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PROPOSED AMENDMENTS TO THE ITAR BROKERING REGULATIONS AND OTHER RECENT EXPORT CONTROL DEVELOPMENTS

The Department of State issued a proposed rule on December 19, 2011 that would substantially overhaul the brokering provisions of the International Traffic in Arms Regulations ("ITAR"). Comments on the proposal are being accepted by the Department's Directorate of Defense Trade Controls ("DDTC"), which administers the ITAR, until February 17, 2012.

The brokering regulations have long posed compliance challenges due to their broad and ambiguous scope. While the proposed rule clarifies and simplifies the regulations in some respects, companies and individuals in the defense sector could be significantly affected by the proposed further expansion of regulated brokering activities to include many actions that "facilitate" the manufacture, export, import, transfer, or retransfer of a defense article or defense service -- even when the broker is not acting as an agent or intermediary. In particular, the revisions, if adopted, could result in a sharp increase in the number of persons required to register as brokers and a new compliance burden for these persons.

In other export control developments, the State and Commerce Departments have continued to publish proposed rules in connection with the Administration's export control reform efforts, proposing to transfer control over specific items from the U.S. Munitions List ("USML") of the ITAR to the Commerce Control List ("CCL") of the Export Administration Regulations ("EAR"). Four proposed rules were published on December 6, 2011, and four on December 23, 2011. The proposed rules, which are briefly summarized below following our discussion of the brokering proposed rule, would transfer control from the USML to CCL of certain military ground vehicles (Commerce rule and State rule), gas turbine engines (Commerce rule and State rule), submersible vessels and oceanographic equipment (Commerce rule and State rule), and surface warships and other combatant vessels (Commerce rule and State rule).

We are well-positioned to help companies and individuals analyze the impact of all nine rules on their business, and to prepare comments for the agencies' consideration.

ANALYSIS OF PROPOSED REVISIONS TO THE BROKERING REGULATIONS

The proposed rewrite of Part 129 of the ITAR, regulating brokering, contains major amendments to all facets of the brokering regulations, from the key definitions of "broker" and "brokering activity" to broker registration and prior approval requirements, the latter of which are similar to licensing for brokering activities. We examine proposed changes in each of these aspects of the regulations in turn below.

By way of background, these proposed amendments to the brokering regulations have been long awaited. The process of reviewing and amending these rules began in 2003, when the State Department noted in a report to Congress that it planned to assess the need to modify the brokering

regulations in light of its experience administering them. Draft revisions to the brokering regulations were released in 2009, but never officially published or opened for public comment. The current proposed rule differs in significant ways from the 2009 proposal, as highlighted below.

Definition of Broker and Brokering Activities

The revised Part 129 would change the definitions of "broker" and "brokering activities" to more closely track the definitions in the Arms Export Control Act ("AECA"), the statute that provides authority for the ITAR. These definitional changes are significant, since they establish the scope of the application of the brokering regulations.

Currently, ITAR Section 129.2 defines "broker" as "any person who acts as an agent for another" in negotiating or arranging contracts, purchases, sales, or transfers of defense articles or defense services in return for a fee, commission, or other consideration. Under the proposed rule, the definition of "broker" removes the agency and remuneration requirements, defining a broker simply as a person "who engages in brokering activities." According to DDTC, the removal of a requirement for an agency relationship brings the regulations in line with the AECA, which does not require that a person act as an agent to be considered a "broker" of defense articles or defense services. DDTC does not address the removal from the definition of "broker" of the remuneration requirement, which also does not appear in the statute. However, the information required to obtain prior approval for brokering activities under the proposed rule includes the "type of consideration received or expected to be received" by the applicant or others who participate in brokering activities from or at the direction of the applicant, and consideration for brokering activities also is required to be provided in annual brokering reports. Thus, DDTC still seems to assume that brokering will involve some exchange of consideration, even though that is no longer part of the definition of "broker."

The proposed rule similarly would modify the definition of "brokering activities" under ITAR Section 129.2 to encompass a broad range of activities, potentially resulting in a significant expansion in the activities that would be considered brokering. Currently, "brokering activities" are defined to include "acting as a broker" (thereby incorporating the agency and fee/commission requirements) and engaging in specific actions that "facilitate[] the manufacture, export, or import of a defense article or defense service." Under the revised Section 129.2, "brokering activities" would be defined as "any action to facilitate the manufacture, export, reexport, import, transfer, or retransfer of a defense article or defense service." As the ITAR do not define "facilitate," and a broker under the new Part 129 would not require any agency or intermediary relationship, a wide range of activities could constitute brokering under the revised definition. By contrast, the 2009 draft rule limited the scope of "brokering activities" by clarifying that such activities were limited to activities of an "intermediary nature" and which "materially facilitate[]" the manufacture, export, reexport, import, transfer, or retransfer of a defense article or defense service.

To illustrate the possible expanded scope, the proposed definition in Section 129.2(b) would provide broad descriptions of activities that would be considered "brokering activities," including financing, insuring, transporting, and freight forwarding of defense articles and defense services. Such activities also include "but [are] not limited to" soliciting, promoting, negotiating, contracting for, arranging, or otherwise assisting in the purchase, sale, transfer, loan, or lease of a defense article or defense service.

Brokering activities under the revised Section 129.2 would, as in the current version of the regulations, include those brokering activities performed by U.S. persons wherever located and by foreign persons present in the United States. The proposed rule also would clarify the extraterritorial application of the brokering regulations by including within their scope actions by any foreign person

located outside of the United States involving a U.S.-origin defense article or defense service, actions involving the import into the United States of any foreign-origin defense article, and brokering activities by a foreign person that are undertaken on behalf of a U.S. person. The issue of the reach of the ITAR brokering regulations into the activities of foreign persons has long been a subject of debate (highlighted by the 2005 ruling by the United States Court of Appeals for the D.C. Circuit in *United States v. Yakou*, 393 F.3d 231 (D.C. Cir. 2005), *amended*, 428 F.3d 241 (D.C. Cir. 2005)). The new regulations formalize the position that DDTC has taken about the expansive reach of the regulations to foreign persons when their activities involve U.S. defense imports, U.S.-origin defense articles, or defense trade activities with U.S. persons.

Finally, the proposed rule lists several specific categories of activities that are excluded from the scope of "brokering activities," including:

- Activities by a U.S. person in the United States that are limited exclusively to U.S. domestic sales or transfers;
- Activities by employees of the U.S. Government acting in an official capacity; and
- Activities that are limited to administrative services.

The first two exclusions largely track carve-outs in the definitions and registration exemptions sections of the current brokering regulations, while the "administrative services" exclusion is new. Examples in the proposal (Section 129.2(e)(3)) of administrative services that do not rise to the level of brokering include providing or arranging office space and equipment, hospitality, advertising, or clerical, visa, or translation services. Also outside the scope of brokering are "activities by an attorney that do not extend beyond providing legal advice to a broker," a carve-out that is narrowly framed and may require law firms to register as brokers if they assist companies in obtaining U.S. export licenses. However, it is noteworthy that DDTC describes this exclusion in the proposed rule's preamble more broadly, as excluding "the provision of legal advice by an attorney to his client."

Although these exclusions cabin the reach of the brokering regulations, they appear quite limited in scope. By contrast, the 2009 draft proposed rule provided an extensive list of activities that would have been excluded from the scope of brokering activities, including activities undertaken for a person's own benefit, activities that are not of an intermediate nature, activities undertaken by related companies on behalf of each other, and activities undertaken by a person on behalf of its employer or a related company of the employer. Under the expansive scope of the current proposed rule, without the benefit of these specific limitations or DDTC clarification of its intent in omitting these from the final proposal, all of these activities would appear to potentially fall within the scope of brokering.

Registration Requirements

The proposed revisions to Part 129 continue the requirement for brokers to register annually with DDTC, but make some changes in the registration process.

A revised Section 129.3 would clarify that registration is a precondition for both the issuance of prior approval for brokering activities and the use of exemptions. The proposed rule also adds and clarifies exemptions from broker registration requirements. Proposed Section 129.3(b) generally would exempt from brokering registration, prior approval, and reporting requirements:

- Employees of foreign governments and international organizations acting in an official capacity (ITAR Section 129.3(b)(1));

- Persons exclusively in the business of financing, insuring, transporting, or freight forwarding whose activities do not extend beyond such business (ITAR Section 129.3(b)(2));
- Persons registered as manufacturers or exporters under the ITAR and their U.S. person subsidiaries, joint ventures, and affiliates covered in their registration; their "bona fide and full-time regular employees"; and foreign brokers identified in their registration as their "exclusive brokers," where the activities of such persons do not extend beyond defense articles or defense services that are or will be covered by a DDTC export approval and are made by or on behalf of the registrant[1] (ITAR Section 129.3(b)(3)); and
- Persons, including their bona fide regular employees, whose activities do not extend beyond acting as an end-user of a defense article or defense service exported pursuant to a DDTC license or approval, or subsequently acting as a reexporter or retransferor of such items. (ITAR Section 129.3(b)(4)) (Note: in an example, DDTC explains that a foreign manufacturer that incorporates U.S. defense articles and sells the resulting foreign defense article is exempt from registration under this provision. *See* Example 7, 76 Fed. Reg. at 78,581. This provision is significant in light of the recent widely-reported BAE Systems plc enforcement case, in which DDTC imposed large penalties for such unregistered activities.)

Although these persons are exempted from registration, prior approval, and reporting requirements, under the proposed Section 129.3(c), exempt persons would remain subject to the policy on embargoes, which prohibits brokering activities involving countries listed in ITAR Section 126.1. Thus, while certain persons, such as freight forwarders or persons acting solely as end-users of defense articles exported pursuant to DDTC authorization, would be generally exempt from the requirements of the brokering regulations, they would be required under the brokering regulations to ensure that they are not engaging in any brokering activities involving proscribed countries or restricted persons.

If the revised ITAR Section 129.3(b)(3) does not apply, U.S. persons who are registered as manufacturers or exporters under Part 122 of the ITAR, including entities listed on their registration, are not required to register separately under Part 129 or pay a separate broker registration fee as long as they have identified themselves as brokers on the Statement of Registration. (Section 129.3(d).) However, the other requirements of Part 129 still apply.

In light of the new expansive scope of brokering activities, it is likely that the proposed rule, if adopted, could significantly expand the number of persons and companies required to register as brokers. This could impose a significant administrative burden on DDTC to process the applications and on "brokers" who then would be required to maintain, update, and renew their registrations and file annual reports of their brokering activities.

Prior Approval and the Elimination of Prior Notification Requirements

The brokering regulations currently require those engaging in brokering activities to obtain prior approval from DDTC, which is similar to licensing, for brokering activities that are not exempt from this requirement. In addition, certain activities may be subject to a slightly different process known as "prior notification." The interplay of the prior approval and prior notification provisions, and the exemptions to these requirements, has long been a source of confusion among those in the defense industry.

The proposed revised Section 129.6 would specify that all persons engaged in brokering activities must obtain prior approval, unless such activities are specifically exempted from this requirement.

[1] However, in this situation, such persons must still retain records of their brokering activity.

Prior approvals would be valid for not more than four years. The prior notification provision would be eliminated in its entirety.

The list of brokering activities exempt from prior approval requirements, as set forth in ITAR Section 129.7, would be expanded from the current list of exclusions in certain significant ways, but would be limited in other ways.

First, the current exemptions for brokering activities undertaken by or for an agency of the U.S. government and for activities arranged within the North Atlantic Treaty Organization ("NATO"), NATO member countries, Australia, Japan, New Zealand, and South Korea are preserved within the proposed revision. However, both provisions were revised by DDTC. The exemption for brokering activities undertaken for or by an agency of the U.S. government is available only for activities undertaken pursuant to a contract between the government and the broker, and the defense articles must be for use solely by the U.S. government agency. This limitation makes clear that the exemption may not be utilized by subcontractors on U.S. government programs who are not directly contracting with the government. Similarly, the NATO exemption would be clarified to state that brokering activities must be undertaken wholly within the listed countries and the defense articles or defense services must be located within those countries.

Second, the revised ITAR Section 129.7 also would add a new exemption from prior approval requirements for brokering activities outside of the NATO member countries, Australia, Japan, New Zealand, and South Korea that involve U.S. defense articles or defense services that are not designated as significant military equipment ("SME"), are valued at less than $25 million, and are not on a list of sensitive items for which exemptions from prior approval are unavailable. This new exemption is only available, however, where the end use is "by an international organization or foreign government."

As noted above, if brokering activities involve any of a long list of specific items, these exemptions are not available and prior approval still would be required. This list includes all of the items found in the current Section 129.7, but also would include additional items, such as man-portable air defense systems, non-automatic firearms, night vision equipment, spacecraft items that are SME, submersible vessels and oceanographic equipment, directed energy weapons, and miscellaneous articles classified in Category XXI of the ITAR. These exclusions are significant and limit the utility of these prior approval exemptions for brokers in a number of industries.

As noted, the proposed rule would eliminate the prior notification requirement found in the current ITAR Section 129.8. As DDTC explained in the Notice of Proposed Rulemaking, this provision was nominally a notice provision, but "had the effect of being a prior approval requirement and proved to be confusing and difficult to administer."

Other Issues

Section 129.10 of the proposed rule would expand somewhat the information that must be provided in the required reports of brokering activities, which are not made publicly available. In particular, the rule would require registrants to identify all persons who participated in the activities, including their name and function, and describe the compensation received by any person who participated in the brokering activities. Reports would be submitted annually with registration renewals, not all at one specified time, as now.

In addition, Section 127.1 would be revised to state that any person who is granted a license or other approval by DDTC is responsible for the acts of brokers relating to the relevant defense article.

This change is significant because it demonstrates that DDTC will hold exporters liable for their brokers' failure to register, report, and keep records. The approach is consistent with the penalties DDTC recently imposed on BAE Systems plc for the use of unregistered brokers.

Summary

While those affected by the brokering regulations have long awaited a change to the confusing and ambiguous requirements of this part of the defense trade controls scheme, the proposed rule released recently by DDTC provides mixed results in terms of clarifying the limits of the brokering regulations. Certain of these changes are likely to be welcomed by industry, including the expansion of exemptions from prior approval requirements and the elimination of prior notification. However, this is likely to be overshadowed by the elimination of the agency and remuneration requirements in the definition of brokering activities, which could significantly expand the regulatory reach of the brokering provisions and require many other companies and persons to comply with this regime through registration, prior approval, reporting, and recordkeeping requirements.

OTHER RECENT PROPOSED RULES

As noted above, the Departments of State and Commerce each also recently published four proposed rules each in connection with the advancement of the Administration's export control reform initiative. Similar to other recent proposed rules involving military aircraft, these proposed rules would remove certain items from the USML and create corresponding new entries on the CCL where the former ITAR items would be controlled. These proposed rules help to implement efforts to establish the USML as a "positive list" and move away from its emphasis on design intent in determining control.

Military Vehicles

The State Department proposed rule related to military vehicles would alter Category VII of the USML to "narrow the types of ground vehicle[s] controlled on the USML to only those that warrant control under the stringent requirements of the AECA." In proposing this rule, DDTC intended to create a "bright line" between the USML and CCL controls on ground vehicles. In doing so, most unarmored and unarmed military vehicles, along with armored (but unarmed) vehicles manufactured prior to 1956, would be moved to Commerce jurisdiction. The State proposed rule also would establish a positive list of ground vehicle parts and components that would remain controlled on the USML, while other parts and components would be controlled under the CCL.

The corresponding Commerce Department proposed rule represents a revision of a proposal it published on July 15, 2011 to describe the controls on military vehicles and related articles that no longer warranted control under the USML. The proposed rule addresses a number of comments received in connection with the earlier proposed rule, and proposes some additional changes.

Manufacturers and exporters of military vehicles and vehicle parts and components should closely review both proposed rules to assess their potential impact, and both Departments have encouraged the submission of industry comments, which are due by January 20, 2012.

Gas Turbine Engines

The State Department proposes to add a new Category XIX to the USML, which would control certain gas turbine engines and associated equipment currently controlled in Categories VI, VII, and VIII. The new Category would combine controls for gas turbine engines used for surface vessels, vehicles, and aircraft that meet specific criteria. Certain specified parts and components of gas turbine engines also would be controlled under the Category XIX, while other specific parts would be controlled under the CCL.

The corresponding Commerce Department proposed rule would establish these new CCL engine controls, combining the transferred items with certain aircraft engines currently controlled in various entries on the CCL. As a result, a single new CCL entry for Commerce-controlled aircraft gas turbine engines would be created.

The Departments of State and Commerce both encourage the submission of comments regarding the effects that the proposed rule would have on exporters of gas turbine engines. Comments are due by January 20, 2012.

Submersible Vessels

The State Department has proposed to revise Category XX of the USML by adding submarines that were formerly controlled under Category VI to consolidate the controls that would apply to all submersible vessels into one category of the USML. The revised Category XX also would control naval nuclear propulsion power plants for submersible vessels, currently controlled under Category VI. To add greater clarity, the proposed rule would add a definition of submersible vessel to ITAR Section 121.14. Notably, unlike other similar proposed rules that would move items from the USML to the CCL, this rule would not affect the licensing jurisdiction of parts, components, and accessories that are "specially designed" for articles controlled under Category XX of the USML; due to the sensitivity of the technology associated with submersible vessels, such items would continue to be controlled on the USML, rather than being shifted to the CCL.

The corresponding rule published by the Commerce Department would create four new entries on the CCL, in Category 8, that would clarify EAR controls over submersible vessels not controlled on the USML and would impose controls over harbor entrance detection devices and related articles that no longer warrant control under the USML. The Commerce rule also proposes to establish new unilateral controls on submersibles "specially designed" for cargo transport, which are not currently subject to USML or CCL controls, because such devices are known to be used for illegal drug trafficking.

Comments to the Departments of State and Commerce are due by February 6, 2012.

Vessels of War

The proposed rule published by the State Department would revise USML Category VI to establish a bright line between USML and CCL controls over surface vessels of war (such as warships and combatant vessels) and special naval equipment and related accessories. This proposed rule also would, as discussed above, remove harbor entrance detection devices from control on the USML (shifting such items to the CCL), and would move control of submarines from Category VI to Category XX of the USML.

Similarly, the related Commerce rule would establish five new entries on the CCL, in Category 8, to control surface vessels of war and related articles that no longer warrant control under the USML.

Comments regarding these rules are due by February 6, 2012.

CONCLUSION

We are well-positioned to assist clients in understanding the impact that the above-described proposed rules would have, if adopted, on their operations, and in assisting clients or groups of clients in preparing comments in response to these proposed rules.

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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