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international trade alert

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Proposed DDTC Rule Would Reform Requirements Affecting Dual- and Third-Country National Employees

Think dealing with non-U.S. employees is difficult now? Just wait. U.S. companies engaged in defense trade activities, foreign companies involved in unclassified defense programs and even third parties (such as subcontractors, suppliers, and vendors) should all take note of this important proposed change to U.S. regulations. Now is the time to examine closely the proposed rule and take action – before it is finalized and alters how you have to manage your business.

Non-U.S. companies have wrestled for years with U.S. International Traffic in Arms Regulations ("ITAR") that prohibit employees of certain nationalities, born in certain countries or holding certain dual-citizenship, from unauthorized access to ITAR-controlled defense articles or technical data. Even where these non-U.S. companies had been authorized by the U.S. State Department's Department of Defense Trade Controls ("DDTC") to participate as an approved end-user on a U.S. program, the company was obligated to either prohibit access or undertake the added burden of obtaining specific DDTC authorization for its dual- and third-country national ("DTCN") employees.

Recognizing that these requirements have not significantly increased U.S. national security and, in fact, may run afoul of anti-discrimination laws and human rights protections overseas, under the President's "Export Control Reform" initiative, DDTC released a Proposed Rule on August 11, 2010 to amend key regulations (75 Fed. Reg. 48625 (August 11, 2010)). The proposed amendments to ITAR Parts 124 and 126 reflect a significant shift in DDTC policy regarding end-user employment of DTCNs.

The good news is that the proposed rule would remove the requirement that approved "foreign person" end-users seek additional DDTC authorization before transferring defense articles and technical data to DTCNs provided they are "*bona fide*, regular employees, directly employed by the foreign business entity." The transfer, however, must take place completely within the territory where the end user is located, or where the consignee operates, and must be within the scope of the approved export license, or other DDTC authorization or exemption. While the proposed changes appear to reduce the burden of ITAR compliance for foreign companies, this is not necessarily the case.

In fact, the bad news is that the proposed rule specifically shifts the burden for "screening" and compliance to the end-user. Specifically, the proposed rule places an "*affirmative responsibility upon the foreign company… that by accepting the USML defense article, they must comply with the provisions of U.S. laws and regulations to* ***prevent the possible diversion*** *of U.S. defense articles and technology.*"

What will this "affirmative responsibility" look like? Previously, under ITAR section 124.8(5), transfer by an approved end-user of technical data or defense articles authorized by a manufacturing license agreement or technical assistance agreement to a person in a third country or a national of a third country was restricted, unless specifically authorized in the agreement or by specific written DDTC approval. The proposed rule would authorize transfer to the approved end-user, including transfer to its DTCN employees, subject to the following conditions (proposed section 126.18):

- The "prerequisite": Prior to any transfer by the end-user, "effective procedures to prevent diversion" to any unauthorized destinations, entities, or purposes must be in place. This essentially requires a technology security and control plan to protect defense articles and technical data from unauthorized employees, site visitors, and the like.

- In order to meet the "effective procedures" requirements, prior to access to defense articles, the company must either:

    1. require a "security clearance" for its employees, of a kind approved by the host nation government; or

    2. execute a Non-Disclosure Agreement ("NDA") that provides assurances that its employees will not transfer any information to persons or entities unless specifically authorized, *and* have a documented process in place to "screen its employees."

- The end-user or consignees must “screen” its employees for “**substantive contacts**” with restricted or prohibited countries listed in section 126.1 (such as China, Sudan, Cuba, etc.).

- The foreign end-user or consignee’s technology security/clearance plan and its screening records must be made available to DDTC upon request.

What are “substantive contacts”? DDTC has initially defined “substantive contacts” rather broadly. For instance, they include “regular travel to such countries, recent or continuing contact with agents and nationals of such countries, continued allegiance to such countries, or acts otherwise indicating a risk of diversion.” While mere nationality of a prohibited or restricted country would not prohibit access under the proposed rule, an employee with any such “substantive contacts” is “presumed” to raise a risk of diversion.

This proposed rule, as drafted, raises certain important considerations for non-U.S. companies doing business in the defense industry. In its imposition of additional due diligence on the foreign person end user, concerns as to the interpretation and breadth of the terms “substantial contacts” or “indicating a risk of diversion” may be ripe for further clarification. Also needed is clarification regarding the scope of an end user’s obligations when dealing with DTCN employees, where the existence of such contacts is discovered. Moreover, DDTC has not yet provided substantive details on what an “internal screening system” might entail.

Are you or your foreign affiliate affected by these changes? Would the affirmative obligations on gathering such employee information still present complications for your company under your national laws? If so, we recommend submitting Comments on this proposed rule to ensure that your concerns are heard and that your future business activities are not in violation of the ITAR. DDTC will accept comments on the proposed rule until Friday, September 10, 2010.

For more information on the ramifications of this proposed rule, or for assistance in preparing official Comments, Venable can help. Please contact Venable's International Trade and Customs team for assistance.

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