Fox Rothschild LLP
ATTORNEYS AT LAW

MAY 2011

CORPORATE DEPARTMENT & INTERNATIONAL PRACTICE GROUP

ALERT

Export Compliance Reform and Its Implication for U.S. Companies

By Nevena Simidjiyska

The U.S. export control system impacts a wide variety of commercial transactions within the United States and abroad. After determining that the current system is overly complicated and inflexible, the Obama administration initiated a reform initiative aimed at consolidating and streamlining export controls to promote efficiency, national security and U.S. business interests. The reform initiative is intended to ease regulatory burdens for U.S. companies to export products abroad, cut compliance costs and reduce potential exposure to export violation penalties for noncompliance. The challenge for these companies will be to adopt their compliance programs and keep them current in accordance with newly issued regulations.

The definition of controlled "exports" under current U.S. law is very broad and complex. It covers products, activities, technology transfers and technical services companies may not typically recognize as controlled items. In 2009, an interagency review of the current export control system directed by President Obama determined the system is highly ineffective because it is overly complicated, redundant, inflexible and inclusive. These deficiencies complicate companies' compliance and put companies at a competitive disadvantage in the global market place. In response, the Obama Administration initiated an Export Control Reform Initiative aimed at restructuring the current system by consolidating and streamlining export licensing, control lists, administration and enforcement under one government agency to promote efficiency, national security and U.S. business interests.

The current export control system operates through two control lists administered by two different departments, three licensing agencies, several enforcement agencies and several incompatible information technology systems. The Department of Commerce's Bureau of Industry and Security (BIS) administers the Export Administration Regulations (EAR) through the Commerce Control List, which governs the export of "dual use items" that have both civilian and military applications. The State Department's Directorate of Defense Trade Controls (DDTC) administers the International Traffic in Arms Regulations (ITAR) through the Munitions List, which governs the export of defense articles and services. The Department of the Treasury's Office of Foreign Assets Control (OFAC) administers and enforces economic and trade sanctions against targeted foreign individuals, countries and regimes engaged in activities that pose a threat to the U.S. economy, national security or foreign policy. BIS, DDTC and OFAC do not share information regarding the licenses that each issues, resulting in redundant, inconsistent and burdensome licensing requirements and decisions. In addition, the agencies that enforce EAR and ITAR have duplicative authorities, making enforcement highly inefficient. Finally, the incompatibility of the information technology systems of BIS, DDTC and OFAC makes synergy among these agencies virtually impossible.

The current export compliance system, therefore, generates jurisdictional overlap and inconsistency among the different licensing and enforcement agencies. As an example, a pivot block for Marine all-terrain vehicles requires an export license from DDTC but a nearly identical pivot block for fire trucks can be exported to almost every country without a license. This burdensome and inefficient system, combined with two over-restrictive control lists, dilutes the government's ability to properly control key exports. Attempting to control too many items without proper focus has led to over-regulation of items that pose little or no risk and under-regulation of high-risk items. Furthermore, this system puts U.S. companies at a competitive disadvantage by forcing them to waste resources navigating an unclear and complex export control administration and prohibiting the export of globally available items to overseas markets. The labyrinth of regulatory overlap has reached the point that Charles Edelstenne, president of the Aerospace and Defense Industries Association of Europe, stated "the only way to resolve technology access and U.S. government export restrictions is by not including any U.S.-sourced technology in our products."

The Export Control Reform Initiative led by the Obama Administration seeks to streamline the export control process by consolidating all export control under a single revised control list, single primary enforcement coordination agency, single information technology system and single licensing agency. The Administration plans to complete this initiative through a three-phase approach. Phase I will focus on immediate improvements to the existing system and the establishment of a framework for the creation of a new system. Phase II will center on the restructuring of the two export control lists and the licensing system, expansion of export compliance enforcement and transition toward a single electronic licensing arrangement. These reforms will be a stepping stone towards the consolidation of export control. Finally, Phase III will complete the transition to an export control system governed by a single control list, enforcement agency, information technology system and licensing agency.

Phase I of Export Control Reform Initiative

During Phase I, the Departments of Commerce and State will work together to clearly distinguish which items are controlled by each of the two export control lists: the Commerce Control List and the Munitions List. To accomplish this, the two lists will be converted to "positive lists" that classify and control items based on specific technical parameters, such as size, composition or horsepower, rather than based on broad or subjective criteria. This conversion will help end ambiguity, jurisdictional confusion and overlap between the BIS-directed Commerce Control List and the DDTC-directed Munitions List. Licensing will also be improved by creating a standard licensing process that will increase efficiency. Enforcement of all export compliance regulations will be synchronized through the creation of an Enforcement Fusion Center. Finally, the incompatibility of the current information technology systems of BIS, DDTC and OFAC will be addressed by determining common needs of the three agencies and establishing a single U.S. government point of entry for exporters.

Phase II of Export Control Reform Initiative

The most critical reform under Phase II will be the rebuilding of the two export control lists. Each list will be "tiered," dividing products into three tiers based on export risk. High-risk products that provide a critical military or intelligence advantage to the United States and are only available in the United States or that relate to weapons of mass destruction will be placed in the highest tier. Medium-risk products that provide a substantial military or intelligence advantage to the United States and are only available through U.S. multilateral partners and allies will be placed in the middle tier. Finally, lower-risk products that provide a significant military or intelligence advantage to the United States but are available more broadly will be placed in the lowest tier. The higher tiered products will be subject to stricter levels of control. The interagency team revising the two export control lists will also create a "bright line" between the two lists that clarifies which list an item is controlled by and will structurally align the two lists in preparation for combining them into a single list in Phase III.

Once the items controlled by the two export control lists are tiered, corresponding licensing policy will be assigned to each tier to streamline agency review. Generally, a license will be required for all items in the highest tier to all destinations. Items placed in the middle tier will typically be authorized for export to multilateral partners and allies pursuant to license exemptions. Items in the lowest tier will require a license only to particular destinations, if at all. Items exported without a license will be strictly controlled for re-export to prevent their transfer to unauthorized destinations. Notwithstanding reforms to the control lists and licensing requirements, the U.S. government will continue to prohibit exports to certain countries, such as Iran or Cuba.

The U.S. government will also enhance export compliance enforcement in Phase II and begin to establish infrastructure required to transition the current information technology systems of BIS, DDTC and OFAC to a single electronic licensing system.

Phase III of Export Control Reform Initiative

Phase III, the final stage of export reform, will focus on completing the transition to the new export control system. The U.S. government will merge the two control lists into one tiered list, merge the licensing agencies and the enforcement agencies into a single license and enforcement agency, respectively, and launch a uniform information technology system that will record and track all information related to each license application. The Administration expects the single licensing agency to be comprised of the cabinet officials of BIS, DDTC and OFAC and to report directly to the President. The single enforcement agency will likely be the product of the merger of the Department of Commerce's Export Enforcement Office and the Immigration and Customs Enforcement's (ICE) Counter-Proliferation Program into a single export enforcement agency within ICE.

Progress Report

The Administration is currently in Phase I of the Export Control Reform Initiative and hopes to transition into Phase II in 2011. On December 9, 2010, the Departments of Commerce and State each issued proposed regulations on the restructuring of the Munitions List and the Commerce Control List, respectively, and solicited public comments on the conversion of the two control lists into "positive lists" and on dividing the lists into tiers. Specifically, the Department of State published a proposed regulation, redrafting Category VII (Tanks and Military Vehicles) of the Munitions List into a "positive list" that only represents items determined to provide significant military or intelligence advantage to the United States. The proposed revised Category VII contains only about one quarter of the items listed in the current version of Category VII. The remaining 75 percent of items currently controlled under this category are expected to be transferred to the jurisdiction of EAR or removed from the control lists altogether. The result will be a Munitions List focused on key military and intelligence items and a significant increase in items that can be exported without a license. Once the Category VII revisions are complete, the Administration will continue restructuring the remainder of the Munitions List, with a goal to complete the redraft by the end of 2011. Simultaneously, the Department of Commerce proposed an initial draft of new licensing policies that create new license exceptions. These exceptions would allow exports of controlled items to certain destinations or for certain end-uses that the U.S. government determines do not pose a threat to U.S. interests. This revised licensing policy would expand the number of items that can be exported without a license under the Commerce Control List.

In addition to the proposed revisions to the two control lists, the Administration consolidated the export screening lists of prohibited individuals, entities, regimes or countries administered by the Departments of State, Commerce and Treasury into a collective electronic directory to facilitate export compliance with EAR, ITAR and OFAC. Previously, exporters had to consult different screening lists published in different formats to ensure they are not exporting to sanctioned destinations or end-users. The consolidated screening list now provides exporters with a single database that contains all individual or entity names for which an export control restriction or requirement exists. In November 2010, the President also signed Executive Order 13558, which established an Export Enforcement Coordination Center (EECC) among the Departments of State, Treasury, Defense, Justice, Commerce, Energy and Homeland Security, as well as parts of the intelligence community. The purpose of the EECC is to serve as a primary point of contact for enforcement agencies and for the U.S. intelligence community to resolve inter-agency conflict, facilitate cooperation and establish government-wide statistical tracking system for U.S. export enforcement activities.

The Export Control Reform Initiative launched by the Obama Administration is, therefore, already showing significant improvement to the export control system just one year after its launch. The new system will focus on controlling high-risk technologies that pose the greatest risk to national security and economic interest while permitting the export of items that pose little or no risk. The reform will significantly simplify the export compliance process by consolidating and streamlining the current system. A simplified system will allow U.S. companies to export products abroad with more ease, cutting compliance costs and reducing potential exposure to export violation penalties for non-compliance. The reformed system will also promote business between U.S. companies and foreign markets by allowing U.S. companies to export more products to a broader range of customers with decreased license requirements. The challenge for these companies through the export reform transition process will be to keep their compliance programs current in accordance with newly issued regulations. Companies that have incomplete compliance programs or do not fully enforce these programs will struggle through the reforms, constantly playing catch-up. Staying current with revised regulations will be significantly easier for companies that have existing functional compliance programs that can simply be adjusted to meet the requirements of ongoing reforms. These companies will benefit from increased efficiency and decreased regulation without exposure to potential violation penalties.

For more information about this Alert, please contact Nevena Simidjiyska at 215.299.2093 or nsimidjiyska@foxrothschild.com or any member of Fox Rothschild's Corporate Department or International Practice Group.