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Briefing note May 2013

Publication of the First **Final** US Export Control Reform Rules: Don't Be Surprised, Be Prepared

The first set of final Export Control Reform rules should have caught no one by surprise given the steady drumbeat since 2009 announcing the US government's intent to rethink its entire approach to protecting sensitive US technology. These new rules, published in final form on April 16, 2013, by the US Departments of Commerce[1] and State,[2] have been previously published in five proposal notices, commented on extensively by interested parties, and discussed via weekly teleconferences with the officials involved. And yet, they promise a shock, pleasant or unpleasant, to export compliance systems and managers who have not experienced reforms on this scale in decades.

The new rules begin a massive shake up of the existing controls for US exports. The Reform effort boils down to this: only the most sensitive or strategic items will be covered by the strictest controls and those items will be enumerated in a positive list; the rest, that had been captured with "catch-all provisions" and other "bucket classifications," will move to a different list and will be subject to less strict controls. In order to accommodate the move, both regulatory regimes were substantially modified by the new rules and the entire process was kicked off by transferring certain aircraft parts and engines, effective in 180 days, to be followed by additional transfers in coming months.

Key issues

The impact will be profound on aerospace and defense companies. But there will be a ripple effect on the commercial sector as well, particularly companies in the electronics, chemical, satellite and military vehicle sector.

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[1] http://www.gpo.gov/fdsys/pkg/FR-2013-04-16/html/2013-08352.htm
[2] http://www.gpo.gov/fdsys/pkg/FR-2013-04-16/html/2013-08351.htm

Background

After interagency review and industry consultation, certain US-origin items were deemed to no longer warrant the strict controls on exports, re-export or transfers imposed on defense articles by the International Traffic in Arms Regulations (ITAR, 22 CFR §§ 120-130), administered by the US Department of State Directorate of Defense Trade Controls (DDTC). Those items are to be moved from the ITAR US Munitions List (USML) to the Commerce Control List (CCL). The CCL is administered by the US Department of Commerce, Bureau of Industry & Security (BIS), pursuant to the Export Administration Regulations (EAR. 15 CFR §§ 730-774), which govern the export, re-export, and transfer of virtually all items not covered under ITAR (or other regulations).

Commodities Transferred

The first set of items transferred to the EAR CCL includes certain aircraft and associated equipment (from USML Category VIII) and certain gas turbine engines (from USML Category XIX). The USML Categories are reserved now for enumerated items that provide the United States with a critical military or intelligence advantage. This will now trigger a massive effort to convert ITAR compliance managers to EAR experts, as companies will find that millions of their old parts will be caught up in this shift to an entirely new and at least initially more complicated licensing regime, with license exceptions and new classifications.

New Classification

In order to quell fears that the formerly tightly controlled USML items would not be sufficiently controlled when moved to the traditionally less-strict CCL, BIS created a new category of Export Control Classification Numbers (ECCNs), the "600 series," to govern the level of licensing requirements, exceptions, and restrictions that would apply. For example, certain license exceptions applicable to other ECCNs will not be available to items classified in the 600 series, and BIS proposed amendments to exceptions for temporary exports and imports (TMP), servicing and replacement of parts (RPL), exports to various government entities (GOV), release of unrestricted technology and software (TSU), and intracompany transfers (STA).

Moreover, while the 25% EAR threshold for foreign-made items incorporating less than *de minimis* levels of US content will apply for exports abroad to non-arms embargoed countries, there will be no 10% threshold for countries subject to arms embargoes, as referenced in a new country group D:5; for those countries, it is a 0% *de minimis* threshold. Items in the 600 series incorporated in a foreign-made item cannot be exported, re-exported or transferred to those countries in any amount without a license.

All 600 series items are subject to the China Military End Use provision, which prohibits exports to China of these items without a license. Because the items were previously defense articles on the USML, they were presumptively for military use. There is, as yet, no change in that presumption.

Other Changes

The movement of these items to the CCL, and the revision of the USML Categories, triggered corresponding revisions throughout both the EAR and ITAR. BIS, in particular, used the opportunity for a

major retrospective regulatory review, streamlining and amending its regulations, only tangentially in relation to the Export Control Reforms.

For example, BIS added new red flags and expanded its Know Your Customer Guidance, and amended the Country Groups list to, among other changes, add a new column to Country Group A to address the intracompany license exception applicable to only 36 countries and a new column to Country Group D to incorporate the list of countries subject to a US arms embargo. BIS also removed obsolete references to Shipper's Export Declarations (SEDs), at last.

New Definition of "Specially Designed"

Of particular note is the revision by joint agency action of the definition of "specially designed" for military use. The former definition had caught and covered --to great industry consternation—simple or multi-use parts, militarily obsolete items and items for which the design intent was in dispute. As opposed to a "catch-all" effect, the definition is now based on an objective "catch and release" principle. It is a two paragraph rule: (a) identifying which commodities and software are "specially designed" and (b) identifying which parts, components, accessories, attachments and software are excluded. An item is caught if one of the subparagraphs of (a) applies and released if they do not, or if one of the (b) exclusions applies.

To determine whether a commodity is "specially designed," three questions should be asked: 1) does the commodity, *as a result of development*, have properties peculiarly responsible for achieving or exceeding controlled performance levels, characteristics or functions described in the relevant USML category; (2) is the part or component, *as a result of development*, necessary for an enumerated defense article to function as designed; and (3) is the accessory or attachment, *as a result of development*, used with an enumerated defense article to enhance its usefulness or effectiveness.

Including the qualifying phrase "as a result of development" means that there must be an objective nexus between the commodity's development and its ultimate use. "Development" means all of the stages prior to serial production such as design (including research, analyses, concepts, data and the process of transforming design data into a product), assembly and testing of prototypes, pilot production schemes, configuration and integration design, and layouts, with respect to the item. This qualifying clause is applicable throughout the definition.

Thus, even if an item is used in a defense article, it is not specially designed and thus, covered by ITAR, unless someone did something during its development to ensure that one of the answers to the above questions is yes. If the answer to the questions above is no, the item is not specially designed.

If one of the (a) subparagraphs does apply, then, the applicability of the (b) exclusions must be determined. The exclusions boil down to the principle that an item should not be ITAR controlled if it is for a predominantly civilian application or has performance equivalent to a commodity used for civilian application. If an item provides the United States with a critical military or intelligence advantage, it should be enumerated to be covered by the ITAR.

BIS created a new process for confirming whether an item is specially designed by consensus of the Departments of Commerce, State, and Defense, which replicates the process used formerly by the latter two agencies. Moreover, BIS affirmatively stated that if State issued a determination that an item was not

subject to a catch-all provision of ITAR, e.g., not specially designed, then Commerce would issue a similar classification that the item was not within the scope of the 600 series as being specially designed, after interagency consultation.

Licensing Changes

In order to harmonize the EAR with the ITAR, the validity period of BIS licenses was extended from two to four years, with some exceptions. During the transition, license applications should be submitted to DDTC until the effective date of the move from the USML to the CCL (October 15, 2013, for this rule). Licenses issued by DDTC during the 180-day transition period will be valid for two years unless otherwise indicated on the license. Finally, if an item has both ITAR and EAR components, a DDTC license will be sufficient to cover the entire product.

Transition Recommendations

During the 180-day transition period, companies are advised to begin the process of revising their compliance programs and systems. In some instances, it will be clear that an item has moved from the USML to the CCL, in which case the process can begin. But in other cases, it will not be clear and a mistake is deadly. Commodity jurisdictions and licensing determinations take time, 30-60 days at a minimum and over a year for a complicated situation. Those who are first in the door at the relevant agency with a complete application requesting clarity will not face the delays that other applicants will see as more companies join in seeking help from the agencies. The process of re-classifying and marking controlled products takes time. New licenses must be obtained, although valid licenses remain so for a specified period. Internal procedures will need to be evaluated and adjusted, and training on the new regime must be implemented. And as each new final rule is published-- 72 are expected by the end of the year-- the process will need to be repeated.

Companies are advised to adopt a process now to address the fuller transition. The State Department characterized the publication of the first set of rules as a "major milestone" in the US government's efforts to "overhaul" and "redefine" the US export control system.

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