WorldECR

DC FOCUS

The city. The law. The lawyers.

Special focus: Washington, DC

bikeriderlondon

EXPORT CONTROL REFORM: THE PAIN BEFORE THE GAIN

The Export Control Reform initiative is the biggest shake-up in trade controls in years. It aims to simplify export controls and in so doing improve export opportunities for U.S. businesses as well as facilitating export to America's allies. Five years on from its conception, *WorldECR* asks practitioners if their clients are benefiting from the new regime.

The United States' export control regime is a bedrock of its national security strategy, governing, as it does, how the nation's strategic and military products are sold across the world. Doing so has always been a balancing act, with the aim, as per all export control regimes, of striking the right note between the country's obligations to foreign partners and allies, concerns about human rights abroad, international commitments to anti-proliferation regimes such as the Wassenaar Arrangement, domestic competitiveness, and regional and international security.

The basic principles have always been clear enough: goods fall under the jurisdiction of the International Traffic in Arms Regulations ('ITAR') administered by the Directorate of Defense Trade Controls ('DDTC') within the Department of State, or that of the Export Administration Regulations ('EAR') under the remit of the Bureau of Industry and Security ('BIS') within the Department of Commerce. Generally speaking, ITAR applies to military ('USML') goods, and the EAR governs dual-use ('CCL') products, with quite different rules pertaining to their export and re-export.

But the status quo is being shaken up by the Export Control Reform ('ECR') initiative, a radical rethink of how 'the system' should function. 'It's akin,' said one lawyer, 'to asking all the nation's aerospace and defence contractors to go through their toy boxes and sort them out all over again.'

The catchy slogan used to describe the philosophy underlying the Export Control Reform initiative is, of course, 'a higher fence around a smaller yard' – or, as the U.S. State Department described it (less pithily, but more explanatorily): 'Export Control Reform will move less sensitive items that no longer merit controls under the USML, such as certain parts and components, to the CCL, to allow for more flexible licensing authorisations to allies and partners while increasing the number of enforcement officials available to safeguard against illicit attempts to procure sensitive defense technologies.'

The underlying policy drivers are that once completed ECR should increase interoperability with NATO and other close allies while reducing the current incentives for companies in 'friendly' (i.e., non-embargoed countries) to design out or avoid the use of U.S. origin content previously/currently controlled under ITAR. As at time of writing, Final Rules have been published redefining how around a dozen categories of items should be treated. Not all these changes impact on every manufacturer or exporter (by some estimates, defence trade is only around 10% of the total of U.S. trade)

but for those that do the process of reform is proving significant.

'This is the biggest revision to the export control regime that I've seen in over 30 years of practice,' says Ben Flowe of Berliner, Corcoran & Rowe. 'It is extremely complicated because what you have is two sets of rule revisions, ITAR and the EAR, that are happening in parallel. It's a huge amount of work for companies to have to reclassify all their products.'

'For people used to dealing with the ITAR, their first instinct is that a product requires a licence. But now they are responsible for deciding whether, in fact, a licence is required – and there's a strict liability if they get it wrong.'

Ben Flowe, Berliner, Corcoran & Rowe

In essence, says Flowe, the process requires a major shift of responsibility from government licensing officers to company export administrators: 'For people used to dealing with the ITAR, their first instinct is that a product requires a licence. But now they are responsible for deciding whether, in fact, a licence is required – and there's a strict liability if they get it wrong.'

Flowe says that the wrong response to the ECR programme is to think 'This merely removes a whole lot of licensing requirements, so we can shed some of our compliance people. If anything there's a need for more, not less.'

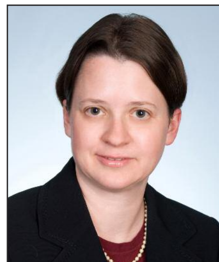
Big challenges for all sizes

The challenge of compliance with U.S. export controls has never been straightforward. One issue that arises, says Richard Matheny of Goodwin Procter, is that the potential for unwitting breaches of export controls is so broad – in other words, it is very easy for companies, especially smaller businesses lacking the resources to commit to dedicated compliance personnel to slip up against a backdrop of 'dynamic' changes in the law. 'We're still finding [encryption control] violations every day,' says Matheny. 'In part, that's because companies find it counter-intuitive, for example, that technologies that are openly available should be controlled for export purposes.'

Fried Frank partner Mario Mancuso says that it is surprising how many companies are either unaware about their export control compliance obligations or overconfident about their export control compliance posture, regardless of the reform programme. 'It isn't uncommon,' says Mancuso, 'to find companies with really antiquated classification systems that haven't taken into account how their products have been upgraded or modified over the years. You'd be surprised how many simply don't classify their products at all, or have their sales teams self-classify without expert guidance. You'd seldom find that with large cap public companies, but it is often true of large, private companies, even those with turnovers running into hundreds of millions of dollars.'

This might reflect the fact that until recently the U.S. itself has provided a more than lucrative market for U.S. products, and that for obvious reasons companies which are traditionally domestically focused have paid less attention to their export-related obligations. These are now coming up to speed with the legal and technical complexities of, for example, the EAR, as they look for new buyers for their products.

This is a trend noticed by Covington & Burling's Kim Strosnider who says that U.S. defence contractors 'are seeking out new international markets and opportunities as the U.S. defence budget shrinks. That of course increases the need for understanding the export control regimes, not just for the big players but medium-sized businesses in the sector too.'



'This is an ongoing process, so it's going to take some time before the new controls are integrated with existing product lines and processes.'

Kim Strosnider, Covington & Burling

The reform process will in time provide greater clarity and efficiencies for businesses, she says, but not before companies get to grips with it: 'This is an ongoing process, so it's going to take some time before the new controls are integrated with existing product lines and processes. In the meantime, businesses are asking all the same questions about licence requirements, exporting dual-use goods – but the answers are changing as the regulations are revised and as product jurisdictions and classifications shift.'

Barbara D. Linney of Miller & Chevalier points out that the struggle to come to terms with the new regime is not felt only at home. 'These folks are facing a very steep learning curve. This is particularly true for non-U.S. clients who deal in formerly ITAR-controlled goods that now are subject to the EAR. For these companies, the challenge of learning a new export control regime is exacerbated by the need to obtain the new classifications from their U.S. suppliers. U.S. suppliers with an extensive product line to reclassify are doing the best they can to get through the process, but since they must of necessity prioritise the order in which their products are to be reclassified, not all of their customers will find the products they buy at the top of the list.'

Tricky transition

Bill McGlone of Latham & Watkins says that ECR is proving to be 'an extremely complex transition that raises some complicated issues – there is plenty of room for confusion.'

As McGlone points out, one of the subtleties (or indeed ironies) of the reform process is that the two longstanding export control lists (USML, subject to ITAR, and CCL, subject to the EAR) have essentially morphed into three lists: those two, and the new 600 series within the CCL, which includes defence items previously on the USML and to which a whole new set of parameters applies. At least at this stage, this is causing some exporters to question whether the policy objective of simplification is being achieved.

Further, as the administration has been keen to emphasise, this doesn't represent a complete 'decontrol'. Many items that have moved from the USML

to the CCL remain controlled under the 600 series list and are generally subject to a licensing requirement for all foreign destinations and are ineligible for shipment to ITAR embargoed countries.

'Correct classification, or categorisation, of commodities, software, and technology is the cornerstone of compliance with the U.S. export control rules, both before and after ECR,' says Latham & Watkins' Les Carnegie. 'Doing it properly means drawing on a number of skill sets – there's a need for both engineering/technical and regulatory expertise.'

Currently, a hot topic amongst exporters of 600 series products is the use of what Sidley Austin's Rob Torresen calls the 'tricky' License Exception Strategic Trade Authorisation ('STA'), the effect of which is to remove the need for specific licences for exports, re-exports, and in-country transfers (including 'deemed exports' and 'deemed re-exports') of some 600 series products to some destinations and nationals of eligible destinations where it has been determined that there's a low risk of diversion.

But it does nonetheless contain its own compliance requirements, some of which place considerable burdens on the company to whom a product has been exported: 'Although the License Exception STA is intended to make life easier, it is actually so complicated that in many instances companies are opting, or their customers are requesting, that the exporter actually obtain the licence and not use STA,' says Torresen.

Jacobson Burton partner Michael Burton says that one of the problems is that 'It is as if the old regime had been more "either/or" – generally speaking, you either needed a licence under the ITAR, or the EAR applied and you were subject to those somewhat more complicated but flexible rules. Many companies had become comfortable operating in one of the two regimes. But the new system is more ambiguous, at least during this transitional period, as portions of the USML are gradually being transferred to the CCL. Many companies simply don't have systems in place to cope with these changes.'

All of which, Burton points out, is less straightforward in practice than theory: 'Ultimately, License Exception Strategic Trade Authorisation is not simple to apply, just as the new definition of "Specially Designed", introduced last year and now used in both the USML and the CCL, is a difficult concept for many exporters to understand and operationalise, notwithstanding BIS's outstanding efforts to educate industry.'

Steve Pelak of Holland & Hart has also witnessed confusion over the changes. 'Companies that typically dealt only in ITAR-related goods, e.g., defence contractors,' says Pelak, 'seem to be having the most difficulty adapting to the export control reform initiative's changes. These companies are not as familiar with the EAR, which generally is more complicated than the ITAR. A USML item almost always requires a State Department export licence. But once that same item moves from the USML to the CCL, the item might fall under an EAR licence exception or might require a licence from the Commerce Department. Under the EAR, the determination can depend on the country and/or end-user to which the item is going, the end use of the item, the value of the item, or a combination of these factors. Non-U.S. manufacturers are often confused because their U.S. suppliers do not fully understand these changes and are having difficulty explaining them.'

'Companies that typically dealt only in ITAR-related goods, e.g., defence contractors, seem to be having the most difficulty adapting to the Export Control Reform initiative's changes.'

Steve Pelak, Holland & Hart

Corey Norton of Trade Pacific PLLC points to another challenge: how to stay abreast of the staggered implementation of reform. According to Norton, 'The fact that some USML categories have been reformed, such as Category VIII (aircraft and related articles), but others are still pending revision, means that many businesses find themselves in a state of limbo, pending the completion of the programme.'

Not all those seeking export control advice are defence players. Alongside a client portfolio of major players in the hi-tech sector, Nixon Peabody partner Grayson Yeargin routinely advises a number of universities and research of institutions: 'It would be hard to pigeon-hole the kind of practice we have – but one of the issues that keeps coming up is that of deemed exports where it's really easy to get caught up in the technicalities. Universities are very cosmopolitan settings – many students and researchers from all over the world working and collaborating on research projects. But it's easy for them to cross the line between what's controlled by ITAR, and what's controlled by the Department of Commerce. Often, when clients have fallen foul it's because of a lack of awareness. Half the time the trick lies in knowing to ask the question: "Is this controlled material?"'

Counter-intuitive they may be, but at the heart of the export control regulation is (and though the transposition into law is sometimes blunt and imperfect) the laudable objective of keeping dangerous technologies out of the hands of those who might use them for nefarious purposes – either against the interests of the United States and its allies, or, for example, for the oppression of their own peoples or neighbours.

The challenge for U.S. lawmakers is to ensure that the regime is fit, not for one, but for several purposes. But, say lawyers, the authorities are to be credited with extensive outreach, including BIS's weekly teleconferences, seminars provided by the DDTC, and live events. Each stage of change has been accompanied by consultation with industry, giving companies the opportunity to put to government how the rule changes would impact upon their commercial interests and, say lawyers, the government has been responsive to that input. Reform takes time, and even its own architects don't yet know all the answers to the questions constituents want to pose.

There are no short-cuts to export control compliance, but there are pointers. As Michael Burton notes: 'Within export controls and economic sanctions compliance, the key questions are these: "What is the product? Where is the product being exported and ultimately destined? Who are the recipients of the product and parties to the transaction? For what purpose will it be used? And where is the money coming from? If you can't answer these questions, or worse don't ask, you simply can't comply.'