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U.S. MOVES TO TIGHTEN EXPORT CONTROLS ON CHINA AND OTHER JURISDICTIONS WITH POLICIES OF CIVIL-MILITARY FUSION

To Our Clients and Friends:

The U.S. Department of Commerce, Bureau of Industry and Security (“BIS”) is moving forward with long-anticipated efforts to further restrict trade in a large number of sensitive technologies. Though the rules ostensibly apply to a number of countries, they are particularly focused on China and, as such, will have a significant impact on global supply chains that link the United States and China for years to come. While aspects of the new rules reflect the United States’ longstanding restrictions on exports in support of the Chinese military, they also advance several more recent Trump Administration national security and foreign policy priorities.

With broad Congressional support, the Trump Administration has significantly expanded restrictions on all facets of trade with China over the last several years. Using a wide array of tools, the U.S. Government has (1) increased its scrutiny of Chinese investment in the United States and associated technology transfers to China under the Committee on Foreign Investment in the United States’ (“CFIUS”) review process, (2) discouraged the import of Chinese goods through the imposition of new tariffs, (3) prohibited U.S. Government procurement of telecommunications and security technology from several major Chinese companies, and (4) engaged in efforts to dissuade U.S. allies from partnering with Huawei and other Chinese telecommunications providers in the development and deployment of 5G networks. The Departments of Justice and Commerce have also brought sweeping enforcement actions against some of China’s most significant companies, which combine criminal and civil enforcement with potent export controls, such as the BIS’s sweeping export restrictions on Huawei and many of its affiliates.

BIS’s actions this past week further expand U.S. export controls in an effort to address the U.S. government’s increasing concerns regarding overlap between China’s economic and military programs.

Expanding Restrictions on Exports for Military End Uses or to Military End Users

BIS’s announced rule changes are only the latest steps in a series of moves set in motion by the enactment of the Export Controls Reform Act of 2018 (“ECRA”). Through ECRA, Congress expressed concern about the strength of U.S. trade controls concerning China, and required an interagency review of the U.S. arms embargo and controls on exports of dual use items for military end uses and end users. The regulatory changes stemming from this review were due to be released in May 2019, but were likely delayed as BIS officials juggled other ECRA and Administration priorities, including the identification of new controls on emerging and foundational technologies and weighing how new rules focused on

military end users would impact the broader U.S.-China trade dispute and the Trump administration's on-again-off-again trade negotiations with China.

The United States has had a decades-long embargo in place on the export of military items to China. The United States last **expanded** these restrictions in 2007 to prohibit the export to China of certain dual-use items—items with both civil and military applications—that are intended for a “military end use.” In the most substantial change announced this past week, BIS is imposing strict new licensing requirements, effective June 29, 2020, on the export of an expanded list of dual-use items when those items are exported for military end uses or end users in China, Russia, and Venezuela.

Specifically, the new rule strengthens the controls on exports to these jurisdictions by:

- Expanding the definition of “military end uses” for which exports must be authorized;
- Adding a new license requirement for exports to Chinese “military end users”;
- Expanding the list of products to which these license requirements apply; and
- Broadening the reporting requirement for exports to China, Russia, and Venezuela.

Expanding Military End Uses Subject to Control

Exporters of certain goods, software, or technology that are subject to the Export Administration Regulations (“EAR”)[1] currently require a license from BIS to provide those items to China, Russia, or Venezuela if the exporters know or have reason to know that the items are intended, entirely or in part, for a “military end use” in those countries. Under this license requirement, “military end use” is defined to include the “use,” “development,” or “production” of certain military items. An export is considered to be for the “use” of a military item if the export is for the operation, installation, maintenance, repair, overhaul **and** refurbishing of the military item. The exported item must perform all six functions in order to be considered a “use” item subject to the military end use restriction.

The new rule expands the definition of “military end use” in two important ways. Where the current formulation only captures items exported for the purpose of using, developing, or producing military items, the revised rule also captures items that merely “*support or contribute to*” those functions. The revised rule also effectively broadens the definition of “use.” Rather than requiring that an item perform all six previously listed functions, an item that supports or contributes to any one of those functions will now be subject to the military end use license requirement. For example, a repair part for a military item that might not have required a license under the previous formulation (perhaps because it was not also required for the military item’s installation) would be subject to the updated license requirement.

Restricting Exports to Chinese Military End Users

Under the current regulations, exports to military end *users* in Russia and Venezuela are subject to a specific license requirement. The revised rule will also require licenses for exports of covered items to Chinese military end users.

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Military end users covered by this license requirement not only include national armed services, police, and intelligence services, but also include “any person or entity whose actions or functions are intended to support ‘military end uses.’” Taken together with the newly broadened definition of “military end uses,” this restriction could apply to a significant number of private entities in China, even those that are engaged largely in civilian activities. For example, a manufacturing company that has a single, unrelated contract with a military entity could be considered a “military end user” subject to these strict licensing requirements. Given that applications for BIS licenses to export covered items for military end uses or end users face a presumption of denial, this restriction could have a significant impact on large swaths of the Chinese economy, where the U.S. government has indicated its concerns about military-civilian collaboration in Chinese industry.

Expanding the List of Covered Items

The updated rule also expands the category of goods, software, or technology that require a license for military end use or end user exports. The current license requirement applies to a relatively limited set of items specifically described in a supplement to the rule. The revised rule will expand the scope of the item categories already listed and add many new categories of covered items—including goods, technology, and software relating to materials processing, electronics, telecommunications, information security, sensors and lasers, and propulsion.

Many of the new items are currently subject to some of the EAR’s most permissive controls and, at this time, do not generally require a license for export to China, Russia, or Venezuela. For example, mass market encryption items—a category which includes many types of software that incorporate or call on common encryption functionality—are not currently subject to the military end use restrictions but will be added pursuant to this week’s revision.

Broadening the Reporting Requirement

BIS will also be requiring exporters to report more often and to provide more data on items provided to China, Russia, or Venezuela.

Under the current rules, exporters are not required to provide Electronic Export Information (“EEI”) for shipments valued under \$2,500. Exporters also are not required to provide the Export Control Classification Number (“ECCN”) for shipments of items that are only controlled for export because of antiterrorism concerns—the most permissive and most frequently applied category of control on the EAR’s list of items controlled for export.

Under the new rules, there will be no value threshold. EEI will generally be required for all shipments to China, Russia, or Venezuela, regardless of value. Moreover, exporters will be required to provide the ECCNs for all items exported to China, Russia, or Venezuela, regardless of the reason for control.

In announcing this change, Commerce Secretary Wilbur Ross noted that “[c]ertain entities in China, Russia, and Venezuela have sought to circumvent America’s export controls, and undermine American interests in general.” Secretary Ross vowed that the United States would “remain vigilant to ensure U.S. technology does not get into the wrong hands.” This amendment to the EEI reporting requirements is

designed to ensure that BIS and other U.S. Government trade enforcement agencies have increased visibility into shipments to jurisdictions of significant concern.

Removing the License Exception for Civilian End Uses

BIS also announced that it will remove License Exception Civil End Users (“CIV”) from Part 740 of the EAR. This exception currently allows eligible items controlled only for National Security (NS) reasons to be exported or reexported without a license for civil end users and civil end uses in countries included in Country Group D:1, excluding North Korea. NS controls are BIS’s second most frequently applied type of control, applying to a wide range of items listed in all categories of the Commerce Control List (“CCL”). Country Group D:1 identifies countries of national security concern for which the Commerce Department will review proposed exports for potential contribution to the destination country’s military capability. D:1 countries include China, Russia, Ukraine, and Venezuela, among others.

By removing License Exception CIV, the Commerce Department will now require a license for the export of items subject to the EAR and controlled for NS reasons to D:1 countries. As with the expansion of the military end use/end user license requirements described above, the Commerce Department has stated that the reason for the removal of License Exception CIV is the increasing integration of civilian and military technological development pursued by countries identified in Country Group D:1, making it difficult for exporters or the U.S. government to be sufficiently assured that U.S.-origin items exported for apparent civil end uses will not actually also be used to enhance the military capacity contrary to U.S. national security interests.

Proposing the Expansion of License Requirements for Reexports

The third change is a proposed amendment to the EAR’s License Exception Additional Permissive Reexports (“APR”). License Exception APR currently allows the unlicensed reexport (the export of a U.S.-origin item from one non-U.S. country to another non-U.S. country) of an item subject to the EAR from trusted allies with similar export control regimes (i.e., listed in Country Group A:1, and Hong Kong) to countries presenting national security concerns (i.e., Country Group D:1, except North Korea). To be eligible for the exception, the reexport must also be consistent with the export licensing policy of the reexporting country and the item must be subject to only a subset of other controls (i.e., controlled only for antiterrorism, national security, or regional security reasons), among other limitations. The reexporting countries identified in Country Group A:1 include those countries that are participants with the United States in the Wassenaar Arrangement, a multilateral consortium that develops export controls on conventional weapons and dual-use items and underlies much of the U.S. export control regime. BIS’s proposed amendment would remove this portion of the license exception.

The Commerce Department explained that it has proposed this amendment because of concerns regarding variations in how the United States and its international partners, including those in Country Group A:1, perceive the threat caused by the policy of civil-military technological integration pursued by D:1 countries. Due to these disparities, reexports under License Exception APR have occurred that would not have been licensed by BIS if the export had taken place directly from the United States.

This proposed rule change echoes recent changes affecting the scope of investment reviews by CFIUS, by which the United States has similarly sought to incentivize foreign allies to harmonize their national security-related measures with those of the United States. In the new CFIUS rules implemented in February and previously described [here](#), the Committee will require “excepted foreign states” to ensure their national security-based foreign investment review process meets requirements established by CFIUS in order to retain their excepted status.

How Will the New Rules Impact U.S.-China Trade and Global Supply Chains?

The removal of the CIV license exception, the imposition of new controls on military end uses and military end users in China, and the proposed modification of the APR license exception, taken together, will have significant and far-reaching impacts on U.S.-China trade and global supply chains that include many kinds of U.S. origin commodities, software and technology.

Upstream Suppliers to Chinese Companies

For upstream suppliers to Chinese companies (and their Russian and Venezuelan counterparts), enhanced due diligence to determine whether items to be supplied are destined to military end users or will be put to military end uses will become the norm. Not only will exporters, reexporters, and those transferring items subject to export controls need to better know their proposed customers and how their customers intend to use their products through front-end diligence, if possible military end use and end user concerns are identified, exporters can expect BIS to ask probing follow-up questions regarding customers and end users identified in license applications.

The diligence required to monitor for military end use will not end with the sale of many items. Especially for products that are provided with aftermarket service or warranties, companies will need to consider how to train those business personnel with continued contacts with Chinese, Russian and Venezuelan counterparties to monitor for potential diversion to military end use. Moreover, diligence will not necessarily be limited to the supply of items to subject to the EAR to China, Russia and Venezuela. For example, to the extent China-owned companies or joint ventures in Europe or elsewhere place orders for items subject to the EAR, BIS’s new diligence and licensing requirements will apply to those transactions as well.

License Application Processing and Delay

The removal of License Exception CIV and proposed changes to License Exception APR will also introduce new trade compliance resource burdens on companies that continue to do business with China and delays and uncertainty into supplier transactions and relationships. Companies that have made significant use of CIV in the past will now need to allocate additional labor to the preparation of license applications, and many non-U.S. companies that source items from U.S. suppliers will need to devote resources to learning how to prepare and file re-export and transfer license requests with BIS. Even if BIS has developed a plan to increase the staffing available to process these license applications, the interagency review of license applications can easily introduce months of delay to planned transactions. Especially for companies that have shifted to just-in-time production models, delays of even a few days can scuttle proposed business. Global suppliers may be faced with the hard choice of continuing to source

commodities, technology and software from the U.S. for products destined for China and D:1 country markets, or switching out U.S. for non-U.S. content in order to avoid this type of supply chain disruption.

Downstream Customers of Chinese Companies

At least in the short term, BIS's rule changes are also likely to have an impact on companies that source products from Chinese suppliers. To the extent the Chinese suppliers might be identified as military end users, or may not provide the kinds of information that will be required to continue receiving items subject to the EAR under a license requirement, these suppliers may lose access to key commodities, software and technology that they require for their own products. Until Chinese suppliers design-out U.S.-origin content or provide their U.S. suppliers with the additional information required to obtain licenses for their supply transactions, their own customers are likely to experience delay and disruption in their receipt of items with U.S.-controlled content.

Fragmentation of Non-U.S. Export Control Regimes and Trade Relationships

Although BIS's proposed changes to the APR license exception are still only proposed, the frequent use by the Trump Administration of other trade tools to leverage changes by U.S. trade partners in other areas of trade policy provides a glimpse of the potentially divergent paths that responses to this sort of selective leveraging might take. In essence, the changes to the APR rules will force other Wassenaar Arrangement countries to decide whether to impose more stringent licensing requirements on proposed reexports to China, or impose new transaction costs on their own companies associated with supply transactions that could now require transaction-by-transaction licensing. Depending on the strength (and dependence) of their own trade ties with China or other D:1 countries, these countries may be more or less willing to follow the United States' lead toward stricter trade controls. Over time, this could lead to greater fragmentation in the international trade system and a realignment of global trade in the sensitive technologies current licensed by APR both toward and away from the United States and China. Especially given the longer-term impacts that APR may have on U.S., EU, UK, and other Wassenaar Arrangement participants' trade arrangements with the U.S., companies straddling the trade controls regimes of these countries should consider providing comments to BIS' proposed rule, which are due by June 29, 2020.

[1] Including all items located in the United States, all U.S. origin items wherever located, foreign-made items incorporating, bundled with, or comingled with any amount of certain controlled content or more than a minimal amount of other controlled U.S.-origin content, and certain foreign-made items that are direct products of U.S. technology or software.



The following Gibson Dunn lawyers assisted in preparing this client update: Judith Alison Lee, Chris Timura, R.L. Pratt, Samantha Sewall, Laura Cole and Josh Suo Zhang.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding the above developments. Please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any of the following leaders and members of the firm's International Trade practice group:

United States:

Judith Alison Lee - Co-Chair, International Trade Practice, Washington, D.C. (+1 202-887-3591, jalee@gibsondunn.com)

Ronald Kirk - Co-Chair, International Trade Practice, Dallas (+1 214-698-3295, rkirk@gibsondunn.com)

Jose W. Fernandez - New York (+1 212-351-2376, jfernandez@gibsondunn.com)

Marcellus A. McRae - Los Angeles (+1 213-229-7675, mmcrae@gibsondunn.com)

Adam M. Smith - Washington, D.C. (+1 202-887-3547, asmith@gibsondunn.com)

Stephanie L. Connor - Washington, D.C. (+1 202-955-8586, sconnor@gibsondunn.com)

Christopher T. Timura - Washington, D.C. (+1 202-887-3690, ctimura@gibsondunn.com)

Ben K. Belair - Washington, D.C. (+1 202-887-3743, bbelair@gibsondunn.com)

Courtney M. Brown - Washington, D.C. (+1 202-955-8685, cmbrown@gibsondunn.com)

Laura R. Cole - Washington, D.C. (+1 202-887-3787, lcole@gibsondunn.com)

R.L. Pratt - Washington, D.C. (+1 202-887-3785, rpratt@gibsondunn.com)

Samantha Sewall - Washington, D.C. (+1 202-887-3509, ssewall@gibsondunn.com)

Audi K. Syarief - Washington, D.C. (+1 202-955-8266, asyarief@gibsondunn.com)

Scott R. Toussaint - Washington, D.C. (+1 202-887-3588, stoussaint@gibsondunn.com)

Shuo (Josh) Zhang - Washington, D.C. (+1 202-955-8270, szhang@gibsondunn.com)

Europe:

Peter Alexiadis - Brussels (+32 2 554 72 00, palexiadis@gibsondunn.com)

Nicolas Autet - Paris (+33 1 56 43 13 00, nautet@gibsondunn.com)

Attila Borsos - Brussels (+32 2 554 72 10, aborsos@gibsondunn.com)

Patrick Doris - London (+44 (0)207 071 4276, pdoris@gibsondunn.com)

Sacha Harber-Kelly - London (+44 20 7071 4205, sharber-kelly@gibsondunn.com)

Penny Madden - London (+44 (0)20 7071 4226, pmadden@gibsondunn.com)

Steve Melrose - London (+44 (0)20 7071 4219, smelrose@gibsondunn.com)

Benno Schwarz - Munich (+49 89 189 33 110, bschwarz@gibsondunn.com)

Michael Walther - Munich (+49 89 189 33-180, mwalther@gibsondunn.com)

Richard W. Roeder - Munich (+49 89 189 33-160, rroeder@gibsondunn.com)

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