China – Law Firms

U.S. Department Of Commerce Poised To Impose New Restrictions On Exports To China

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In early 2007, the U.S. Department of Commerce will likely impose new unilateral restrictions on exports of certain commercial products and technologies to the People's Republic of China. As set forth in a proposed rule issued this summer, these restrictions would significantly expand the types of commercial products requiring a license for export to China where the products will have a military end-use. Despite widespread criticism of the proposed rule by U.S. industry, the Commerce Department has repeatedly signaled that it will move forward with finalizing the proposed rule. Moreover, while the actual impact on most U.S. exports is unclear, this rule will *de facto* require U.S. exporters to take additional due diligence steps where their products or technologies will be exported or re-exported to China. Since the proposed rule may come into effect with little or no grace period, companies need to immediately begin considering how they will address these additional requirements in their export compliance procedures and contractual arrangements with Chinese companies.

Major Aspects Of The Proposal

Expanded List Of Items That May Require Licenses To China. The rule, proposed by the U.S. Department of Commerce, Bureau of Industry and Security (BIS), would require U.S. exporters to obtain licenses to export a range of products to China, which currently do not require licenses, where the exporter has *knowledge* that the item will have a *military end-use*. These products include many items currently on the Commerce Control List (CCL) that are only controlled for "anti-terrorism" reasons, such as:

• Chemical mixtures containing certain percentages of Chemical Weapons Convention (CWC) precursors

• Certain manufacturing equipment gear making/finishing machines, dimensional inspection/measuring equipment, machine tools for making optical quality surfaces, and certain multi-axis machine tools

• Specific electronics manufacturing design and test equipment including most semi-conductor manufacturing equipment and related test equipment, oscilloscopes, and flash x-ray machines

• Computers with adjusted peak performance exceeding 0.1 Weighted TeraFLOPS (WT)

• Certain telecommunications equipment including equipment utilizing lasers, QAM techniques, phased array, or capable of operating at extreme temperatures

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• Software, and commodities containing encryption functionality, except for mass market (over the counter) encryption products

• Certain lasers, avionics, and underwater systems

• Commercial aircraft, engines, and related systems

To understand the scope of this rule, the following are explanations of some of the key terms/restrictions:

• *Knowledge*. As drafted, the rule only requires a license if the U.S. exporter "knows" that the item will be used for a military end-use. In this context, knowledge is broader than actual knowledge, and would include constructive knowledge where the exporter had reason to know or believe, based on the circumstances, that there was a military end-use, or intentionally blinded itself to the facts.

• *Military End-Use*. Military end-use does not necessarily mean sale to the Chinese military, but rather export for use in an item on the U.S. Munitions List, which includes, in addition to specialized military equipment, commercial satellites and satellite ground control equipment, certain GPS receivers, and certain chemicals used in conventional or chemical munitions.

• *No License Exceptions*. In general, no license exceptions will be applicable where there is a military end-use. This means that virtually all commercial software that contains encryption (other than mass market encryption) will no longer be eligible for export to China under a license exception if a military end-use is indicated.

• *Presumption of Denial*. BIS would adopt a formal "presumption of denial" for any license applications for the export of items controlled for national security, chemical, biological proliferation, or where the item would make a material contribution to China's military capabilities, with the implication that exports for *bona fide* civil uses would not be subject to this presumption.

Validated End-User (VEU). BIS proposes a method for a Chinese company to receive advance screening as a "Validated End-User" that would then allow it to receive many otherwise licensable items without a license. The VEU could only obtain the items for its own use or transfer the goods in accordance with the EAR, and would be subject to reporting, compliance visits, etc.

End-Use Certificates. BIS has proposed that an "End-Use" certificate be required for any export that requires a BIS license to China and exceeds $5,000 in value. This End-Use certificate is issued by MOFCON, the Chinese Ministry of Commerce.

The Bottom Line: How Can U.S. Companies Prepare?

Any U.S. company exporting to China should consider whether its products are affected and start developing a plan of action for how it will conform with the new requirements, which likely will not vary significantly from the proposal. For many companies, compliance with these new rules will not be easy to implement because of the uncertainty regarding the level of due diligence expected from the BIS. Some of the issues are the following:

• Currently, products which are listed on the Commerce Control List (CCL) only for anti-terrorism reasons can generally be sold to all but embargoed countries, subject primarily to checks of the various barred entity lists. However, unlike barred entity lists, there is no affirmative list to screen, and the exporter who does not ask about the end-use could potentially be prosecuted for willful blindness under the BIS definition of "knowledge."

• It is unclear whether the added categories of restricted products could be sold to distributors in China, since the end-user/end-use will be unknown at the time of sale.

• While the VEU program could be a benefit to certain companies, particularly U.S. subsidiaries in China, it is unclear what type of showing is required to meet the VEU standards. If a Chinese company applies and is rejected for VEU status, that company could face difficulties in obtaining licenses in the future. Further, it is unclear how VEU status would be flagged on export documentation to avoid problems clearing U.S. customs on export.

• Although the definition of *military end-use* appears to apply only where a product will be specifically incorporated or used in a military article, in practice the rule may make it difficult to sell any of these products to the multitude of Chinese companies that are owned by, or otherwise tied to, the Chinese government and military.

• It is not unlikely that the "presumption of denial" of licenses will, as a matter of practice, "bleed over" to applications for commercial uses in China, requiring exporters to go to great lengths to demonstrate the *bona fide* commercial uses intended by their Chinese customers.

In terms of a plan of action, U.S. exporters should start now to consider how they will incorporate aspects of this rule into their due diligence. Steps may include:

• Determining whether any company products are on the list of additional items subject to control;

• Revising existing export control documentation (*e.g.*, customer certificates, contractual language) to prohibit military end-use for certain items;

• Determining what additional due diligence will be required for exports to China; and

• If conducting offshore production in China, considering whether the VEU program may be beneficial.

Getting Off The List

While the official comment period on the proposed rule closed on December 4, 2006, companies whose products will be captured by the expanded list of products controlled for export to China may still be able to seek relief. In particular, if an industry can demonstrate that products controlled under a particular classification are widely available from other countries and/or produced domestically in China, BIS may consider removing such items from these controls. This may be difficult to do given BIS statements that exporters have a high burden of proof to show international availability.

Is There Any Chance The Rule Will Be Withdrawn?

Although U.S. Industry has loudly voiced its concerns with the BIS, agency officials continue to indicate that this proposed rule will be finalized in early 2007. This proposed rule appears to be one piece of the Bush Administration's broader strategy to deny or delay technological development by the Chinese military. And this particular policy is probably not something that the new Democratic leadership in Congress would focus on in the short-term. Further, BIS officials have pointed out that the proposed rules will affect only a small percentage of U.S. exports to China, implying that the economic impact on U.S. exporters will be minimal. On the other hand, the new rule will create additional compliance costs and uncertainty for U.S. exporters, and may have a chilling effect well beyond its stated scope. Further, because the products on the expanded list are not generally subject to export restrictions in other countries, the proposal is unlikely to effectively deny the Chinese military access to these items.

Earlier this year, in the face of widespread criticism from industry, BIS withdrew its "deemed export" rulemaking dealing with disclosure of technology to foreign nationals in the U.S. BIS subsequently created a blue ribbon panel to examine these issues, and it is likely it will revisit this issue again. However, the withdrawal of the deemed export rulemaking may make it more, rather than less, likely the BIS will not relent on this China "catch-all" proposal. Hence, this author's opinion is that, while the proposal could be delayed by the opposition, given the political realities of the day, the Commerce Department is likely to implement the rule.

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