FEBRUARY 2009

DEVELOPMENTS IN ECONOMIC SANCTIONS AND EXPORT CONTROLS IN 2008 AND WHAT'S AHEAD IN 2009

The primary export controls and economic sanctions imposed by the United States Government are under the authority of the Treasury Department, Commerce Department, and State Department. The Treasury Department's Office of Foreign Assets Control ("OFAC") administers and enforces a number of economic sanctions programs, using the blocking of assets and trade restrictions to accomplish U.S. foreign policy and national security goals. The Commerce Department's Bureau of Industry and Security ("BIS") regulates the export and reexport of most commercial items under the Export Administration Regulations ("EAR"). The State Department's Directorate of Defense Trade Controls ("DDTC") regulates the export and import of defense articles and defense services identified on the U.S. Munitions List, which is part of the International Traffic in Arms Regulations ("ITAR").

Notable developments in 2008 from each sector are summarized below. These developments counsel continued vigilance to economic sanctions and export control issues, including, in particular, the development and strengthening of compliance programs directed at these issues.

OFFICE OF FOREIGN ASSETS CONTROL

Iran. Late in 2007, OFAC had designated a number of major Iranian banks under the Nonproliferation and Anti-Terrorism sanctions programs, including Bank Mellat, Bank Melli, and Bank Saderat, as well as their branches and certain subsidiaries. U.S. persons are prohibited from engaging in any unlicensed transactions with designated entities. Continuing that initiative in 2008, OFAC expanded the scope of the Iranian sanctions program by designating a number of Iranian shipping companies under the Nonproliferation sanctions on September 10, 2008. *See* http://www.treas.gov/offices/enforcement/ofac/actions/20080910.shtml. Going forward in 2009, OFAC is expected to make

increasing use of its designating authority, which serves to disrupt international trade transactions involving Iran and other countries and entities of concern.

Effective November 10, 2008, OFAC also tightened sanctions against Iran by revoking an authorization previously granted to U.S. depository institutions to process so-called "U-turn" transfers. As described by OFAC, "A 'U-turn' transfer is so termed because it is initiated offshore as a dollar-denominated transaction by order of a foreign bank's customer; it then becomes a transfer from a correspondent account held by a domestic bank for the foreign bank to a correspondent account held by a domestic bank for another foreign bank; and it ends up offshore as a transfer to a dollar-denominated account of the second foreign bank's customer." Further information about this change is available at http://www.treas.gov/offices/enforcement/ofac/actions/20081110.shtml.

Sanctions on Designated Entities. In an important set of Guidance documents, OFAC clarified that sanctions imposed on a blocked entity also apply to any entity "in which [the blocked entity] owns, directly or indirectly, a 50% or greater interest." Applying this principle to the Belarusian State Concern for Oil and Chemistry ("Belneftekhim"), OFAC made clear that the sanctions also extended to any entities in which Belneftekhim owns, "directly or indirectly, a 50% or greater interest . . . regardless of whether the entities themselves are . . . placed on OFAC's list of Specially Designated Nationals."

While purportedly clarifying existing OFAC policy only, the Guidance clearly established that U.S. persons must be concerned not only with specific individuals and entities designated by the U.S. government for blocking, but also entities owned or controlled by the blocked person. OFAC also advised that U.S. persons should "act with caution when considering a transaction with a non-blocked entity in which a blocked person has a significant ownership interest that is less than 50% or which a blocked person may control by means other than a majority ownership interest." OFAC warned that such entities may be designated for blocking in the future. OFAC also noted that intermediaries may not be used to engage indirectly in prohibited transactions with blocked persons. The Guidance documents are available at http://www.treas.gov/offices/enforcement/ofac/actions/20080214.shtml and http://www.treas.gov/offices/enforcement/ofac/actions/20080306.shtml.

New Enforcement Guidelines. OFAC issued new Economic Sanctions Enforcement Guidelines, which took effect on September 8, 2008. Building on prior iterations of OFAC's enforcement procedures and philosophy set forth in 2003 and 2006, the Enforcement Guidelines addressed four key areas.

First, instead of identifying "mitigating" and "aggravating" factors, as it had done on prior occasions, OFAC set forth "General Factors" that the agency will consider in its "holistic consideration of the facts and circumstances of a particular case." The General Factors include the willfulness or recklessness of the conduct at issue, the existence of concealment, a pattern of misconduct, prior notice, management involvement, the harm to sanctions program objectives, individual characteristics of the person such as size and volume of transactions handled, the existence and nature of a compliance program, the remedial response, and cooperation with OFAC.

Second, OFAC will issue "Cautionary letters" in situations where there is an apparent violation but there is insufficient evidence to conclude that a violation has occurred or if a finding of violation is not warranted. The Cautionary letter would not constitute a determination that a violation has or has not occurred but would serve as a warning.

Third, the Guidelines distinguish between egregious and non-egregious civil monetary penalty cases and note that OFAC intends to limit the use of the $250,000 statutory maximum as a penalty to egregious cases. In determining egregiousness, substantial weight is to be given to considerations of willfulness or recklessness, awareness of the conduct giving rise to an apparent violation, harm to sanctions program objectives, and the individual characteristics of the person.

Finally, the Guidelines establish a procedure for calculating a civil penalty, basing it on two primary considerations—the egregiousness of the conduct and whether the person made a voluntary self-disclosure. Submitting a voluntary disclosure will significantly reduce the penalty in egregious and non-egregious cases. The Guidelines can be found at http://www.treas.gov/offices/enforcement/ofac/actions/20080908.shtml.

New Securities Industry Guidance. On November 5, 2008, OFAC issued a new Guidance for firms dealing in securities and futures, emphasizing the importance of such firms maintaining a strong compliance program. OFAC noted that it will consider "both the adequacy of a company's transaction processing system, as well as its overall OFAC compliance program" in the event of a violation. The Guidance also outlined the components of an effective compliance program for securities and futures firms. The Guidance, as well as a summary of risk factors to be evaluated by the securities industry, can be found at http://www.treas.gov/offices/enforcement/ofac/actions/20081106.shtml.

BUREAU OF INDUSTRY AND SECURITY

Changes to the Entity List. The Entity List provides notice to the public of license requirements for export or reexport transactions with entities on the list. On August 21, 2008, BIS published a final rule that authorizes an inter-agency End-User Review Committee to make decisions to add parties to the Entity List when "there is reasonable cause to believe, based on specific and articulable facts, that an entity has been involved, is involved or poses a risk of being involved in activities that are contrary to the national security or foreign policy interests of the United States or is acting on behalf of such an entity." 73 Fed. Reg. 49311-49323. A month after this final rule was published, on September 22, 2008, BIS added 75 persons to the Entity List. BIS also permanently removed General Order No. 3 from the EAR and moved the 33 persons who were listed in that general order to the Entity List.

Proposed Intra-Company License Exception. On October 3, 2008, BIS published a proposed rule that would establish a new license exception entitled Intra-Company Transfer ("ICT"). This license exception would allow an approved parent company and its approved wholly owned or controlled-in-fact entities to export, reexport, or transfer in-country many items on the Commerce Control List among themselves for internal company use. The proposed rule was designed in part to simplify licensing issues, including deemed export licensing issues, for companies with global research, development, and manufacturing operations.

In order to use the proposed ICT license exception, a company must obtain prior authorization from BIS, submit an annual report to BIS on its own use of the ICT license exception as well as use by its related authorized entities, and submit to audits by BIS approximately once every two years.

Comments to this proposed rule were due on November 17, 2008. BIS has advised that it received many insightful comments on this proposed rule, and it is possible that its next step will be to publish a revised proposed rule rather than a final rule.

Changes to the *De Minimis* Rules. On October 1, 2008, the Department of Commerce published an interim final rule that revised the provisions of the EAR relating to foreign-made items that incorporate controlled U.S.-origin items. These provisions are known as the "*de minimis*" rules.

Principally, the interim rule:

- **Changes the *de minimis* calculation for foreign-produced hardware that is bundled with U.S.-origin software.** Under the previous *de minimis* rules, U.S. content value had to be calculated separately for commodities, software, and technology. The new rule introduces the concept of "bundled" software, which will require that the *de minimis* calculation include certain software within the overall calculated value of U.S.-origin content in a foreign-made commodity. Software that is eligible to be "bundled" with foreign-made commodities for purposes of the *de minimis* calculation is only (i) software that is on the Commerce Control List and is controlled for anti-terrorism reasons; or (ii) software that is designated as EAR99.
- **Clarifies the definition of "incorporated" as it is applied to the *de minimis* rules.** The new rule clarifies that U.S.-origin controlled content is considered incorporated for *de minimis* purposes if the U.S.-origin controlled item: (i) is essential to the functioning of the foreign equipment; (ii) is customarily included in the sale of foreign-made items; and (iii) is reexported with the foreign-produced items. Also, for purposes of determining *de minimis* levels, technology and source code that is used to design or produce foreign-made commodities or software are not considered to be incorporated into the foreign-made commodity or software.

- **Removes the requirement to submit a one-time report to BIS for foreign-made software that incorporates controlled U.S.-origin software.** While this reporting requirement for software has been removed, the requirement of a one-time report for foreign-made technology that incorporates controlled U.S.-origin technology remains in place.
- **Revises the term "controlled."** Under the new rule, U.S.-origin content is considered controlled for purposes of the *de minimis* percentage calculation when it requires a license to the intended ultimate country of destination of the foreign-made item. This is a clarification of BIS's existing interpretation.
- **Clarifies recordkeeping requirements.** Specifically, the method used to determine the percentage of U.S. content in foreign software or technology must be documented and retained in accordance with the manner in which the EAR generally requires records to be kept. Additionally, as part of those records, an individual is expected to indicate whether the values used in the calculations are actual arm's-length market prices or prices derived from comparable transactions or costs of production, overhead, and profit.

Comments on this interim final rule were due by December 1, 2008.

Guidance on Preventing Illicit Diversion to Iran. On September 24, 2008, BIS issued guidance on actions exporters can take to prevent illicit diversion of items to Iran. The impetus for this Guidance was an investigation and subsequent enforcement action by BIS following discovery of a global network that sought to illegally acquire U.S.-origin dual use and military items on behalf of the Iranian government that could be used to develop weapons of mass destruction. The Guidance detailed the items the Iranian government is seeking, its methods of doing so, and steps U.S. exporters can take to prevent unauthorized exports to Iran.

Switch to Mandatory Use of Electronic Filing. On August 21, 2008, BIS published a final rule requiring that, effective October 20, 2008, export and reexport license applications, classification requests, encryption review requests, License Exception AGR notifications, and related documents be submitted through its SNAP-R system. This requirement does not apply to applications for Special Comprehensive Licenses or in particular situations where BIS authorizes paper submissions. 73 Fed. Reg. 49323-49331.

DIRECTORATE OF DEFENSE TRADE CONTROLS

Increased Registration Fees. The ITAR requires nearly every manufacturer, exporter, and broker of defense articles, data, or services to register with the DDTC. In 2008, DDTC amended the requirements for registering in two ways. 73 Fed. Reg. 55439-55441. First, DDTC reduced the validity period of registration to just one year. Second, DDTC created a three-tiered registration fee structure.

In the past, a company could register for one year ($1,750) or two years ($3,500). The new fee structure sets the cost of registering according to the number of license applications from the applicant that DDTC has reviewed, adjudicated, or issued a response during a recent 12-month period. The first-tier fee is $2,250 for new registrants and those for which DDTC has not handled a license application during the 12 months ending 90 days prior to the expiration of the current registration. The second-tier fee is $2,750 for registrants for which DDTC has handled 10 or fewer license applications during the 12 months ending 90 days prior to the expiration of the current registration. Third-tier fees start at $2,750 and increase by $250 for every application handled by DDTC in excess of 10. The new fee structure also caps registration fees at the greater of 3 percent of the value of the registrant's applications submitted during the 12 months ending 90 days prior to the expiration of the current registration or $2,750.

Aircraft Component Changes. In August 2008, DDTC amended Category VIII of the U.S. Munitions List to add language clarifying the circumstances under which an aircraft part or component may or may not be subject to the ITAR. 73 Fed. Reg. 47523. In general, the Commerce Department's EAR will control the export of aircraft parts or components if the item is (a) standard equipment; (b) covered under a certificate issued by the FAA for certain civil, nonmilitary aircraft; and (c) an integral part of such civil aircraft.

Increased Export Control Enforcement. The Department of Justice continued to devote significant resources to enforcing export controls. According to an October 2008 press release highlighting the Department's more notorious criminal prosecutions, at least 33 prosecutions in 2008 involved violations of the ITAR. Of those, 18 involved either aircraft or other aerospace related items. *See* http://www.usdoj.gov/opa/pr/2008/October/08-nsd-959.html.

OUTLOOK FOR 2009

There have been repeated calls in recent years to completely overhaul the U.S. export control system. Given the pressing economic issues facing the Obama administration, one should not expect major reforms in export controls in the near future, although President Obama has said recently that he would review existing U.S. export controls that have unduly hampered U.S. competitiveness. A Commerce Department "foreign availability" study due to be released soon will likely discuss the fact that many U.S. allies have open transfer policies with countries as to which the United States maintains restrictive export controls.

Iran, which has been a focus of U.S. export controls for several years, will continue to be a focus in 2009. Indeed, there have been numerous legislative efforts in recent years to further strengthen sanctions regulations against Iran, and it is likely that there will be more legislation introduced this year. One area of possible focus will be the Iran Sanctions Act ("ISA"), which requires the President to sanction foreign entities that invest more than $20 million in one year in Iran's energy industry. To date, however, no entity has ever been sanctioned under the ISA.

For now, the administration has halted all pending federal regulations until new administration heads can review them. In that regard, in connection with her confirmation proceeding, Secretary of State Hillary Clinton noted in written answers to the Senate Foreign Relations Committee that she places "high importance on arms control, nonproliferation, and other political-military issues." Clinton more recently stated that U.S. economic sanctions imposed against Burma have failed to effect desired changes from the repressive Burmese government. This suggests that there could be discussions in the near future regarding a possible shift in policy vis-a-vis Burma. The months ahead will undoubtedly bring interesting developments.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Michael Gurdak
1.202.879.5470
mpgurdak@jonesday.com

Fahad Habib
1.202.879.3663
fahabib@jonesday.com

Alexandria Mihalcik
1.202.879.5478
amihalcik@jonesday.com

Lee Perla
1.202.879.3843
lperla@jonesday.com