

The Latest Developments in US Export Controls: Export Control Reform and Compliance Strategies

Contacts

Jeffrey Gerrish

202.371.7381
jeffrey.gerrish@skadden.com

Michael Loucks

617.573.4840
michael.loucks@skadden.com

Nathaniel Bolin

202.371.7893
nathaniel.bolin@skadden.com

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Four Times Square
New York, NY 10036
212.735.3000

500 Boylston Street
Boston, MA 02116
617.573.4800

1440 New York Avenue, NW
Washington, D.C. 20005
202.371.7000

On October 22, 2015, Skadden presented a webinar titled “The Latest Developments in U.S. Export Controls: Export Control Reform and Compliance Strategies.” Guest speakers were Benjamin Turkel, trade compliance counsel at Raytheon; Sarah Heidema, chief of regulatory and multilateral affairs at the U.S. State Department’s Directorate of Defense Trade Controls (DDTC); and John McKenna, special agent in charge of the Boston Office of Export Enforcement for the U.S. Commerce Department’s Bureau of Industry and Security (BIS). Panelists from Skadden were Michael Loucks, a government enforcement and white collar criminal defense partner; Jeffrey Gerrish, partner in the International Trade Group; and counsel Nathaniel Bolin, also of the International Trade Group.

Mr. Loucks opened the conference with the observation that in this arena of export controls, there are a thicket of rules and regulations applicable to exports to a broad array of countries, and businesses engaged in export to those countries that must be cognizant of these rules range from defense industry contractors to transportation companies, universities, high-tech companies and banks. Mr. Loucks also observed that enforcement of export laws has increased substantially over the past decade, with cases including fines upward of \$600 million imposed on a financial institution for engaging in financial transactions associated with prohibited exports. Mr. Loucks commented that prohibited countries for exports of defense articles and defense services range from the expected — China and Iran — to countries like Syria and Cuba, and that the array or listing of controlled exports of dual-use items is even more complex and extensive. Issues can arise not only in ongoing operations but during the acquisition of companies and the discovery of issues in the acquired company. Mr. Loucks commented that understanding the rules is the first priority, followed by implementation of steps to assure compliance. The last piece concerns federal enforcement and the need to deal with federal prosecutors, not only with the Departments of Commerce and State but also with U.S. attorney’s offices and the Department of Justice.

Overview

Mr. Gerrish provided an overview of the major export control regimes in the United States: the International Traffic in Arms Regulations (ITAR) administered by DDTC, which controls the manufacture and export of defense articles and defense services as well as associated brokering activities, and the Export Administration Regulations (EAR) administered by BIS, which controls the export of dual-use goods, software and technology. Both regimes require licenses for exports and transfers of controlled

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items, provide exceptions for certain transactions, and impose significant civil and criminal penalties for violations. In addition, companies that manufacture, export or engage in various “brokering activities” involving defense articles and defense services must register under the ITAR. Mr. Gerrish highlighted the U.S. government’s position that successors-in-interest are liable for violations by the entities that they acquire, regardless of the form of the acquisition. Accordingly, it is imperative for investors as well as manufacturers, exporters and brokers to stay up to date on developments such as Export Control Reform (ECR) and to ensure that best practices for export control compliance are in place.

Export Control Reform

Mr. Bolin gave an overview of the ongoing ECR process. Major goals of ECR include simplifying and streamlining trade in controlled items with NATO and major non-NATO allies, moving certain items from the U.S. Munitions List (USML) to the less-restrictive Commerce Control List (CCL), placing higher regulatory fences around the “crown jewels” of the U.S. defense industry and laying the groundwork for a transition to a single export licensing and enforcement agency. Since ECR began in August 2009, DDTC and BIS have revised most of the 21 major categories of controlled defense articles and services and will soon release proposed rules for the remaining categories: firearms; artillery; ammunition; fire control, sensors and night vision; toxicological agents; and directed energy weapons. Participants were given links to a variety of resources on the BIS and DDTC websites where they can learn more about the ECR changes.

Ms. Heidema emphasized that the ECR process will not be the end of reforms to the U.S. export control regime. The USML’s redesign as a positive list of specifically enumerated defense article and defense services will require ongoing review and engagement with industry to determine whether items should be removed or added to the list. Ms. Heidema noted that DDTC relies on public comments and industry feedback on what is working with the ECR process and what isn’t, and encouraged active participation in the process. Ms. Heidema explained that there is still work to do on ECR, but that she expected that final rules revising key ITAR and EAR definitions and USML Category XII (fire control, sensors and night vision) would be released in the near future. Finally, Ms. Heidema encouraged compliance personnel who are seeking guidance regarding the impact of ECR on their operations to visit the Frequently Asked Questions section of DDTC’s website and to contact DDTC with questions.

Mr. McKenna observed that as result of ECR, enforcement officials are increasingly focused on the crown jewels and other priority areas that have been identified during the ECR process. In addition, BIS is continuing to reach out to industries and specific companies impacted by ECR.

Mr. Turkel gave an overview of ECR’s impact on his company and industry. According to Mr. Turkel, ECR has made exporting and importing easier for small- and medium-sized enterprises and has provided much-needed clarity and harmonization. On the other hand, for larger entities, compliance costs have increased in the short term due to the ongoing revisions to the ITAR and EAR and the need to flow down compliance requirements to suppliers.

Mr. Gerrish ended the panel discussion on ECR by noting that the pace of ECR may accelerate as President Barack Obama’s term draws to a close and that companies should expect to see more movement on outstanding issues such as USML categories that have not yet been revised. He also noted that in recognition of the complexities of complying with the ECR changes, DDTC has recently extended the transition period for ITAR licenses granted prior to the revisions to the USML and CCL.

Enforcement Trends

Mr. Loucks introduced the current trends in enforcement by discussing several recent cases where individuals and entities were penalized for export control violations. The cases involved individuals and entities across a wide spectrum of the economy, from educational institutions to industrial and consumer companies, financial institutions, and foreign entities.

Addressing recent trends in export control enforcement, Mr. McKenna explained that many export control violations are bleeding into areas outside of export controls such as sanctions, government contracts, homeland security and other areas of criminal law. As a result, BIS and DDTC have increased their cooperation with other government agencies to investigate and enforce export control violations. Transactions involving sensitive countries such as Iran, North Korea, China, Russia and Syria continue to make up the bulk of enforcement actions. This enforcement environment has made the need for effective compliance programs greater than ever.

Ensuring Compliance with Export Control Laws and Regulations

Mr. Turkel discussed some practical ways to keep up to date on compliance cases and best practices and how to communicate compliance goals to internal stakeholders. He explained that Raytheon’s compliance personnel and in-house legal counsel regularly monitor press releases from DDTC and BIS for developments or enforcement actions that may impact his company’s line of business or its suppliers. When discrete issues arise, the general counsel’s office will establish a project team to address and resolve problems. Changes in policies and procedures are communicated to company personnel through internal email, news bulletins and announcements.

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Mr. Turkel also explained that a company should employ many tools to ensure export control compliance since all parts of an organization can be affected by export control requirements, including sales, logistics, security, engineering, human resources and the legal department. Mr. Turkel advised companies to develop a coherent way of allocating resources to export control compliance. He suggested performing organizational effectiveness reviews for compliance personnel, benchmarking against other company and industry practices, conducting risk-based assessments and audits, and identifying company divisions with more intense levels of export-controlled activities and risks.

With respect to investors looking at acquiring a company involved in the manufacture or export of controlled items, Mr. Gerrish emphasized that investors should perform thorough due diligence in advance of signing. Investors should ensure that any merger and acquisition agreements include appropriate representations, warranties and indemnity provisions specifically addressing export control risks. He also emphasized the potential impact of violations on valuation and how acquirers can get ahead of these risks, such as by requiring voluntary self-disclosures of potential violations to DDTC or BIS before closing. After closing, it is wise for the acquiring party to actively address compliance risks, such as by conducting audits and assessments, enhancing policies and procedures, and investing in staffing and systems.

Mr. Bolin discussed specific steps that companies and investors can take when conducting presigning due diligence. It is critical for potential acquirers to thoroughly understand a potential target's business lines, technologies and services, and how they may be regulated under the export control laws. Additionally, companies must be cognizant of the potential need to register under the ITAR, procure or transfer export licenses and notify agencies of possible sales or acquisitions of businesses involved in export-controlled activities. The presentation accompanying Mr. Gerrish's and Mr. Bolin's comments included a detailed list of export compliance best practices and due diligence questions that can help companies and investors reduce the risk of liability for export control violations.

Mr. Bolin also addressed likely changes in the U.S. export control laws with respect to Iran and Russia. He noted that in the short term, little is likely to change with regard to the existing U.S. export controls on trade with Iran. With respect to Russia, it also is unlikely that existing export controls will be loosened over the next six months or more, and that much will depend on developments on the ground in Crimea and elsewhere.

Internal Investigations, Voluntary Disclosures and Agency Action

Mr. Turkel discussed concrete steps that companies can take when they become aware of potential export control violations, and how to learn about and address potential issues as soon as possible. For example, companies should provide a way for employees to easily report potential violations, such as an anonymous hotline. Once a potential violation has been identified, the company should set up a case number for the investigation, maintain records and proceed in a timely manner. It can also be helpful to engage outside counsel to provide additional knowledge and an independent opinion. The investigation should be broad and seek to uncover all relevant facts. Ultimately, the investigation should result in corrective action. If necessary, companies should be prepared to discipline employees and provide a voluntary self-disclosure to the relevant agencies.

Mr. Gerrish agreed that companies should move as quickly as possible to stop the conduct at issue and prevent future violations. Companies should ensure that inquiries and analyses are made under attorney-client privilege, set up a schedule for the investigation and establish target dates for making key decisions such as whether or not to make a voluntary self-disclosure. In order to get credit for voluntary self-disclosures, companies must ensure that their submissions are complete and accurate.

Mr. McKenna also emphasized the importance to BIS of timeliness and completeness in internal investigations and voluntary self-disclosures. BIS gives great weight as a mitigating factor to a company's attempt to report a potential violation. Mr. McKenna provided presentation slides summarizing the results of voluntary self-disclosures in recent years, which showed that penalties resulting from such self-disclosures were rare. Such cases typically involved a repeat offender, willful avoidance of export controls or violations involving problematic destinations such as Iran or Syria.

Mr. Turkel emphasized that companies should take investigations of potential export control violations seriously and ensure that the highest levels of leadership are engaged. It is important for in-house legal counsel to quickly identify records custodians, impose a legal hold on documents and determine how attorney-client privilege will be used throughout the investigation. Mr. Gerrish concurred that counsel must move quickly and be thorough. In addition, he advised that upon receiving notice of an investigation, in-house counsel should broadly examine the company's compliance practices to identify any other problem areas that may come up during the agency's investigation.

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Mr. McKenna reiterated that companies can greatly mitigate any consequences by timely and complete cooperation. However, with respect to the relevance of companies' compliance practices, he drew a distinction between civil and criminal investigations. To the extent that criminal violations are involved, BIS is less concerned with internal company policies, procedures and investigations.

Mr. Loucks addressed the policy memorandum recently issued by Deputy Attorney General Sally Quillian Yates regarding individual liability in matters of corporate wrongdoing. While the focus on individual liability for corporate wrongdoing is not new, the Yates memo is likely to have an impact on a variety of issues that may arise during an investigation, such as establishing attorney-client privilege and managing an investigation potentially involving both civil and criminal charges against both the company and individuals. Mr. Bolin observed that the Yates memo also underscores the need to have effective compliance policies and practices in place, including those that emphasize individual accountability.

In closing, Mr. McKenna and Ms. Heidema offered some thoughts on what their agencies would like to see from industry and individual companies that may be affected by U.S. export controls. Mr. McKenna stated that with respect to export control compliance, BIS hopes that company leadership will be strongly supportive of compliance efforts. Leadership should see compliance as an investment rather than a cost even though the benefits can sometimes be difficult to quantify in the short term. Ms. Heidema also encouraged companies to prioritize compliance, especially in light of the far-reaching changes implemented under ECR, and encouraged companies to provide input to the ECR process and other ongoing efforts to improve the U.S. export control regulations.