

To: Our Clients and Friends

December 27, 2011

Be Careful What You Wish For: DDTC Issues Proposed Brokering Revisions

Since its adoption, Part 129 has caused much confusion within industry. Many hours have been spent by U.S. and foreign persons attempting to figure out who was a “broker,” if “brokering activities” (subject to U.S. jurisdiction) were occurring, and if so, what requirements needed to be satisfied. Since a draft proposed rule was issued in 2009, industry has been awaiting publication of a proposed rule that would hopefully resolve some of these ambiguities. On December 19, 2011, DDTC issued a proposed rule to amend Part 129 and other sections of the ITAR relating to brokering and brokering activities. 76 Fed. Reg. 78578.

In the Federal Register notice, DDTC describes the proposed rule as an attempt to “clarify” numerous aspects of the brokering regulations. The proposed rule not only provides clarification of key issues such as what constitutes “brokering activities” and who falls within DDTC jurisdiction, but impacts registration, prior approval and almost every other aspect of Part 129. The clarifications, in many cases, could actually increase the administrative and compliance burdens faced by industry, as the proposed rule confirms DDTC’s broad view of the scope of Part 129 over both U.S. and foreign persons. There are multiple aspects of the rule that warrant comment to both resolve ambiguities and ensure DDTC appreciates the impact the proposed regulation is likely to have on industry. Comments are due to DDTC by February 17, 2012.

I. The Proposed Rule’s Potential Impact on U.S. Persons

The proposed rule’s revisions to the definition of “broker” and “brokering activities,” while eliminating some confusion, unfortunately confirm just how broadly DDTC views the scope of Part 129. In particular, there is no exclusion for activities undertaken by affiliated entities on behalf of one another. For example, unless the parties could meet one of two new exemptions (discussed in Section II), the proposed rule would appear to capture brokering activities by a European affiliate on behalf of a U.S. parent, despite the fact that they companies fall within the same corporate umbrella.¹

The examples of what do not constitute “brokering activities” are narrow enough that compliance managers must conduct a brokering analysis with respect to almost every international transaction involving an intermediary. Further, the proposed rule includes almost none of the DTAG recommendations that would have provided more substantive carve outs from what constitutes “brokering activities.” What is left of the exclusions from brokering activities is an array of administrative functions that may not permit parties to conduct international transactions involving an intermediary without falling under Part 129.

In addition to the scope of Part 129, DDTC proposes to clarify “prior approvals.” Parties previously were required to confront a confusing web of prior approval, prior notification and exemption

¹ In addition, many in industry concluded that foreign resellers/distributors are not brokers so long as the foreign parties purchase and take legal ownership of the defense articles. At least one example in the accompanying comments to the proposed rule calls this conclusion into question. Parties should be certain to comment on this section lest they be faced with a regulation that, at worst, could cause significant disruption to their business model and, at best, requires a complicated analysis of potential exemptions and conditions to be conducted with respect to each transaction.

requirements. Even if such an approval was needed, it was unclear what type of approval was required or how to obtain one from DDTC. To its credit, DDTC has eliminated prior notification requirements, simplified prior approval concepts and provided guidance about the process. The proposed rule makes it clear that prior approval would be required for all brokering activities that do not fall within an exemption found in the proposed ITAR § 129.7. While simplified, parties may find that this clarification actually increases the number of instances in which a prior approval is required. The revision to the “on behalf of a U.S. government” agency exemption is a good example of the potential additional requirements imposed by the proposed rule. The proposed rule exempts brokering only by the party with a *direct* contract with the U.S. Government – typically a large, U.S. prime contractor; it would not cover the prime contractor’s foreign affiliate or activities by a subcontractor.

A positive change in the proposed rule is that U.S. persons should benefit from a streamlined registration process, including the ability to add related entities such as foreign subsidiaries to their DS-2032, in many cases, relieving a burden from U.S. compliance managers who were responsible for ensuring foreign subsidiaries and affiliates met their independent registration obligations. As discussed below in Section II, DDTC also proposes two (2) new registration exemptions, though at this time it is difficult to judge the impact of these exemptions as clarification of a number of key terms is needed to fully understand their applicability. For example, ITAR § 129.3(b)(3), discussed below, exempts bona fide and full-time regular employees of persons registered under Part 122 from the requirement to separately register as a broker. However, this exemption does not cover part-time employees and does not clearly cover temporary employees working a full-time schedule. Further, the conditions imposed to meet the exemption could also prove to be problematic for full-time employees as well.

Finally, as the word “broker” is proposed to be added to ITAR § 127.1(b), license holders will now be faced with the compliance challenges of ensuring that their brokers are aware of their expanded (and in many cases, new) requirements under Part 129 as well as the risk that license holders may be subject to penalties for violations by parties that may only have an attenuated connection to the transaction at issue.

II. The Proposed Rule’s Potential Impact on Foreign Persons

The proposed rule has significant implications for foreign persons and may well erase the goodwill obtained through the recent ITAR amendments that attempted to address ongoing foreign concerns about dual/third country national employees. As discussed below, in addition to many of the issues discussed in Section I, the potential effects of the proposed rule have the possibility to greatly impact a foreign person’s business. In particular, foreign persons may find themselves subject to U.S. jurisdiction for brokering activities that take place wholly outside of the United States.

Through its clarifications of ITAR § 129.2(d), DDTC has confirmed its broad view of just how far the jurisdictional reach of Part 129 extends. Under DDTC’s proposal, its jurisdiction explicitly reaches brokering of foreign origin items incorporating a U.S.-origin defense article, thus encompassing a French manufacturer’s sale to India of a trainer jet incorporating a U.S.-origin part or component, even if the actual “brokering activities” were conducted wholly overseas and the part or component itself is the only connection to the United States. Jurisdiction would extend to the brokering activities by any foreign person located outside the United States involving the import into the United States of any defense article or service, even if the part that is imported is of foreign origin. This provision may make foreign suppliers more hesitant to do business with U.S. partners, as, for example, the brokering activities between a French procurement officer and his/her Indian supplier are now subject to U.S. jurisdiction if the part is ultimately imported into the United States. Finally, jurisdiction extends to brokering activities by any foreign person outside of the United States acting on behalf of a U.S. person. However, “on behalf of a U.S. person” is not defined, leaving foreign affiliates and subsidiaries of U.S. persons at risk of falling under DDTC jurisdiction for what appear to be wholly foreign transactions.

The proposed rule does include two (2) exemptions that appear to be designed to minimize the instances in which foreign persons would be required to separately register as brokers with DDTC.

First, under ITAR § 129.3(b)(3), a separate brokering registration would not be required for foreign persons identified as “exclusive brokers” on a U.S. registrant’s DS-2032. However, the critical term of “exclusive broker” is not defined. Further, even if the foreign person could qualify as an “exclusive broker,” the exemption may be of limited value for foreign affiliates with their own product lines and relatively little contact with the U.S. parent. Finally, even if the foreign person could meet the conditions imposed, the foreign person would be subject to ITAR § 122.5 (and DDTC’s authority to demand records for inspection on short notice, which again could prove disruptive to a foreign person’s business).

Second, ITAR § 129.3(b)(4) is proposed to help exempt already licensed transactions from Part 129 and mitigate the impact of the so-called “see-through” rule. Because this section exempts brokers from all of the brokering requirements (including recordkeeping) and impacts licensed activities as well as the “see-through” rule, the proposed exemption could provide numerous benefits for industry. However, as with other exemptions and carve outs contained in the proposed rule (such as defining the term “exclusive broker”), clarifications are required to ensure that the exemption clearly encompasses DDTC’s intended scope. For example, DDTC should clearly define when parties to a license or agreement will be considered a “retransferor” or “reexporter.” Further, this exemption still does not address the fact that in many cases, brokering activities will occur prior to such time as a license or approval is obtained.

Should a foreign subsidiary or affiliate of a U.S. registered person be unable to fall within one of the new registration exemptions and be required to register, they would now be expressly able to do so on the U.S. registered person’s DS-2032, which will eliminate separate fees and provide for consolidated registration activity with the U.S. parent. This also appears to be a positive development. In the case of a foreign parent of a U.S. registered person, the foreign parent would now be able to be listed on the DS-2032 of the U.S. registered person, so long as they complete and provide to the U.S. registered person a written certification expressly acknowledging that the foreign parent will be subject to Part 129 (though it is likely that completion of such jurisdictional certifications will be strongly opposed by foreign legal counsel).

III. Conclusion

The proposed rule is an extremely complicated regulation that will have a significant impact on all parties engaged in defense trade. The issues discussed in this bulletin represent just a small number of issues presented for U.S. and foreign persons should the proposed rule be adopted without significant changes.

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