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International Trade Alert

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October 15th Export Control Reform Changes Are Around the Corner: Take Time Now to Understand the Impact on Your Existing Licenses & Authorizations

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Venable's **International Trade and Customs Practice Group** is publishing a four-part series of Client Alerts to highlight the changes surrounding the ECR (Export Control Reform). Below is Part 2 of the series.

Click here to read Part 1, *State Department Publishes Long-Awaited Interim Final Rule Amending ITAR Brokering Provisions*.

On October 15, 2013, two Final Rules ushering in the "initial implementation" of the Export Control Reform (ECR), by the Departments of **State** and **Commerce**, will take effect. The Final Rules transfer jurisdiction of many less-sensitive military items, which are currently controlled on the U.S. Munitions List and governed by the State Department's International Traffic in Arms Regulations (ITAR) to the Commerce Control List that are governed by the Commerce Department's Export Administration Regulations (EAR). This is done through the creation of new "600 Series" classification provisions. The Final Rules mandate significant changes in licensing authority for affected items and pronounce transition rules for existing authorizations. Importantly, the Rules create a "catch-and-release" definition of "Specially Designed" items controlled for defense trade purposes. These new Final Rules may impact your current jurisdictional authority and classifications.

While the ECR aims to reduce certain restrictions on exports, such as on the new 600 Series items (certain vehicles and aircraft, for example), the new framework also maintains certain controls through licensing and classification requirements. Notably, the 600 Series coverage is intended to differentiate between those military items that are "critical to maintaining a military or intelligence advantage to the United States" and those that require more flexible controls in order to facilitate and encourage exports to U.S. allies.

Will these new Commerce classification provisions and License Exceptions positively impact your business? Whether you are a manufacturer, exporter or logistics provider, understanding this new landscape and adopting it into your business model now, is critical in order to remain competitive in our global market.

The New 600 Series: Providing a "Higher Fence Around a Smaller Field"

Within the EAR, each applicable Commerce Control List (CCL) category will now have new Series 600 export control classification numbers (ECCN), capturing certain articles previously subject to the ITAR. The Final Rules move items from U.S. Munitions List (USML) Categories VIII (Aircraft and Related Articles), XVII (Classified Articles, Technical Data, and Defense Services Not Otherwise Enumerated), and XXI (Articles, Technical Data, and Defense Services Not Otherwise Enumerated) to Commerce Control List (CCL) Category 9 (Propulsion Systems, Space Vehicles, and Related Equipment). The Final Rules also consolidate the 13 Wassenaar Arrangement Munitions List (WAML) entries. Be aware, as the changes affect aircraft, refuelers, round equipment, parachutes, harnesses, and instrument flight rains, as well as related parts, accessories, and attachments, among other items.

In addition, each new 600 Series ECCN includes subparagraphs which further designate the controlled articles. These delineations correspond to specific licensing requirements and include:

- **Subparagraphs .a through .w:** Specifically enumerated end items, parts, components, accessories, and attachments migrating from USML to CCL. These articles are controlled for reasons of National Security (NS), Regional Stability (RS), Anti-Terrorism (AT), and United Nations (UN) embargoes.

- **Subparagraph .x:** Parts, components, accessories, attachments, and software not enumerated on the USML or in paragraphs .a through .w which are "specially designed" for an item enumerated on the USML or in a 600 Series ECCN.
- **Subparagraph .y:** Parts, components, accessories, and attachments that, although specially designed, warrant no more than "AT-only" controls and restrictions to embargoed destinations.

Understanding the New Catch-and-Release Concept of "Specially Designed"

Importantly, the Final Rules implement a revised definition of "specially designed." This definition was formerly a catch-all ITAR provision bringing certain commodities within the coverage of the USML. Now, however, the Rules reframe the definition as a multi-step "catch-and-release" provision. According to the BIS Final Rule, the "catch-and-release" approach was adopted because the agencies "found that it was easier to describe what the term *did not* or *should not* include than what it does include." Accordingly, a major part of your company's transition plan should include the examination and possible reclassification of your products and/or exports under this definition.

Paragraph (a) of the new definition *catches* two overlapping categories of "specially designed" exports: (1) commodities or software that, as a result of development, have properties peculiarly responsible for achieving or exceeding the controlled performance levels, characteristics, or functions described in the relevant USML paragraph; and (2) parts, accessories, attachments, or software designed "for use in or with a defense article."

Paragraph (b) of the new definition then *releases* or excludes certain commodities "caught" by paragraph (a), described above. A part, component, accessory, attachment, or software is not specially designed if it: (1) is subject to the EAR pursuant to a commodity jurisdiction (CJ) request; (2) is, regardless of form or fit, a fastener; (3) has the same function, performance capabilities, and the same or equivalent form and fit as a commodity or software used in or with a commodity that is or was in production (*i.e.,* not development); and is not enumerated on the USML; (4) was or is being developed with knowledge that is or would be for use in or with both defense articles enumerated on the USML and also commodities not on the USML; or (5) was or is being developed as a general purpose commodity or software, *i.e.*, with no knowledge of use in or with a particular commodity or type of commodity.

If a defense article is determined to be within the scope of paragraph (a)(1), (a)(2), or both, you must then determine whether any of the five exclusions in paragraph (b) apply, thereby "releasing" it from USML control as "specially designed." Companies should be mindful that a commodity excluded by paragraph (b) is not "specially designed," but may still be ITAR-controlled pursuant to another USML provision.

What Is the Impact on the de *Minimis* and End Use/End User Rules?

Take note: the *de minimis* rules for foreign-made items incorporating less than a threshold level (10% or 25%) of U.S. content under the EAR have been altered for purposes of Series 600 items. First, the Rules provide that there is **no** *de minimis* exception available for foreign-made items that incorporate U.S.-origin 600 Series items when destined for a country listed in Country Group D:5 of Supplement No. 1 to EAR Part 740. Thus, the Final Rules prohibit the unlicensed export or reexport of 600 Series items or of foreign-made items containing 600 Series content, to countries subject to U.S. arms embargoes (*i.e.*, Country Group D:5). Supplement No. 1 to Part 740 lists the D:5 countries and reflects the embargoed destinations listed in ITAR, 22 CFR § 126.1, and further notes that the State Department's list of countries subject to U.S. embargoes is controlling.

The Final Rules also expand the "military end use" definition to include items incorporated into products covered by the 600 Series, in addition to those incorporated into a military item described on the USML, Wassenaar Arrangement Munitions List, and certain other classifications. Similarly, the Rules expand end user restrictions, including a general prohibition regarding exports, reexports, or transfers without a license of any 600 Series item to the People's Republic of China.

The BIS Rule expands the EAR's **"Know Your Customer Guidance"** to add two additional examples of red flags pertaining directly to items classified under the 600 Series. Manufacturers and exporters should, at a minimum, halt the subject transaction and conduct additional due diligence if any of the BIS red flags is triggered by a proposed export transaction.

How Do you Deal with Existing Authorizations?

What happens to articles licensed by the State Department (under ITAR control) once they migrate to Commerce control pursuant to the new 600 Series?

To address these transition issues, the Administration published **General Order No. 5 in Supplement No 1 to Part 736 of the EAR**. General Order No. 5 establishes temporary licensing procedures for items migrating from USML to CCL, permanent licensing procedures for CCL items to be used in or with defense articles controlled by USML, and grandfathering agreements among other procedures. A few key guidance points are as follows:

- Existing authorizations remain valid until their individual expiration date, or for up to two (2) years after the Final Rules take effect;
- If all items on a particular DSP-5 license, for example, have migrated to CCL, the DSP-5 is valid for up to two (2) years from the effective date of the Final Rules;
- If only some of the items on a DSP-5 have transitioned to CCL, the license is valid only until its expiration date. Alternatively, exporters may return licenses to the Directorate of Defense Trade Controls (DDTC) and apply for new authorizations from BIS prior to the expiration; and
- Until October 15, 2013, existing EAR and ITAR provisions remain in effect. BIS is accepting advanced review requests for applications for new ECCNs, but BIS will not authorize exports with new licenses until the effective date of the Final Rules.

Is There Overlapping Authority Resulting from this Transition?

If an article used in conjunction with an ITAR-controlled article migrates to EAR control, does the exporter have to get two licenses, one from the State Department and one from the Commerce Department?

No. BIS amended Section 734 of the EAR to grant DDTC exclusive licensing authority over items subject to the EAR that are used in or with items subject to ITAR. Accordingly, DDTC amended the USML to add a new subparagraph (x), designating such items for licensing purposes. Thus, the items will remain subject to the EAR, and BIS will maintain jurisdiction for licensing and authority; however, applicants can export under *either* BIS or DDTC authorization. For example, if a program authorized by a Technical Assistance Agreement (TAA) or Manufacturing Licensing Agreement (MLA) requires that parts and components subject to the EAR and ITAR, respectively, will be shipped in furtherance of the TAA or MLA, the exporter may ship all the components together pursuant to its valid DDTC-authorized DSP-5 license.

Remember to Transition Your Compliance!

All manufacturers and exporters should assess the impact of the reforms on their business and review and update internal export control compliance policies and procedures in advance of the October 15th effective date for the Rules. For companies dealing in articles migrating from ITAR control to CCL control, updates to licensing procedures could result in significant cost and time savings as regulatory burdens are reduced. All manufacturers and exporters should take this opportunity to communicate the regulatory changes to management and to employees with compliance responsibilities. Training is critical. Ensure that your personnel are equipped to adjust to the new export control regime. Transition teams should include all affected departments, including information technology for companies utilizing automated systems, as well as coordination with external vendors, such as U.S. Customs brokers or freight forwarders. If you are a logistics provider, it will also be critical to communicate with your clients to understand if their classifications or authorizations have changed so that you can take appropriate action.

If you have been engaged in defense trade and regulated only under the ITAR until now, review your options and determine whether to continue exporting under your DDTC licenses until expiration, or return the licenses and apply anew to BIS. Companies should identify any products or technology that may be subject to revised classification and reclassify these items based on the Final Rules using a consistent and well-documented procedure. Lastly, some companies may be interfacing with BIS for the first time because they deal exclusively in articles now migrating from ITAR control control under the EAR. If this is your business, it is critical that you become familiar with the EAR and BIS's online system, SNAP-R. On the flip-side, those exporters who exclusively export 600 Series items will no longer be required to register with DDTC post-implementation.

Conclusion

The changes taking effect October 15, 2013 are arguably the most significant changes to the export control regulatory landscape in decades. Although the ECR aims to reduce the administrative burden on licensed entities, learning and mastering the new rules presents a steep learning curve for exporters and manufacturers, particularly those which have not been regulated by the Department of Commerce in the

past.

Venable is well positioned to provide advice with respect to the pending rule changes or any other aspects of Export Control Reform. Please contact any attorneys in our **International Trade and Customs Group** for assistance.