

StayCurrent

A Client Alert from Paul Hastings

New Rules on China Exports

By Behnam Dayanim and Christopher Timura

The U.S. Department of Commerce's Bureau of Industry and Security ("BIS") recently issued its final amendments to the regulations that guide licensing for exports to China ("China Rules"). The Government has defended the tightening of the rules as necessary in light of increasing reliance by the Chinese military on commercial, off-the-shelf products. The new China Rules modify the existing export licensing regime in three primary ways:

- First, they create a new military end-use licensing requirement and identify a list of controlled items that will be subject to this new license scheme;
- Second, they modify End-User Statement requirements, broadening its scope but raising the threshold that triggers the requirement to \$50,000; and
- Third, they introduce a controversial new Validated End-User ("VEU") program.

Observers have fiercely debated the impact of these new rules. It is our sense that, ultimately, the majority of exporters will not see a material effect, but that some companies and industries will encounter increased amounts of paperwork and bureaucracy due to new licensing or end-user statement requirements.

NEW CHINA MILITARY END-USE LICENSING REQUIREMENTS

The new China Rules now require an exporter to apply for a license whenever it knows or has reason to know that certain identified items – commodities, software or technology – planned for export to China, reexport from a third country to China, or transfer within China are intended for military end-use there. (The export regulations generally cover U.S. persons and U.S. origin items, wherever located.) The rules list 31 items in 20

product categories on the Commerce Control List, identified by their Export Classification Control Number ("ECCN"), as subject to this new requirement. The China Rules state that BIS will deny licenses if an export of one of these items, or items controlled for the non-proliferation of missile technology, or nuclear, chemical and biological weapons, will make a "direct and significant contribution" to China's military capabilities.

WHAT IS A "MILITARY END-USE" AND WILL THIS INCREASE MY DUE DILIGENCE BURDEN?

BIS defines "military end-use" as "incorporation into, or use for the production, design, development, maintenance, operation, installation, or deployment, repair, overhaul, or refurbishing of items." The amended rules also provide new definitions for "operation," "installation," and "maintenance" to guide parties in their due diligence.

The 31 identified ECCNs include items related to aircraft and aircraft engines, avionics and internal navigation systems, certain composite materials and some telecommunications equipment that can be used in space communications and air defense. BIS shortened this final list considerably from its earlier proposal in response to fierce industry opposition. Among the items removed were those that use or are capable of encryption (controlled under 5A992 and related ECCNs).

BIS argues that the new rule will not add appreciably to exporters' due diligence burdens. For the most part, this is probably accurate. Exporters always have been responsible for "knowing" their end-users and the end-use for exported items. Although BIS was considering a heightened military end-use knowledge standard, export community concerns led them to revert to the

same knowledge standard that applies to the EAR more generally. Under this standard, exporters will be required to apply for a military-end use license if at the time of export, reexport or transfer, they know or have reason to know that the newly controlled item (controlled under any of the 31 ECCNs specified in the new rules) to be exported is intended, entirely or in part, for a military end use in China. BIS also may notify exporters of known end-user risks and of the need to apply for a military end-use license.

MOFCOM AND END USER STATEMENTS

The new China Rules will now require exporters to obtain an End-User Statement from China's Ministry of Commerce ("MOFCOM") whenever the total value of exports controlled for any reason exceeds \$50,000. This restatement substantially broadens the requirement, which previously applied only to items controlled for national security reasons, while raising the monetary threshold. As before, exporters need submit these statements only for exports of commodities, not software or technology (technical information).

BIS asserts that the two changes will offset each other, resulting in the same total number of statements per year. Of course, even if BIS is correct, burdens will be redistributed among exporters, so the real-world impact is likely to be uneven. Exporters widely detest the end-user statement requirement, as it often leads to substantial delay and added expense.

VALIDATED END-USER PROGRAM

Perhaps the most controversial aspect of the new China Rules is the introduction of the Validated End-User ("VEU") program for China. The VEU program purports to offer opportunities to streamline compliance for U.S. companies with regular exports to China, by "validating" specific end-users in that country. Validation requires review and approval by an interagency government review committee, which will include confirmation that exports received by the end-user are destined solely for civilian purposes.

Applicants must submit general business information, including ownership structure, information regarding subsidiaries and joint ventures, information on the nature of their business, items to be imported, plans to re-transfer items, and internal control and record keeping procedures. In addition to civilian end-use, the government will consider – among other factors – the applicant's compliance with U.S. export controls and

require the VEU applicant to agree to on-site audits by U.S. government officials. The VEU application must identify specific ECCNs that the applicant requests be included within the scope of its new "validated" status.

Status as a VEU will enable a company to receive exports of those identified items without need for a license.

BIS plans to grant VEU authorization to an initial list of 20 companies next month. All others will need to apply independently or be sponsored by a U.S. company that applies in their stead. The list of VEUs will be published and available to all exporters.

Whether this new program yields the trade-enhancing benefits BIS promises remains very much in doubt. The willingness of Chinese companies to cooperate with on-site visits and the other VEU requirements and the difficulty and expense of the application process promise to present obstacles to widespread acceptance. How the Chinese government reacts also remains to be seen.

In the course of promoting the VEU program, BIS has maintained that it intends to expand what it argues are its benefits to India and elsewhere. Most other countries (including India) are not subject to the same degree of licensing control as is China. If BIS truly does pursue a widening of the VEU program, the reactions of those other countries should prove of great interest.



Paul Hastings' International Trade and Export Controls Practice advises clients on all aspects of trade, export, sanctions and related licensing and compliance. Behnam Dayanim is a partner and Christopher Timura is an associate in Paul Hastings' Washington, D.C. office.

For more information on the subject of this Alert or on any other export compliance or related topic, please contact:

Washington, D.C.

Behnam Dayanim
202-551-1737
bdayanim@paulhastings.com

Hamilton Loeb
202-551-1711
hamiltonloeb@paulhastings.com

Scott M. Flicker
202-551-1726
scottflicker@paulhastings.com

Christopher Timura
202-551-1811
christophertimura@paulhastings.com
