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Proceed With Caution! Companies Must Understand And Heed Enhanced Export Compliance Requirements In Dealings With China

Government contractors, more than other companies, have a significant degree of sensitivity when it comes to dealings with China. However, many large Government contractors have important business relationships with Chinese companies, either directly or through foreign subsidiaries, that are unrelated to their U.S. Government business areas. These companies now face new export compliance requirements when engaging in commercial dealings with Chinese companies. The enhanced requirements apply to companies exporting to China and, in some cases, extend to companies sourcing from China. As a result, it is imperative that Government contractors doing business with Chinese companies proceed with caution and ensure compliance with U.S. export laws. The stakes for contractors doing business with China are higher than for other companies, particularly because they are subject not only to potential monetary penalties, imprisonment and the denial of export privileges for infractions of export controls laws, but also because they may face suspension of their right to contract with the U.S. Government. However, if the shifting regulatory waters of conducting business in China are navigated correctly, companies willing to venture into China may gain an advantage over their competitors.

The U.S. Department of Commerce's Bureau of Industry and Security (BIS) recently revised its regulations on export and reexport controls for dual-use items to the Peoples' Republic of China (China or PRC). The regulations, effective June 19, 2007, implement new licensing provisions that may impact companies that both sell directly to Chinese consumers and rely on Chinese suppliers. Most notably, the regulations adopt a licensing policy of denial for certain items that would enhance China's military capabilities, a new "military end-use" rule for items that otherwise do not require a license to be transferred to China and new end-user statement requirements. BIS has sought to mitigate the effect of these regulations by offering exporters a carrot in the form of a validated end-user authorization process that—for exports to certain qualifying Chinese companies—provides a blanket export authorization.

Background and Overview—BIS administers the Export Administration Regulations. These regulations control the export of what are commonly referred to as "dual-use" items and technologies that are not controlled as "defense articles" by the Department of State. The majority of items controlled by BIS do not require a license to export to China or most other countries. However, BIS identifies a number of more sensitive items and technologies on the Commerce Control List (CCL). Items are listed on the CCL by category, and then within each category by a specific Export Control Classification Number (ECCN). CCL items, which typically have both civil and military applications, may require a BIS license for export depending on their destination and their reason for control. Licenses also may be required for specific end uses and end users.

New BIS regulations expand licensing requirements for exports to China based on ECCN classification, and end-use and end-user requirements. BIS' stated goal in promulgating the regulations is to maintain a policy of facilitating "exports to legitimate civilian end-users in [China] while preventing exports that would enhance the military capability of the PRC." *Revisions and Clarification of Export and Reexport Controls for the Peoples' Republic of China*, 72 Fed. Reg. 33646 (June 19, 2007) (*PRC Rule*). Though it recognizes the benefits of increased trade between the U.S. and China, BIS noted that "the United States has an interest in restricting exports of certain dual-use products and technologies that would not otherwise need an export license."

Presumption of Denial for Items Making a "Direct and Significant Contribution to the PRC's Military Capabilities"—Pursuant to the new regulation, BIS is adopting a policy of presumption of denial for all CCL items controlled for national security, biological and

chemical weapons proliferation, nuclear proliferation, and missile technology if these items could make a "direct and significant contribution to the PRC's military capabilities." This significantly expands BIS' prior practice, which generally was to deny license applications for items controlled only for national security reasons that made a "direct and significant contribution" to Chinese military assets identified on a limited list of military items, such as those related to anti-submarine warfare, intelligence gathering, power projection and air superiority.

The new rule not only expands the types of items subject to the policy of denial, but also dramatically expands the types of Chinese military capabilities that may trigger a license denial to Chinese military capabilities "as a whole," far beyond the specific defense systems listed in the past. *PRC Rule* at 33656. This requires more exporters to evaluate how their items will be used and to demonstrate to BIS in license applications that the items will not make a "direct and significant" contribution to the PRC's overall military capability.

Unfortunately for exporters, the universe of "military capability" is not clearly defined and now is open to expansion through BIS interpretation, thereby increasing an exporter's due diligence burden while hampering its ability to predict whether a license may be granted. BIS attempted to clarify "military capability" by providing an illustrative list of weapons systems in the new Supplement No. 7 to Part 742 of the EAR (Description of Major Weapons Systems). Supplement No. 7 identifies battle tanks, other armored combat vehicles, large-caliber artillery, combat aircraft, attack helicopters, warships, missiles, rockets and launchers, unmanned aerial vehicles, offensive space weapons, precision munitions, and night vision equipment. Id.

The list also includes a broad category of systems designated as "command, control, communications, computer, intelligence, surveillance, and reconnaissance," which encompasses an array of data-analyzing and remote-sensing technologies that can "support military commanders in the exercise of authority and direction" of their forces. Such technologies may be those that "collect, process, integrate, analyze, evaluate, or interpret information concerning foreign countries or areas," systematically observe "aerospace, surface or subsurface areas, places, persons, or things by visual, aural, electronic, photographic, or other means," or "secure data concerning the meteorological, hydrographic, or geographic characteristics of a particular area." Id. Such descriptions, however, can encompass a number of items with civilian uses as well.

Because the supplement is illustrative and BIS will consider contributions to any PRC military capability in its licensing determination, an exporter faces a potentially shifting and expanding universe of items that may be viewed as directly and significantly contributing to China's military capabilities.

> *Practice Point*: Before exporting an item to China, whether it is for an end use there or is technology to be used to build a product that will be imported into the U.S. or reexported to a third country, contractors should identify both the intermediate use and the end use for an article produced in China. For example, if you are transmitting technical drawings for a civilian end-use item such as a commercial aviation system to a PRC manufacturer, and you will import the final product, consider whether the technical drawings also could be used to make a direct and significant contribution to Chinese military capabilities.

Control of Items Destined for "Military End Use" in China—The new rule creates a more stringent licensing procedure for certain specified items if an exporter knows that the item to be exported "is intended, entirely or in part, for a 'military end-use.' " 15 CFR § 744.21. As a result, even if a listed item does not require an export license to China, based on its reason for control, an exporter would still need a BIS license if the item were destined for a "military end use" in China.

Items subject to this control fall into approximately 20 product categories identified in Supplement No. 2 to Part 744 of the EAR. These include, but are not limited to, depleted uranium, fibrous materials used in composite structures, certain hydraulic fluids, "numerically controlled" machine tools, oscilloscopes, software allowing the automatic generation of source codes, certain telecommunications equipment, certain lasers, navigation direction-finding equipment, certain underwater systems, and certain aircraft and gas turbine engines. In some instances, software and technology for the development, production or use of the controlled equipment also is subject to the military end-use control.

Under this rule, an exporter that supplies items falling within any of the Supplement No. 2 categories must investigate the item's end use to determine whether a license application must be filed. BIS has emphasized, however, two new aspects of the rule. First, the end use, not the end user, determines whether an application must be filed. Second, an application must be filed only

if the exporter knows the item actually or likely will be used for a military end use, not if the item simply *could be* used for a military end use.

The BIS definition of "military end use" encompasses exports to be incorporated into items on the State Department's U.S. Munitions List, items on the International Munitions List, items listed under ECCNs ending in "A018" on the CCL, or items designed for the "use," "development," "production" and, in some cases, "deployment" of the above items. See, e.g., 15 CFR § 744.17, and Supplement No. 1 to Part 744. Therefore, any item listed in Supplement No. 2 that is destined for any of the above uses in the PRC must be licensed, even if the EAR does not otherwise require a license.

> *Practice Point*: To comply with this requirement, an exporter should determine *how* an item identified in Supplement No. 2 to Part 744 will be used, not *who* will use it. For example, if diagnostic equipment not otherwise requiring a license for export to China is being sent to a military hospital, and an exporter knows that the equipment is for patient care rather than a military end use, no application must be filed.

Another key to navigating this new control and the requirements that remain to be developed through BIS decisions is the level of due diligence an exporter must conduct to establish knowledge of an item's end use. BIS has articulated the knowledge standard to include "not only positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence." See 15 CFR § 744.21(a) (adopting the definition of "knowledge" in 15 CFR § 772.1). BIS has confirmed that the new control covers only items that an exporter knows or has reason to know *will* be, rather than those that *could* be, put to a military end use. Therefore, even if an end user may operate a military business and the item to be exported could be used in that military business, if an exporter conducts sufficient due diligence to determine that the item is not for a military end use, no application is required.

BIS has not provided much guidance on what efforts constitute sufficient due diligence. At a minimum, an exporter must obtain a statement from the end user that the item will not be put to a military end use. An exporter also should consider conducting independent research into the end user's business to validate the end user's statement, including a review of the end user's Web site and other Internet and public sources. If an exporter determines that the end user operates both a civilian and military business, the exporter should probe the end user further to determine how the exported item will be used. Particular attention should be given to a conglomerated entity that may have both civilian and military-related affiliates. Additionally, an exporter should review the BIS list of red-flag indicators to determine whether further investigation is warranted. An exporter that has implemented and enforces "know your customer" policies likely will satisfy its due diligence obligations.

> *Practice Point*: Do not rely solely on a certificate from your PRC customer that your item is for a commercial end use. Conduct research into the company's business and customers, and review materials made available by BIS and other U.S. agencies. If you determine that an application is not necessary, maintain a record of your research for at least five years after the date of export.

If an exporter gains knowledge that its proposed export will or likely will be used for a military end use, it must file a license application informing BIS of all known information concerning that use.

> *Practice Point*: If you determine that your item is listed in Supplement No. 2 and will be put to a military end use, consider whether your item qualifies for the license exception established in §§ 740.11(b)(2)(i) and (ii) covering items exported for personal or official use by U.S. Government personnel and agencies, as this exception was expressly retained under the new control. 15 CFR § 744.21(c).

Applications to export military end-use items will be "reviewed by BIS on a case-by-case basis to determine whether the export, reexport, or transfer would make a 'material contribution' to the military capabilities of the PRC and would result in advancing the country's military activities contrary to the national security interests of the United States." 15 CFR § 744.21(e). If these criteria are met, BIS will deny the application. The "material contribution" standard used is more broad than the "direct and significant contribution" standard applied to items controlled for national security and nonproliferation reasons. BIS adopted this lower standard for the items listed in Supplement No. 2 because it determined that items subject to the military end-use control are more sensitive if they are destined for a military end use and, therefore, should receive closer scrutiny.

> *Practice Point*: If time is not of the essence, consider filing a request for an advisory opinion before applying for a license or exporting an

item, particularly if you anticipate the need to make multiple exports to the same end user for the same end use. While such opinions may take time to obtain, they may prevent you from filing unnecessary license applications in the future.

End-User Statements—The new rule requires exporters to obtain end-user statements from the Chinese Ministry of Commerce (MOFCOM) for all exports worth $50,000 or more that require a license to China for any reason. There are exceptions for the export of certain camera equipment and high-speed computers that are subject to lower dollar thresholds. BIS previously required end-user statements only for items with significantly lower dollar thresholds controlled for national security reasons. Although BIS expects that the increased value threshold should keep constant the overall number of end-user statements required, several companies exporting products not previously subject to the requirement now must obtain such statements if their licensable exports to China exceed the $50,000 threshold. Exporters have expressed concern that compliance with the new requirement will prove difficult, given the reliance on MOFCOM to issue the statements, charging that MOFCOM is under-resourced and has minimal incentive to process the applications in a timely manner.

Validated End-User Authorization—Although BIS expanded the licensing burden for most exports to China, it created a means to lighten that burden for exports to certain Chinese companies through a new validated end-user (VEU) authorization. This will most likely benefit U.S. companies with subsidiaries in China. VEU authorization allows exporters to transfer eligible items to approved end users in China without a license. 15 CFR § 748.15. Under the new program, a PRC company, a U.S. exporter or a non-U.S. re-exporter, on behalf of its Chinese customer, may voluntarily file an advisory opinion request identifying the items to be exported or transferred, and providing information about the VEU candidate company. The advisory opinion request must include a detailed explanation of the items to be exported and the VEU candidate, including its ownership structure, its business activities or corporate relationship with Chinese government or military organizations, and its procedures to ensure compliance with VEU requirements. The VEU candidate must certify that it (1) understands that use or diversion contrary to the EAR of items received under VEU authority is prohibited; (2) understands and will abide by all VEU end-use restrictions, including the requirement that items received under VEU authority will be used only for civil end uses; (3) will comply with VEU recordkeeping requirements; and (4) will allow on-site compliance reviews by U.S. officials.

Advisory opinion requests are submitted to a newly created End-User Review Committee (ERC). The ERC includes representatives from the departments of State, Defense, Energy and Commerce. In evaluating applications, the ERC will consider, among other things, the VEU candidate's record of exclusively civil end-use activities; its compliance with U.S. export controls; the need for an on-site review by U.S. officials prior to approval; the candidate's ability to comply with VEU requirements; its agreement to continuing on-site reviews; and its relationship with U.S. and foreign companies. The ERC also will consider China's adherence to multilateral export control regimes.

Practice Point: If you sponsor a PRC company for VEU authority, be sure to conduct a thorough investigation of the company's business history, partners and customers, as well as its export control compliance systems. If the company has conducted business with the PRC military or has a relationship with military customers, the bar to VEU authorization will be higher, though not insurmountable. If the company does not have a robust export control compliance policy, it should be reviewed and enhanced.

The ERC must conduct its review within 30 days after a completed application is circulated to its member agencies. However, BIS first must evaluate and process the application before it is deemed "complete." This may prolong the review process if BIS or the ERC must continue to request information from the applicant because the 30-day clock is tolled while information requests are pending.

Companies exporting to VEUs must submit annual reports to BIS identifying each VEU to which the exporter transferred eligible items, and the quantity and value of those items. VEUs also must maintain records of their activities under VEU authority, and make those records available to the U.S. upon request.

Once its status is established, a VEU may receive any items, including software and technology, for which it is authorized. VEU authority extends to Chinese national employees of the VEU located in the U.S., who therefore do not need a deemed export license. Items controlled for missile technology or crime control reasons are not eligible for the VEU program. Items received pursuant to the authorization must be for civil end uses and not

for uses described in Part 744 of the EAR (e.g. nuclear end uses, or chemical or biological weapons end uses). If the proposed export items do not meet these requirements, a separate license application may be required.

> *Practice Point*: Because VEU status allows the export of commodities, software and technology, PRC subsidiaries of U.S. companies are prime candidates for this authority. Furthermore, PRC citizens working for VEU-authorized subsidiaries in the U.S. may receive controlled information related to the authorized items without needing additional licensing. It is important to note that VEU status granted to a PRC subsidiary does not mitigate the need for a deemed export license for PRC nationals working directly for a U.S. company.

Some exporters raised concerns that companies that applied for, but were not granted, VEU authorization effectively would be "black-listed" because U.S. exporters would be unwilling to apply for a license to export to those companies. BIS responded to this concern by adding language to § 748.15 stating, "If a request for VEU authorization for a particular end-user is not granted, ... such a result does not render the end-user ineligible for license approvals from BIS."

> *Practice Point*: Although BIS expressly stated that a PRC company denied VEU status would not be considered ineligible for a license, the commercial effect of a denial is difficult to predict at this time. U.S. exporters considering exports to a denied company may determine that obtaining a license for exports to the denied company will require more effort than licensing to another company, and may not be guaranteed.

Conclusion—Like all exporters, Government contractors must be careful to comply with the new rules and to proceed with caution when conducting business with Chinese companies. The new China export control rules present many challenges and opportunities for U.S. companies and foreign reexporters. First, for a host of items controlled for nuclear proliferation, national security, missile technology, or chemical and biological weapons reasons, the new rule may signal a more extensive review of end uses if these items are the subject of export license applications for China. Exporters may need to anticipate longer licensing times, greater scrutiny, and an increase in license denials or conditions for approval. Second, the new "military end-use" rule likely will require some time to understand in its operation and effect. Exporters and reexporters may need to increase their due diligence to confirm that there is no military end use for the items subject to this rule. At the same time, an exporter or reexporter that has robust due diligence and "know your customer" procedures, and follows BIS' red-flag guidance, should be able to rely on those procedures to discharge its responsibilities under this new rule.

As for the VEU program, exporters, reexporters and Chinese end users should, if possible, take advantage of the new opportunity to eliminate licensing requirements by adopting U.S.-compliant export control procedures. U.S. applicants should conduct a significant amount of due diligence on the Chinese party on whose behalf they are applying to minimize the likelihood that the VEU application will be denied. Though the VEU candidate must agree to U.S. Government audits, and exporters and reexporters must file annual reports with BIS, these requirements are manageable if appropriate procedures are implemented.

In short, U.S. Government contractors already know that business dealings with China are complex and sensitive. This is true even for commercial relationships and interactions with Chinese companies unrelated to U.S. Government contracts. Through the promulgation of this rule, BIS has signaled that it will scrutinize dealings with Chinese companies, but also that it is willing to ease the licensing burden for those U.S. companies that demonstrate that their Chinese business partners have a history of commercial activity, solid export compliance programs and a willingness to cooperate with the U.S. Government. Savvy companies will, no doubt, heed BIS' warnings and learn to navigate the changing regulatory landscape to their advantage.

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