

E-ALERT | International Trade Controls

May 16, 2011

NEW DUAL AND THIRD COUNTRY NATIONALS RULE

On May 16, the Department of State, Directorate of Defense Trade Controls (“DDTC”) issued a final rule amending the International Traffic in Arms Regulations (“ITAR”) to include a new license exemption for transfers of defense articles to dual national or third country national employees of foreign end-users. The new rule, which becomes effective on August 15, 2011, eliminates the need to obtain prior approval from DDTC for transfers of unclassified defense articles (including unclassified technical data) to dual national or third country national employees of foreign business entities, foreign government entities, or international organizations that are approved end-users or consignees (including approved sub-licensees) for such defense articles. Use of the exemption is subject to satisfying certain screening and recordkeeping requirements. In particular, in lieu of prior approval, the new ITAR Section 126.18 requires eligible companies and organizations to implement “effective procedures to prevent diversion to destinations, entities, or for purposes other than those authorized by the applicable export license or other authorization.” These requirements for screening and other measures to prevent diversion may impose significant burdens, or may in some instances conflict with employee rights under local law, which may limit the usefulness of the exemption for some companies.

Based on comments submitted in response to the proposed rule published on August 11, 2010, DDTC made important changes before issuing the final rule. Most notably, DDTC has preserved the limited exemption already available under ITAR Section 124.16 for transfers of certain defense articles (including technical data) to employees from NATO and EU member states, Australia, Japan, New Zealand and Switzerland and has expanded the definition of “regular employee” to include contract employees with long term employment relationships with the foreign end-user. Although the anti-diversion screening procedures for employees without security clearances required under the new exemption probably will limit its utility, the final rule at least preserves the status quo with respect to the availability of ITAR Section 124.16.

BACKGROUND

As part of the ongoing Export Control Reform effort, DDTC is amending ITAR Parts 124 and 126 to reflect a new approach to transfers of defense articles to dual national and third country national employees of approved foreign end-users. DDTC’s “deemed reexport” rule treats a transfer to a national of a country as equivalent to a transfer to that country itself. For that reason, under the previous rule, foreign end-users were required to obtain prior approval from DDTC for transfers to dual national and third country national employees by providing additional information within a license to cover these employees or by obtaining a separate license for these transfers. In addition, the old rule absolutely barred transfers of ITAR technology to nationals of ITAR Section 126.1 countries (such as China). This approach was criticized for imposing a significant administrative burden on foreign end-users and, because of its citizenship/nationality-centric approach, raised human rights concerns which had become a source of contention between the U.S. and its allies.

The new rule signifies a shift from this nationality-based approach to transfer licensing to a risk-based approach. DDTC noted in its proposed rule that most diversions of ITAR-controlled articles occur outside the scope of approved licenses, not within licensed foreign companies or organizations that grant access to properly screened dual national or third country national employees. Recognizing that national origin/place of birth is not always an adequate indicator of loyalty, DDTC has now taken the position that the focus of the inquiry, at least in the context of transfers to employees of a foreign end-user, should not be an employee's citizenship or place of birth, but rather on whether persons are "likely to divert" controlled technology. We note that this rule does not change DDTC's basic deemed export rule or its focus on nationality as the measure for deemed exports outside of the specific context of internal transfers by an approved end-user (e.g., DDTC's approach to domestic transfers by U.S. companies to their employees is not affected). However, by including statements such as "nationality does not, in and of itself, prohibit access to defense articles," the new rule perhaps suggests that DDTC may be willing to reconsider its nationality-based approach in other contexts as well.

REQUIREMENTS OF THE NEW RULE

Under the new ITAR Section 126.18, no prior approval is needed from DDTC for the transfer of unclassified defense articles (including unclassified technical data) to or within a foreign business entity, foreign governmental entity, or international organization that is an authorized end-user or consignee (including sub-licensees) for those defense articles, including the transfer to dual nationals or third country nationals who are bona fide regular employees, directly employed by the foreign consignee or end-user. However, these transfers are subject to the following conditions:

- **Physical area restriction.** The transfer must take place completely within the physical territory of the country where the end-user is located, where the government entity or international organization conducts official business, or where the consignee operates, and be within the scope of an approved export license, authorization or license exemption.
- **Screening requirement.** The foreign entity must have effective procedures to prevent diversion to destinations, entities, or for purposes other than those authorized by the applicable export license or other authorization. Foreign entities may satisfy this requirement by:
 1. requiring a security clearance approved by the host nation government for its employees, or
 2. implementing a procedure to screen employees for substantive contacts with restricted or prohibited countries listed in ITAR Section 126.1 and requiring employees to execute a Non-Disclosure Agreement.
- **Technology security/clearance plan.** End-users and consignees must maintain a technology security/clearance plan that includes procedures for screening employees for such substantive contacts and maintain records of such screenings, available at the request of DDTC, for five years.

CHANGES FROM THE PROPOSED RULE

Thirty-two parties filed comments on the proposed rule. DDTC responded to and adopted a number of changes suggested in these comments. The significant changes include the following:

- **The final rule preserves the limited exemption under ITAR Section 124.16.** The existing ITAR Section 124.16 currently provides a limited exemption that authorizes access to unclassified defense articles exported in furtherance of or produced as a result of a Technical Assistance Agreement or Manufacturing License Agreement and the retransfer of covered technical data and defense services to employees of licensed signatories that are nationals of NATO member

states, EU Member States, Australia, Japan, New Zealand or Switzerland. The proposed rule published in August would have eliminated this existing exemption. In response to concerns expressed in comments from industry, DDTC retained the exemption under ITAR Section 124.16. As a result, ITAR Section 126.18 will now effectively become an exemption that is available in addition to, rather than instead of, Section 124.16. DDTC also responded to industry comments by adding language to ITAR Section 126.18 expanding the scope of the new exemption to apply to approved sublicensees.

- **DDTC adopted an expanded definition of “regular employee.”** In response to comments that transfers to contract employees should be eligible for the exemption, DDTC narrowly expanded the definition of “regular employee” to include not only permanent employees, but also workers who have long-term employment relationships with the approved foreign end-user. However, the new definition requires that the contract employees work full-time and exclusively for the company at its facilities under its direction and control, with no involvement by the staffing agency in the employee’s work, and execute a nondisclosure certificate for the company. The intent of the rule is to recognize only circumstances where entities have vested interests in screening employees for trustworthiness.

DUAL AND THIRD COUNTRY NATIONALS OF PROSCRIBED COUNTRIES

In response to comments, DDTC also clarified that the new exemption applies to employees from proscribed or restricted countries listed in ITAR Section 126.1, notwithstanding the last sentence of Section 126.1(a) making license exemptions inapplicable to such persons. Although under the new rule nationality does not, in and of itself, prohibit access to defense articles, employees who have “substantive contacts” with persons from countries listed in Section 126.1(a) are presumed to raise a risk of diversion unless DDTC determines otherwise. We note, however, that the final rule clarifies that screening for such “substantive contacts” is required only for employees without a government security clearance.

DDTC also further explained the meaning of “substantive contacts.” The new rule specifies that “substantive contacts” include the following activities:

- regular travel to proscribed countries;
- recent or continuing contact with agents, brokers, and nationals of such countries;
- continued demonstrated allegiance to such countries;
- maintenance of business relationships with persons from proscribed countries;
- maintenance of a residence in such countries;
- receiving salary or other continuing monetary compensation from such countries; or
- “acts otherwise indicating a risk of diversion.”

The proposed rule, by contrast, had referred to “recent” travel as well as “regular” travel under the first criteria, but DDTC deleted “recent” travel from the final rule. The final rule also added “brokers” to the categories of persons in the second criteria with whom “substantive contacts” may occur, and clarified that only “demonstrated” allegiance constitutes a substantive contact in the third criteria. The final rule also added three new criteria for “substantive contacts” — maintaining business relationships, maintaining a residence, and receiving salary or compensation — which had not appeared at all in the proposed rule.

Moreover, in response to comments, DDTC stated that contacts with family members in, and personal or business travel to, a country listed in ITAR Section 126.1 does not automatically

disqualify a person when the contacts with family members and travel are not likely to lead to diversion of controlled data or articles (e.g., contacts with government officials, agents or proxies). However, it appears that contacts with family members in these countries, as well as personal travel, must still be identified in the screening process.

Despite the additional information on the scope of the substantive contacts analysis, an important question remains as to whether companies would violate foreign privacy laws by collecting and retaining information about such substantive contacts in the course of their required screening processes, as well as making such information available to DDTC on request. We understand that DDTC has engaged with some foreign governments on this issue. However, until a determination of the legality of such screening processes is made under the privacy laws of the host countries, companies may be reluctant to use internal screening procedures in order to apply the exemption. As a result, the most plausible way for companies to use the exemption in the near-term will be with regard to those employees who have government security clearances, where no company screening is required.

FOREIGN BRANCHES OF U.S. COMPANIES

As we noted in our [Client Alert](#) on the proposed rule in August 2010, the proposed exemption does not appear to apply to foreign branches of U.S. companies. A “foreign business entity” is considered a “foreign person” under the new rule, and as defined in the ITAR, this excludes entities or groups incorporated or organized to do business in the United States.

Companies may wish to consider whether and how to adjust their internal procedures in response to this final rule, and whether to seek guidance from foreign privacy/anti-discrimination agencies in order to mitigate potential legal risk. As we are familiar based on past experience with both the ITAR and foreign law aspects of this rule, we are well-placed to assist companies with these issues.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our international trade controls practice group:

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