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Proposed Commerce Rule on Exports to China Expected to Expand Exporters' Liability, Costs and Due Diligence Requirements While Reducing Trade Opportunities

The U.S. Department of Commerce's Bureau of Industry and Security ("BIS") published a proposed rule in the Federal Register on July 6, 2006 that would significantly expand export controls for the People's Republic of China ("PRC") if adopted. The three major changes are: (1) a new export licensing requirement for certain dual-use items to the PRC when the exporter "knows" that the exports would be for a military end-use; (2) an expansion of the existing requirement for exporters to obtain an end-user certificate ("EUC") from the PRC Ministry of Commerce for virtually all license items; (3) a new authorization process for "Validated End-Users" ("VEU") that would allow export of eligible items to the PRC without having to obtain a license for each transaction.

A New Export License Requirement

The proposed rule creates a new export license requirement for certain dual-use items listed in the rule that do not currently require a license for export to the PRC even where the exporter has knowledge or is informed by BIS that the exports would be for a military end-use. The proposed rule adopts the broad knowledge or "reason to know" standard currently applicable throughout the Export Administration Regulations ("EAR") that encompasses both positive knowledge and an awareness of a high probability that a given fact exists. This iteration of the proposed rule expands the definition of knowledge from previous drafts that had been limited to positive or actual knowledge.

Military end-use is defined broadly to mean "incorporation into, or use for the production, design, development, maintenance, operation, installation, or deployment, repair, overhaul, or refurbishing of items" (1) described on the U.S. Munitions List; (2) described on the International Munitions List of the Wassenaar Arrangement; (3) listed under Export Control Classification Numbers ending in "A018." At a public meeting on July 17th, Matthew S. Borman, Deputy Assistant Secretary of Commerce for Export Administration, stated that the proposed rule only concerns military end-uses and not military end-users in acknowledgement of the Chinese military's involvement in the commercial sector. Many believe, however, that this will be a distinction without a difference.

This proposed military end-use license requirement is not a "catch-all" provision because it only applies to items listed in the proposed rule. This list consists of forty-seven items across the categories of the Commerce Control List. License applications for exports, re-exports or transfers of the enumerated dual-use items will be evaluated on a case-by-case basis. The standard of review will be whether the items would make a "material contribution to the military capabilities of the PRC and would

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result in advancing the country's military activities contrary to the national security interests of the United States." License applications for such items will be subject to a presumption of denial.

Increase in Due Diligence Requirements and Liability

This proposal will significantly increase the due diligence that exporters will need to perform on their Chinese customers because now they will have to represent the end-use of their products to BIS. Furthermore, the proposal drastically expands liability to entities that "knowingly support" an export without a license through "any action, including financing, transportation, and freight forwarding." During the public meeting, Mr. Borman conceded that BIS will have to develop guidance on compliance programs. He stated that exporters will not be expected to engage in a higher level of due diligence to the point of inquiring about the original intent of Chinese products to determine "military end-use" when there are no red flags, but they will have to know the end-user.

End-User Certification by the PRC

The proposed rule expands the existing requirement for exporters to obtain an EUC from the PRC Ministry of Commerce. While national security-controlled items currently require an EUC, the proposed rule would require that all exports of items that require a license to the PRC for any reason with a total transaction value greater than \$5,000 would require an EUC. This transaction threshold would not apply to exports of computers that require a license and which already require an EUC. Exporters will retain the EUCs in their records and submit EUC serial numbers with license applications. BIS leaves itself discretion to require an EUC for a specific transaction below the \$5,000 threshold.

BIS states that this proposal will facilitate end-use inspections by the U.S. government. This requirement, however, will impose a potentially significant burden on exporters because delays already exist even though the PRC Ministry of Commerce currently only has to process a limited number of certifications. At the public meeting, Mr. Borman stated only that the PRC has not communicated to the United States that it will be unable to accommodate this increase in certification requests that the proposed rule will require.

Validated End-User Authorization

The proposed rule establishes a new authorization process for VEUs that would allow export, re-export, and transfer of eligible items to such end-users in eligible destinations, including the PRC, without having to obtain a license for each transaction. BIS intends this process to expedite exports to end-users who receive BIS approval as VEUs. Mr. Borman stated that generally, this VEU status would provide exporters a safe harbor and they would not need to screen the transaction because BIS will have already vetted the end-user.

BIS will publish a list of all VEUs in the Federal Register with corresponding authorized Export Control Classification Numbers ("ECCNs"). The factors that BIS will consider in granting VEU authorization include: (1) a demonstrated record of exclusive engagement in civil end-use activities and compliance with U.S. export controls; (2) agreement to on-site compliance reviews by the U.S. government and the capability to comply with other authorization VEU requirements; (3) relationships with U.S. and foreign companies; and (4) host country compliance with U.S. export controls. Exports, re-exporters, or end-users themselves may apply by submitting an advisory opinion request including the ECCNs of items to be exported and a description of how the VEU will use the items. At the public meeting, Mr. Borman stated that the requirements for VEU documentation are forthcoming.

This authorization restricts end-uses to: (1) civil end-use by the VEU; (2) use at facilities owned or effectively controlled by the VEU; (3) consumption of items by the VEU during use; (4) transfer or re-export by the VEU only after receiving BIS authorization. In addition, items controlled under the EAR for missile technology and crime control are not eligible for export under this authorization.

At the public meeting, Mr. Borman stated that the process should be fairly short for Chinese subsidiaries of U.S. companies and companies to whom BIS has already granted licenses and/or visited because BIS already has information on such end-users. Mr. Borman further noted that BIS understands that the authorization process has to be efficient to be effective and that BIS has commenced reviewing its license data for potential VEU candidates to expedite the process.

While attempting to facilitate exports to customers of U.S. goods without military end-use concerns, this authorization imposes substantial recordkeeping, reporting, and auditing requirements on exporters: (1) prior to the initial export, exporters will need to obtain certification from VEUs about their compliance with VEU requirements; (2) exporters will need to submit annual reports to BIS detailing transactions to VEUs; and (3) exporters must allow periodic inspection of records or on-site compliance reviews.

BIS Issues Requests for Comment from Industry

BIS will accept comments on the proposed rule until November 3, 2006. BIS contends that these proposed changes will actually facilitate the expansion of trade with the PRC for civil end-uses, while protecting U.S. national security. BIS and industry have engaged in intense negotiations over drafts of this rule for over a year. This iteration of the rule remains controversial with criticisms from industry that the changes will have high compliance costs and will significantly reduce trade opportunities for only a potential limited improvement in national security. Comments channeled through industry associations as well as from individual companies may highlight the impact of the proposed changes and may provide carve-outs for a company's products in certain circumstances described below. At the public meeting, Mr. Borman specifically cautioned not to assume that comments will not have an impact.

In downplaying the effects of export controls on trade to China, BIS points to the statistic that in 2005, only approximately \$2.4 billion of \$41 billion worth of exports were licensed for export to the PRC and a mere \$12.5 million worth of exports were denied. In doing so, BIS not only discounts the substantial compliance costs involved, but ignores the chilling effect export controls have had and will have on trade with China from both the U.S. exporter and Chinese customer sides. Comments from industry providing data of the estimated compliance costs and effect on trade may assist in monetizing these impacts.

Furthermore, at the public meeting, Mr. Borman welcomed comments containing specific evidence of foreign availability and, most importantly, indigenous Chinese manufacturing capability. Mr. Borman also stated that with the publication of the proposed rule, BIS will be working to get other Wassenaar Arrangement members to adopt similar controls implementing the 2003 Wassenaar Arrangement Statement of Understanding. Thus, even if the current iteration of the rule mechanisms and processes will be adopted by BIS, it appears that companies still have an opportunity to convince BIS to eliminate their products or technologies from the control list by submitting a comment with evidence of indigenous manufacturing in the PRC.

Should you have any questions about the proposed rule, please do not hesitate to contact us.

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