventional Arms Catch-All rule would merely implement U.S. obligations.

The draft proposal, which has been released to industry advisors for comment but has not yet been published in the *Federal Register*, would add a new section 744.11 to the EAR prohibiting the export, re-export or transfer of certain items going to countries against which the United States maintains broad arms embargos, “if, at the time of the export, re-export, or transfer, you ‘know’ the item is intended or have been informed by BIS that the item is or may be intended, entirely or in part, for a “military end-use.”

The definition of “military end-use” would include: “incorporation into; production of; development of; maintenance of; operation of; installation of; or deployment of items described on the U.S. Munitions List...or the International Munitions List...or commodities listed...on the Commerce Control List.”

Affected groups have voiced a number of concerns with the proposal. For example, a broad coalition of industry groups has formally urged BIS, in issuing the rule, to explicitly identify all items that are to be subject to the new controls, inform exporters when a transfer would involve a military end-use, and comprehensively list the foreign entities subject to new restrictions. Moreover, others have publicly argued that key allies do not intend to implement

the rule as aggressively as the United States, particularly with respect to China, thereby undermining the competitiveness of U.S. firms.

However, BIS is under significant pressure from other agencies within the U.S. government to implement tough restrictions on these types of exports. To this end, BIS has been conducting information discussions with industry groups and other agencies. In recent meetings with industry, BIS has suggested that a proposed rule could be published as early as January 2006.

### **DEFENSE FEDERAL ACQUISITION REGULATIONS: IMPOSING AN EXPORT COMPLIANCE PROGRAM REQUIREMENT FOR DEFENSE CONTRACTORS**

DoD published a notice in the *Federal Register* on July 12, 2005, proposing changes to the Defense Federal Acquisition Regulations (DFARS) which would require, inter alia, that all defense contractors “maintain an effective export control compliance program.” The proposed rule is particularly focused on controls over the transfer of controlled technology to foreign nationals, requiring:

- “unique badging requirements” for foreign nationals
- segregated work areas for controlled technology
- periodic training on export controls
- periodic internal audits to ensure compliance with U.S. controls.

To date, U.S. agencies regulating exports, such as BIS and the Department of State, have not codified specific export control compliance program requirements. Thus, the proposed rule represents an augmentation of existing requirements beyond what is currently required by those agencies.

Opposition to this proposed rule, both inside and outside of the government, has been significant. During the comment period, which closed in September, DoD received comments from approximately 150 entities, including academic institutions, businesses, trade organizations and U.S. senators. The comments highlighted problems such as the inconsistency with BIS and State requirements, a failure to allow companies to tailor compliance programs to company structure and operations, the fact that BIS and State are better suited to assess and implement regulations regarding export control compliance programs, and a vagueness in language and terms (e.g., the phrase “effective export control compliance program” is not defined). Senators Lamar Alexander (R-Tenn.) and Jeff Bingaman (D-N.M.), co-chairs of the Senate Science and Technology Caucus, stated in comments that the rule could have “wide-ranging unintended detrimental consequences.” Thus, the timing and language of the final rule is uncertain.

### **IMPACT OF PROPOSALS ON BUSINESSES**

Commentators have posited that the animating rationale for these rules is growing concern within the executive and legislative branches of the U.S. government about the transfer of technology to China and Chinese nationals. The rules would clearly have an impact on Chinese companies owned by the People’s Liberation Army, as well as Chinese nationals working in the United States and for U.S. companies abroad. Specifically, the rules would restrict transfer of equipment and technology to many Chinese firms and persons born in China, while at the same time heightening U.S. government scrutiny of contractor export control compliance programs, particularly with respect to transfers of technology to foreign nationals.

Nevertheless, the impact of the rules is not limited to those companies that do a significant amount of business with China or rely on Chinese labor. Rather, if implemented, the proposed rules could have a significant effect on the export compliance efforts of all companies subject to U.S. export controls. For example, employee screening and hiring procedures will have to be adapted to ensure compliance with the new rule regarding technology transfers. Similarly, company intranets, firewalls, and data access and transfer procedures will have to be modified to address both the technology transfer and DFARs rules. Further, product matrices will need to be reviewed and revised and transaction screening procedures refined to implement changes that arise out of the conventional arms “catch-all” rule. The overall effect on export control compliance programs could be substantial.

Moreover, companies that currently operate without significant export control concerns could find themselves with heightened compliance considerations after the implementation of these new rules. For example, if they contract with the U.S. government, even companies that do not export from the United States apparently would be required to implement an export control compliance program under the proposed DFARs rule. Likewise, under the conventional arms catch-all rule, companies that export uncontrolled items and that have never been required to seek licenses from BIS may now be required to understand and comply with licensing requirements and processes.

#### **STATUS AND OPPORTUNITY FOR COMMENT**

Interested persons will have additional opportunities to comment on the technology transfer and conventional arms catch-all rules currently being drafted by BIS. As noted above, the proposed rules are expected to be published by January 2006, if not before. With this in mind, companies should review these rules after publication to assess the potential impact on their compliance programs and evaluate whether the submission of comments might be appropriate and in the interest of the company.

#### **CONTACT INFORMATION**

If you have questions about this topic, please contact:

|                           |                    |                                |            |
|---------------------------|--------------------|--------------------------------|------------|
| Ed Rubinoff.....          | 202.887.4026 ..... | erubinoff@akingump.com .....   | Washington |
| Wynn Segall.....          | 202.887.4573 ..... | wsegall@akingump.com.....      | Washington |
| Tom McCarthy .....        | 202.887.4047 ..... | tmccarthy@akingump.com.....    | Washington |
| Anne Heavey Scheinfeldt.. | 202.887.4392 ..... | ascheinfeldt@akingump.com..... | Washington |

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