

Practical solutions to managing re-export risks in a global aerospace and defence supply chain



Whether exporting or re-exporting, companies throughout a supply chain should be aware of whether or not a product is controlled under US export regulations, write Sarah Blank, Amanda Spikes and Amie Ahanchian.

The United States, as the world's largest exporter of aerospace and defence products, makes up over a third of aerospace and defence exports worldwide.¹ Given the strict extraterritorial jurisdiction that the US government asserts over US origin export-controlled technology, aerospace and defence supply chains outside of America need to consider US re-export requirements as part of their business model.

The US aerospace and defence industry has seen a significant increase in export sales over the past five years, growing 26% from \$113 billion² in 2012 to \$143 billion in 2017,³ with over half of these exports in parts and components.⁴ Military sales accounted for 15% of total exports.⁵ At the same time, aerospace and defence companies globally are increasingly looking outside their home countries to diversify their supply chains to take advantage of lower costs and to meet burgeoning localisation and offset requirements. As companies look overseas to enhance their portfolios, corporate leaders will naturally consider the corresponding risks and opportunities from a supply chain perspective when it comes to procurement and customers.

Another important consideration is trade and customs, specifically in the area of export compliance. While US Export Control Reform ('ECR')⁶ loosened controls on certain US origin dual-use and military commodities, sellers and buyers alike need to remain vigilant of possible risks related to re-exporting. Specifically, companies throughout the supply chain should be aware of whether or not a product is controlled under US export regulations and, if so, the licensing options available to non-US companies. In

addition, companies can leverage automated solutions to facilitate compliance, establish processes, document internal controls and train personnel to communicate and uphold required standards to support compliance throughout the supply chain.

Is the product subject to US re-export restrictions?

Companies need to be aware that US-origin aerospace and defence products remain subject to US jurisdiction upon export from the US, with the exception of dual-use products that can qualify for the *de minimis* exception.⁷ This may be surprising for aerospace and defence executives who followed ECR with eager anticipation of loosened restrictions as many aerospace products, parts and components moved from the US Munitions List ('USML')^{8,9} to the Commerce Control List ('CCL'),^{10,11} generating benefits such as the ability to utilise licence exceptions and reduced risk of violating the International Traffic in

Arms Regulations ('ITAR')¹² and incurring harsh penalties from the US State Department.

Due to the availability of these opportunities and corresponding potential compliance risks, it is highly advisable for the executive team to invest in a trade compliance strategy when planning any new venture or new market entry as re-exports can be an area of risk for any organisation with controlled products.

When planning the global supply chain, it is important to consider a broad range of re-export scenarios, knowing that one size generally does not fit all. Upon export from the US, products could remain as a standalone end item (such as a complete aircraft), be incorporated into an end item (for example, aircraft parts and components sold to a European aircraft manufacturer for incorporation into a European aircraft), or be removed from an end item (in the case of any item needing repair by an original equipment manufacturer ('OEM') in the US or being sent to a third country



for repair). Each scenario needs to be carefully analysed. In addition, supply chain managers should understand that changing suppliers or repair vendors within the same or a different country can lead to unforeseen challenges. Mapping out product flows can help identify licensing requirements and responsibilities of the parties involved. In some cases, non-US companies can 'go at it alone' in obtaining authorisation for re-export directly from the US government but, in other cases, they may need the assistance of a US company or their own government (for example, in certain instances where US products were sold for government or military end use).

What is the jurisdiction and classification of the product?

In order to evaluate the US re-export requirements for a commodity, the first step to re-export compliance is to ascertain the correct export classification information, which involves understanding the jurisdiction of the US origin product (i.e., whether it is controlled under the ITAR, administered by the Directorate of Defense Trade Controls ('DDTC') within the US State Department, or the Export Administration Regulations ('EAR'), administered by the Bureau of Industry and Security ('BIS' within the US Commerce Department) and the relevant classification (i.e., the specific paragraph under which the product is controlled under the USML, the CCL or by another set of regulations, such as those for nuclear end use).

Companies are increasingly issuing questionnaires to suppliers to solicit US jurisdiction and classification information and going so far as to contractually require suppliers to provide such information. This information is important to determine the re-export requirements for US-origin commodities and to analyse whether a finished product made in another country is eligible for the *de minimis* exception.

Another resource that export compliance officers sometimes overlook is that the US export classification is typically included on the commercial invoice when exported from the US. Non-US companies are aided by changes DDTC made in 2016¹³ requiring US companies to provide the export control classification numbers ('ECCNs') for dual-use parts shipped

on a State Department hardware licence. The challenge, in practice, however, is that the employees on the receiving dock that receive the shipping paperwork along with the hardware delivery are a different set of people,

Companies are increasingly issuing questionnaires to suppliers to solicit US jurisdiction and classification information.

with different reporting responsibilities, than those employees that manage import/export compliance. Many companies are now recording the export classification information in their enterprise resource planning ('ERP') systems or other inventory tracking system when the item is initially ordered or received. Companies can leverage existing technology such as RFID (radio-frequency identification) trackers which are increasingly used to facilitate compliance with other legal requirements, such as US Federal Acquisition Regulations and airworthiness regulations.

In some cases, the re-exporter may not have a contractual relationship with the OEM or have the shipping paperwork from the initial US export, but can contact the OEM directly to obtain the US jurisdiction and classification information.

More and more companies are publishing export control information on their websites by providing the export control classification numbers ('ECCN') or identifying which products are controlled under the ITAR. Furthermore, a benefit of networking in person at conferences or virtually through forums such as LinkedIn is that other trade compliance professionals in the same industry may work at or can put you in contact with a trade compliance point of contact at the company in question. Occasionally, calling a general phone number for customer service at the OEM can lead to surprising success in being connected with a trade compliance professional or customer service representative who can provide the export classification. When cold calling, keep in mind that export

compliance may still be embedded in the logistics or procurement departments at smaller companies.

When these attempts are unsuccessful, non-US companies may elect to self-classify and in doing so can seek assistance from an advisor or leverage the decision-tree tools on the Departments of State and Commerce websites. The US State Department also publishes commodity jurisdiction ('CJ') determinations on its website. Non-US companies are also permitted to submit a CCATS (Commodity Classification Automated Tracking System) request to the Commerce Department for a classification determination on dual-use items. When submitting a CJ, however, the State Department encourages the non-US company to work with the US OEM.

What authorisations are available for re-export?

Once companies know the export jurisdiction and classification, the next step in planning to re-export is knowing which authorisations are available. Due to the long lead time for certain licences, planning is key and it is important for US companies to ask non-US entities for a full list of their suppliers and subcontractors that may need to receive hardware or technology to help ensure they are licensed correctly. The first and best option for re-exporting is to use an existing authorisation, be it a DDTC licence (for defence articles and technical data), DDTC agreement (for technical data and defence services) or BIS licence (for dual-use hardware and technology).

After a non-US entity has already received an export-controlled item, in practice, knowing which authorisation was used for the initial export from the US may be tricky. The export authorisation used to export the hardware from the US should be listed on the commercial invoice. A difficulty for non-US parties is that the same part number can be received under multiple authorisations over time. Similar to tracking the export classification of hardware, companies can leverage existing inventory tracking or ERP systems to track the initial US export authorisation. Additionally, if non-US companies ultimately have to request a re-export authorisation from the US government, they will need to list the original licence numbers as part of their application.

For technical data or technology, although there is no explicit regulatory requirement, US companies can mark data to help ensure others in the supply chain know that technical data is export controlled. A US company can include a reference to the original authorisation along with the export markings. For receipt of data, a popular practice is for non-US companies to record receipt of US-origin technical data and technology in an existing document-management system.

With re-exporting under an existing authorisation, another practical challenge is that US companies are reluctant to provide copies of their licences due to concern about disclosing proprietary information or in the case of DDTC provisos, revealing US foreign policy or national security information. BIS alleviated some of these concerns by specifically stating in its boilerplate approval language that the applicant must inform the recipients of the licence scope and applicable conditions or restrictions. The onus is on the re-exporter to verify the scope, licensees and validity period of a licence prior to re-exporting but this can be accomplished by a review of a redacted licence or even a contractual letter documenting the requisite information. Non-US companies should also be sure to request the US company provide copies of their amendments to hardware licences such as those adding freight-forwarders or foreign intermediate consignees. Also, generally, under a State Department agreement, signatories to the agreement may re-export technical data to a sublicensee, provided it is within the authorised scope.¹⁴ Signatories should verify, however, that the sublicensee has signed a non-disclosure agreement prior to transferring technical data.

If there is no valid licence or agreement, non-US companies may potentially avail themselves of two ITAR exemptions, 22 CFR 123.9(c) and 123.9(e). To re-export under the 123.9(c) exemption, non-US companies can request authorisation to re-export via general correspondence submitted directly to DDTC. However, in order to make such a request to DDTC, the non-US company must know the original authorisation for the initial export from the US.

The provisions of 22 CFR 123.9(e) allow a company (or government) to re-export US origin components

incorporated into a foreign defence article to NATO, NATO agencies, a government of a NATO country, or the governments of Australia, Israel, Japan, New Zealand, or the Republic of Korea. The use of this exemption is limited to the re-export of US origin components that are not designated as 'significant military equipment',¹⁵ are not 'major defense equipment sold under contract in the amount of [\$25 million] or more', are not 'defense articles or defense services sold under a contract in the amount of [\$100 million] or more', and are not identified as Missile Technology Control Regime ('MTCR') items. In

To re-export a product subject to the EAR, the company should first evaluate if there is an existing licence in place.

addition, the re-exporter must provide written notification of the transfer to the State Department within 30 days.¹⁶

To re-export a product subject to the EAR, the company should first evaluate if there is an existing licence in place. If the EAR-controlled items were originally exported on a DDTC hardware licence, they can be re-exported on a DDTC licence provided they are being re-exported in or with the defence article originally exported from the US. If the jurisdiction of the items have transitioned from the ITAR to the EAR as a result of ECR, the EAR-controlled items must be re-exported in accordance with the EAR.¹⁷

If there is no licence in place, the company must know the ECCN to evaluate if a licence is needed for the intended destination, end use and end user. If a licence is required for the intended destination or end use, companies should evaluate possible EAR exceptions that can be used in lieu of a BIS licence, provided the proposed transaction meets the terms and conditions of the licence exception and Section 740.2 restrictions are not applicable.¹⁸ Once it is determined that a licence exception could apply, the company must consider specific licence exception country restrictions, Office of Foreign Assets Control ('OFAC') regulations (i.e., embargoes), and verify that it does not involve a transaction restricted under general prohibitions 1-10. If any 740.2

restrictions apply, an export licence will be required. If the re-exporter cannot avail itself of an EAR licence exception, non-US companies can submit a licence application via the BIS Simplified Network Application Process ('SNAP-R').

Is the product eligible for use of the *De Minimis* exception?

A possible benefit for re-exporters resulting from ECR is that more non-US companies may be able to take advantage of the *de minimis* exception for items that were previously ITAR-controlled and are now classified on the CCL as EAR99.

Under the *de minimis* rule, if a foreign-produced product containing US origin dual-use parts meets specific criteria in the EAR, the US origin product is essentially released from US jurisdiction. While all EAR exceptions require close review prior to use, the *de minimis* exception has particular nuances that must be carefully considered. Under the CCL, items produced outside the US are generally subject to the EAR if they contain more than a certain percentage of US origin, EAR-controlled content. It is important to note that only dual-use items classified on the CCL may be considered for the *de minimis* rule, as military items classified on the USML are ineligible for *de minimis* treatment.¹⁹ The statutory language of the *de minimis* exception provides the specific thresholds on a country-by-country basis,²⁰ and the *de minimis* rules are complex and often misunderstood.

Companies should be aware that the *de minimis* rule is not applicable to any and all items outside the US – instead, in order to qualify for a *de minimis* exception, the product must be manufactured outside the US and use US-origin content that is 'incorporated in' (for hardware components) or 'bundled with' (for software components) the foreign-produced commodity.

In order for the US-origin controlled item to be considered 'incorporated' into the foreign-produced commodity, it must be 'essential to the functioning of the foreign equipment; customarily included in sales of the foreign equipment; and re-exported with the foreign produced item.'²¹ In contrast, in order for the US origin controlled item to be considered 'bundled' with the

foreign-produced commodity, the software must be configured for a specific commodity, but does not necessarily have to be physically integrated into the commodity.²²

It is important to evaluate all criteria relevant for using the *de minimis* exception. When the US

content of a foreign-made item is below the relevant *de minimis* threshold, it may be tempting to assume that the exception applies and that the foreign-made item is not subject to US re-export controls. In some cases, though, the US origin content, regardless of its proportion in the larger commodity, cannot be re-transferred to certain locations under any circumstances. For commodities destined to these countries, the *de minimis* exception is not available, and re-export may result in a breach of US export control laws.

For example, certain items that shifted from the USML to the CCL as a result of ECR are nonetheless ineligible for *de minimis* treatment when sent to D:5 or E:1 countries. As such, foreign-made items incorporating this content and going to these countries will *always* be subject to the EAR, regardless of its proportion. Conversely, EAR99 content does not need to be included as US content in a *de minimis* calculation unless the item will be exported to certain E:1 countries.²³

It is also important to include software in the content calculation. Non-US companies that incorporate US content likely understand that *de minimis* applies to physical US product they produce; however, they may overlook the fact that US origin software or technology must also be considered in a *de minimis* calculation. All three types of US content must be considered for *de minimis*.

The *de minimis* calculation itself is not always simple, and even those that successfully navigate the maze of regulations and requirements may struggle to understand how to complete the calculation. Comparing the 'fair market value' of the US content to the fair market value of the overall item is a great place to start, but for many products – particularly for software and technology – several additional factors will need to be taken into consideration. Further, companies are also required to complete a one-time report to BIS before relying on *de minimis* rules for technology products.²⁴

Planning for long-term success

Aerospace and defence companies face similar challenges of maintaining compliance with US re-export controls over US-origin products and the associated risks across a complex

global supply chain. The key to success is mitigating those risks by engaging with the supply chain, planning ahead, working with export compliance counterparts at US and non-US companies and using technology enablers.

Engaging with the supply chain team critical to success. Few aerospace and defence companies can say with confidence that they have full visibility to their supply chain transactions. It is important to ask suppliers if there is US content in their foreign-produced items, to include export requirements in the standard terms and conditions and to educate customers and suppliers on the US re-export requirements for the products that are being sold. Mapping product flows and planning in advance for possible licensing scenarios will alleviate last-minute bottlenecks resulting from the lack of a valid licence.

Conclusion

As trade compliance moves from a back-office function to a strategic partner, export compliance professionals can collaborate to help ensure success. Companies can leverage already existing automated solutions, such as ERP systems or inventory tracking systems, to track the US jurisdiction and classification, as well as relevant US export authorizations. For companies looking to streamline their ERP software, additional fields to incorporate export compliance information can be easily added. Suppliers can consider publishing US jurisdiction and classification information on their websites either making it publicly available or limiting access specifically to customers or suppliers with an account login. These steps will enable compliance throughout the aerospace and defence supply chain and will strengthen compliance of all parties involved.

Sarah Blank is a senior associate and Amie Ahanchian is a managing director in the Trade & Customs practice of KPMG LLP. Amanda Spikes is the export control officer for KPMG.

sblank@kpmg.com
aahanchian@kpmg.com
aspikes@kpmg.com

Links and notes

¹ Aerospace Industry Association, The Facts on Trade, <https://www.aia-aerospace.org/research-center/statistics/industry-data/foreign-trade/> (last visited 2 May 2018).

² Aerospace Industry Association, 2017 Facts & Figures: U.S. Aerospace & Defense, (15 June 2017), <http://www.aia-aerospace.org/report/2017-facts-figures/>.

³ Aerospace Industry Association, Aerospace & Defense Exports Support America's Manufacturers, (13 March 2018), <https://www.aia-aerospace.org/report/aia-foreign-trade-infographic/>.

⁴ Aerospace Industry Association, 2017 Facts & Figures: U.S. Aerospace & Defense, (15 June 2017), <http://www.aia-aerospace.org/report/2017-facts-figures/>.

⁵ Id.

⁶ US Department of Commerce, About Export Control Reform (ECR), (7 October 2015), <http://2016.export.gov/ecr/>.

⁷ EAR, 15 C.F.R. §734.4.

⁸ US Munitions List, 22 C.F.R. §121.

⁹ The United States Munitions List ('USML') is enumerated under the International Traffic in Arms Regulations ('ITAR') and governed by the United States Department of State, Directorate of Defense Trade Controls ('DDTC')

¹⁰ Commerce Control List, 15 CFR §774.

¹¹ The Commerce Control List ('CCL') is part of the Export Administration Regulations ('EAR') governed by the United States Department of Commerce, Bureau of Industry and Security ('BIS').

¹² 22 CFR §120 - §130

¹³ International Traffic In Arms Regulations, 81 FR 54735, 35611 (17 August 2016) (codified at 22 CFR §123.9)

¹⁴ US Department of State, Guideline for Preparing Agreements, (20 October 2016), https://www.pmdtc.state.gov/sys_attachment.do?ysparm_referring_url=tear_off&view=true&sys_id=3ae1da09db51df00d0a370131f9619c5.

¹⁵ 22 CFR §121.1(a)(2)

¹⁶ 22 CFR §123.9(e)3

¹⁷ US Department of State, ITAR/USML Updates FAQs: Retransfer, https://www.pmdtc.state.gov/?id=ddtc_public_portal_faq_detail&sys_id=428b2d9c3d5b40449ff621f96198f

¹⁸ 15 CFR §740.2(a)(13) provides a list of licence exceptions available for '600 series' items.

¹⁹ The ITAR has carve-outs for specific items incorporated into EAR-controlled items prior to export, re-export, retransfer or temporary import. US Department of State, 22 CFR §121.1.

²⁰ Thresholds are: For E:1 countries: U.S.-origin content < 10%; For all other countries: U.S.-origin content < 25%. EAR, 15 CFR §734.4

²¹ EAR, Supplement No. 1 to 15 CFR §734.

²² EAR, Notes to Paragraph (c)(1) of 15 CFR §734.4.

²³ EAR, Notes to Paragraph (c)(1) of 15 CFR §734.4 and Notes to Paragraph (d)(1) of 15 CFR §734.4

²⁴ EAR, 15 CFR §734.4(c) and §734.4(d)(3).

INTERNATIONAL EXPORT CONTROL

Dual-Use Export Controls in International Transit and Transshipment

Dual-Use Export Controls in International Transit and Transshipment is the newly released book from the publishers of *WorldECR*, the journal of export controls and sanctions.

The book updates a report *WorldECR* originally published in 2012 on the transit and transshipment regimes of countries in the Americas, Europe, Asia and the Middle East. At the urging of many of our readers, we have now re-published in hard copy, providing up-to-date coverage and including a much larger number of jurisdictions than contained in the original report.

Dual-Use Export Controls in International Transit and Transshipment reflects the growing complexity and regulation involved in the transport of freight, not only between differing jurisdictions but also within individual jurisdictions themselves. Each point in the freight journey may give rise

to issues that impact, for example, a cargo's licensing and customs inspection, a process that could in turn have consequences not only for costs but the ultimate success of any freight transaction.

In keeping with the remit of *WorldECR*, the main focus is on transit and transshipment laws as they apply to dual-use goods. However, as is evidenced in the book's country-by-country analysis, a significant number of jurisdictions have no established regime aimed at regulating dual-use versus other types of goods, leaving the transit and transshipment of freight subject to an often-complex array of local customs laws.

The book also examines the different regulations as they may pertain to the types of carriage. Writing in the Foreword, *WorldECR* editor, Tom Blass, notes that while the terms 'transit' and 'transshipment' are frequently used in close

dual-use

EXPORT CONTROLS

in international transit and transshipment

Published by **WorldECR**, the journal of export controls and sanctions

proximity to each other, they should not be used interchangeably: 'A pallet of widgets originating in France is in transit as it travels through Belgium on the back of a truck, but is transhipped on being unloaded from the truck in Hamburg and placed aboard a ship bound for the United States.'

Chapter by chapter

Each chapter is written by an expert in export controls in his/her jurisdiction. Chapter authors detail the export control regime/framework in their country, explaining how transit and transshipment are locally defined and controlled and how controlling regulations are enforced. Useful information on competent authorities, procedures, and penalties for breach is included in most country chapters along with contact details for licensing authorities. Information on free trade and special economic zones is included for some countries.

How to order

Dual-Use Export Controls in International Transit and Transshipment is available from directly from *WorldECR*. Copies cost £85 (plus postage and packing). For further information and to order your copy, please email info@worldecr.com with your order requirements. Discounts for bulk orders are available (email for details).

Chapters and contributing authors

The Americas: Argentina by L. Augusto Vechio; Brazil by Alessandra Machado and Marcelle Silbiger; Canada by Wendy Wagner; Chile by Gaston Medina; Colombia by César Camilo Cermeño; Mexico by Horacio A. López-Portillo; Peru by Julio Guadalupe; USA by Tamer Soliman, Jing Zhang and Bernd Janzen

Europe and the EU: Albania by Besnik Duraj and Bojana Hajdini; Belgium by Fabienne Vermeeren and Charlotte Van Haute; Cyprus by Elena Christodoulou; Denmark by Anders Hedetoft and Anna Martine Stubben; France by Diederik Cops and Nils Duquet; Germany by Dr. Bärbel Sachs; Greece by Michalis Kosmopoulos and Mariliza Kyparissi; Italy by Silvia Salmaso; Netherlands by Jikke Biermasz and Petra Chao; Norway by Hugo Munthe-Kaas and Pernille Engstrøm Skaug; Poland by Krzysztof Korwin-Kossakowski and Kuba Ruiz; Portugal by Tiago Marreiros Moreira and Catarina Belim; Romania by Adrian Roseti and Claudia Hutina; Spain by Diego Pol and Valeria Enrich; Sweden by Mattias Hedwall; Switzerland by Peter Henschel and Prof. Dr. Andreas Furrer; Ukraine by Gleb Bialyi and Oleksandr Maydanyk; United Kingdom by Rhys Williams

Asia and the Middle East: Australia by David Howard and Alexandra Shearer; China by Bo Xie; Egypt by Yulia V. Akinfiev; Hong Kong by George Tan and Cecil Leong; India by Sanjay Notani and Rohit Jain; Iran by Ali Pirmoradi and Zahra Darvish; Israel by Gil Rosen; Japan by Tamotsu Aoi; Malaysia by Cynthia Lian; Singapore by George Tan; South Korea by Jaewon Lee; Turkey by S. Mustafa Durakoğlu; United Arab Emirates by Ryan Cathie.