

Comments from U.S. Exporters Concerning Proposed Revisions and Clarifications of Export and Re-export Controls for the People's Republic of China and New Authorization Validated End-User

Since the U.S. Department of Commerce's Bureau of Industry and Security (BIS) published its proposed rule for the expansion of export and re-export controls for the People's Republic of China (PRC), over 50 U.S. firms have submitted comments to the BIS stating that promulgating this rule would likely cause U.S. firms to lose business opportunities in a highly competitive international market. In the midst of U.S. businesses expressing these concerns, several events have occurred that could result in a significant delay of the implementation of the proposed rule.

First, China successfully fired a missile to destroy one of its own satellites on January 11, 2007, fueling the U.S. government's concern about China's military modernization. Then, as Assistant Secretary of Commerce for Export Administration, Christopher Padilla, visited China in an effort to persuade the Chinese that the proposed rule on high-technology exports would enhance trade, the Office of Management and Budget (OMB) determined that the proposed rule requires further review.

As a result, BIS is now required to submit an analysis of the proposed rule to OMB, making OMB the final authority as to whether the proposed rule moves forward. This means that implementation of the proposed regulations will be significantly delayed. In the meantime, summarized below is both the proposed rule and the comments U.S. firms submitted to the BIS. Readers who have not had the chance to consider the serious impact and consequences that this proposed regulation will have on their business should not hesitate to contact John Liebman at jliebman@mckennalong.com for more information.

Summary of Revisions of Export and Re-export Controls for the PRC

The proposed rule, if adopted, will subject exporters to three noteworthy changes: (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 licensable items; and (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. The proposed rule revises U.S. policy on exports to the PRC of goods and technologies controlled for national security and foreign policy reasons.

In response to the possibility that such a rule could become a reality, many U.S. firms have submitted comments to the BIS regarding the potential serious impact that the proposed rule would have on U.S.

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industry. Comments generally state that the proposed rule threatens to place U.S. firms at a disadvantage in the highly competitive Chinese market. The intent of the proposed rule is to preclude the Chinese military from obtaining U.S. goods. However, U.S. firms assert that when the Chinese military cannot acquire U.S. goods, it will easily procure them from non-U.S. firms. Moreover, almost all comments note that the proposed regulation is unilateral, with the U.S. being the only participating member of the Wassenaar Arrangement to implement a conventional arms embargo with respect to China. A summary of U.S. industry comments to BIS regarding the proposed rule are addressed below.

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End-User Certificate Requirements Stemming U.S. National Security Policy

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. The requirement occurs when 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), and encompasses both positive knowledge and an awareness of a high probability that a given fact exists.¹ This version of the proposed rule expands the definition of knowledge from previous drafts that had limited application of the rule to situations involving positive or actual knowledge. U.S. firms are concerned that at a later date they could find themselves charged with knowledge of facts when actual knowledge did not exist at the time of export.

The proposed rule also requires exporters to state on the export application "all known information" concerning military end-use. This could require an extensive amount of due diligence for each exportation. Comments have suggested that the exporter be required only to provide information reasonably available within a commercial time frame that it has obtained from making a reasonable inquiry of all relevant departments within the company.

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; or (3) listed under Export Control Classification Numbers ending in "A018."

Some U.S. firms are concerned that the definitions of "military end-use" and "support" are overbroad and expose U.S. companies to considerable liability and raise a number of questions about their application. The firms encourage BIS to provide specific examples to U.S. exporters as to which situations fall within the definitions.

The 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 47 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 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.

U.S. firms are concerned that in developing the list, the BIS fails to consider that many products in these categories are readily available in the PRC, as well as around the world from sources other than U.S. companies. Products manufactured by non-U.S. companies will not be subject to the stringent export controls imposed by the proposed rule. Instead, to the detriment of the U.S. companies that must operate under such rules, the PRC will increase its purchases of non-controlled products from non-U.S. companies. In turn, the proposed rule's driving policy of advancing U.S. national security interests will be circumnavigated by the U.S.'s own proposed rule.

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Excessive Due Diligence Poses a Substantial Burden

The proposed rule will significantly increase the due diligence that exporters will need to perform on

their Chinese customers because they now 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."

U.S. firms commented that the unclear terms of the proposed rule, the expansive scope, and the lack of due diligence guidance pose substantial problems. In turn, these problems will lead to increased compliance costs and potential liability for U.S. companies as well as a decrease in competitive advantage against foreign companies.

For example, one commentator explained that customers who are unduly burdened with excessive investigations may simply choose to conduct business with non-U.S.-based competitors who will be selling products without being asked bothersome questions. Further, due diligence will generally involve U.S. firms asking its customers about the possible end-use of the product, without having the opportunity to verify the accuracy of the representation. Often, in the distribution business, customers protect information about their own customers to maintain a competitive advantage.

Another commentator suggested that BIS generate a list of "targeted" end-users as part of any guidance on complying with the new controls. This would ease the burden on exporters of performing due diligence under the new rule. In the absence of definitional clarity and a published list of entities or projects that would prompt the rule's prohibitions, U.S. firms find the due diligence requirement to be excessively burdensome.

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End-User Certificate by the PRC may Thwart Ability to Compete in China

The proposed rule expands the existing requirement for exporters to obtain an End-User Certificate (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.

U.S. firms question whether the Chinese government will cooperate with end user certificates, and, if they do, whether the expansion of the PRC end-user certificates will ultimately result in lengthy delays as the PRC does not have sufficient resources to issue the certificates efficiently. One commentator suggests that proper consideration of this proposed rule requires that the U.S. obtain serious commitments from China to ensure timeliness, appropriate staffing, and the non-discriminatory issuance of certificates.

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Validated End-User Authorization Results in Significant Burdens Hurting Competitiveness

The proposed rule establishes a new authorization process for Validated End-User Authorization (VEU) 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.

U.S. firms cited concerns that such a system could result in costly delays. If interagency review for VEU status is not conducted promptly with established firm deadlines for interagency review, U.S. exporters may lose sales, especially when international suppliers are able to provide the same goods without extensive government approvals. Moreover, U.S. companies state that the proposed VEU creates additional process burdens for both U.S. companies and BIS. One commentator suggested that it would be more beneficial to U.S. companies if the BIS would provide names of companies they have previously vetted and for whom they have provided individually validated licenses.

¹According to section 772.1 of the EAR, knowledge of a circumstance (the term may be a variant, such as "know," "reason to know," or "reason to believe") includes 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. Such awareness is inferred from evidence of the conscious

disregard of facts known to a person and is also inferred from a person's willful avoidance of facts.

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