COVINGTON

COVINGTON & BURLING LLP

E-ALERT | International Trade Controls

August 26, 2013

STATE DEPARTMENT ISSUES INTERIM FINAL RULE AMENDING THE ITAR BROKERING REGULATIONS

The Department of State issued an interim final rule today that will substantially overhaul the brokering provisions of the International Traffic in Arms Regulations ("ITAR"). Comments on the rule are being accepted by the Department's Directorate of Defense Trade Controls ("DDTC"), which administers the ITAR, until October 10, 2013. The rule goes into effect on October 25, 2013.

The interim final rule expands the scope of covered brokering activities in certain respects, but its potentially most significant amendment to the brokering regulations is an apparent narrowing of the circumstances in which foreign persons will be subject to the brokering registration requirement. The rule also excludes from brokering activities those activities performed by one affiliate of an ITAR registrant on behalf of another affiliate of the registrant.

We are well-positioned to advise companies and individuals on the impact of these revisions to their business and on any comments that they may wish to submit to DDTC.

BACKGROUND ON THE BROKERING REGULATIONS

The ITAR's brokering regulations implement the Arms Export Control Act's requirement that persons engaged in the business of brokering arms transfers be registered with the government. The regulations have generally been considered unclear, in large part because they do not specify or define with precision the activities that constitute brokering and thus trigger brokering-related requirements, including registration, reporting, and, in some cases, prior approval for certain brokering activities.

Revisions to the regulations have been awaited for a decade. The process of amending the regulations began in 2003, when a State Department report to Congress indicated that DDTC would consider whether the regulations should be modified. Draft revisions to the regulations were released in 2009, but were never officially published or opened for comment, while a very different proposed rule was issued in December 2011. DDTC released another set of draft revisions in fall 2012 to the Defense Trade Advisory Group ("DTAG") (though these were not formally published for comment), significantly changing its approach from the December 2011 version, and has now published an interim final rule that largely tracks the draft revisions that were released in fall 2012.

THE REVISED SCOPE OF THE BROKERING REGULATIONS

ITAR Section 129.3, as currently in effect, imposes a registration requirement on anyone who engages in brokering activities, which under ITAR Section 129.2 means "acting as a broker . . . and includes the financing, transportation, freight forwarding, or taking of any other action that facilitates the manufacture, export, or import [of] a defense article or defense service, irrespective of its origin." ITAR Section 129.2 in turn defines "broker" as "any person who acts as an agent for others in

negotiating or arranging contracts, purchases, sales or transfers of defense articles or defense services in return for a fee, commission, or other consideration."

The interim final rule revises that language, requiring persons to register if they engage in brokering activities, defined as "any action on behalf of another to facilitate the manufacture, export, permanent import, transfer, reexport, or retransfer of a U.S. or foreign defense article or defense service." The interim final rule defines "broker" to include only a person who "engages in the business of brokering activities" and is a U.S. person (wherever located), a foreign person "located in the United States," or a foreign person located outside the United States and "owned or controlled by a U.S. person." (In a change from the version released in fall 2012, the rule does not include foreign persons by virtue of their involvement in temporary imports into the United States.)

This language expands the scope of brokering activity in certain respects, but also limits its application to foreign persons:

- The new rule clarifies that facilitation of an in-country transfer or retransfer, or a reexport from one foreign country to another, constitutes brokering activity. While DDTC has already considered such activities as within brokering activity, the new rule provides a stronger foundation for DDTC's approach, particularly in the enforcement context.
- The language "on behalf of" in the definition of a "broker" could be interpreted as legally broader than the current language of "act[ing] as an agent for others." While DDTC has long interpreted the "agent" language to extend well beyond the traditional concept of a principal-agent relationship, the revised language provides a stronger basis for DDTC to penalize persons for activity that does not involve acting as the agent of a principal.
- The new rule deletes the previous language that defined a broker as a person who acts "in return for a fee, commission, or other consideration"; there is no payment/consideration element in the new definitions of "broker" or "brokering activities."
- DDTC has sought to narrow the brokering regulations' application to foreign persons. Previously, the brokering regulations required foreign persons to register as brokers if they facilitated sales or other transfers of U.S.-origin defense articles. The new rule strictly limits the situations in which foreign persons will be considered as "brokers," as explained above. The Supplementary Information accompanying the interim final rule states that "foreign persons that are required to register as brokers are those that are in the United States and those foreign persons outside the United States that are owned/controlled by a U.S. person." This approach was intended to limit the registration requirement so that foreign persons acting abroad need not register just because they are facilitating sales of U.S.-origin defense articles.[1]

In addition, the rule provides additional guidance on conduct that does or does not constitute brokering activities. Section 129.2(b) notes that brokering activities include "[f]inancing, insuring, transporting, or freight forwarding defense articles and defense services" (subject to certain exceptions) and "[s]oliciting, promoting, negotiating, contracting for, arranging, or otherwise assisting in the purchase, sale, transfer, loan, or lease of a defense article or defense service." But brokering

[1] Unfortunately, due to an apparent drafting issue, the interim final rule's registration provision apparently does not give legal effect to this limitation. Registration is required of "any person who engages in brokering activities," *i.e.* any person, including any foreign person, who takes "any action on behalf of another to facilitate the manufacture, export, permanent import, transfer, reexport, or retransfer of a U.S. or foreign defense article or defense service." In other words, as the new broker registration requirement in ITAR § 129.3(a) is drafted, the limitation on who is a "broker" does not legally affect the registration requirement, which is triggered solely by the scope of "brokering activities." Addressing this drafting issue in the final rule would eliminate this potential uncertainty regarding the circumstances under which foreign persons must register as brokers.

activities do not include "[a]ctivities by regular employees . . . acting on behalf of their employer." The rule also excludes from the definition of brokering "administrative services," including "activities by an attorney that do not extend beyond the provision of legal advice to clients," and "activities by a U.S. person in the United States that are limited exclusively to U.S. domestic sales or transfers (e.g., not for export)." This latter exclusion is similar to a carve-out in the current brokering regulations for purely domestic activities, although this new exclusion specifies that the activities by the U.S. person must occur "in the United States."

Two other exclusions from brokering activities also will be consequential. One excludes "[a]ctivities performed by an affiliate . . . on behalf of another affiliate." This exception is particularly helpful in clarifying that DDTC no longer recognizes the concept of "intra-company brokering" by one affiliate of a registrant on behalf of another. (In an Advisory Opinion issued a few years ago, DDTC had taken the position that the brokering rules applied to such intra-corporate brokering.) The provision probably exempts the activities of an affiliate on behalf of the registrant itself (and not just acts by one affiliate of a registrant on behalf of another affiliate of the registrant), although this could be clarified. Finally, the interim final rule excludes from brokering conduct that does not extend beyond acting as an end-user of a licensed article/service or subsequently acting as an authorized reexporter of such article/service.

OTHER CHANGES TO THE BROKERING REGULATIONS

The interim final rule also provides for a number of other changes. For example, Section 129.7 of the brokering regulations currently requires those engaging in brokering activities to obtain prior approval from DDTC, which is similar to licensing, in many circumstances. Section 129.4 of the new rule substantially revises the circumstances in which the prior approval requirement applies, focusing the requirement on brokering of foreign defense articles/services and end-items such as USML aircraft, vessels, tanks, night-vision items, etc.

In addition, under the current rules, certain activities are subject to "prior notification," which is distinct from prior approval. The interim final rule will eliminate the prior notification requirement entirely.

Section 129.3(d) of the rule allows U.S. exporters registered as manufacturers or exporters under ITAR Part 122 to include on their Part 122 registration their U.S. and foreign subsidiaries and owned or controlled affiliates that will act as brokers.

Section 127.1(c) of the rule provides that "any person who is granted a license or other approval" is "responsible for the acts of . . . brokers, and all authorized persons to whom possession of the defense article, which includes technical data, has been entrusted regarding the operation, use, possession, transportation, and handling of such defense article abroad." Although not entirely clear, this provision likely clarifies simply that license applicants are responsible for their brokers' compliance with respect to licensed defense articles that come into the brokers' possession, rather than making applicants responsible for their brokers' overall compliance with the brokering rules.

The interim rule makes conforming and other changes to certain other parts of the ITAR, as well. For example, it provides in a note to ITAR § 122.4(a) that certain changes in a registrant's Statement of Registration (such as dealing in a new category of defense articles/defense services) now are to be notified to DDTC as part of the annual registration renewal. In addition, the interim final rule provides in a note to ITAR § 126.1(e) additional insight into what constitutes a "proposal" or "presentation" to sell or transfer defense articles to a proscribed country.

* * *

The State Department is currently in the process of making additional major changes to the ITAR as part of the export control reform effort. We will circulate additional e-alerts concerning these developments as warranted.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our international trade controls practice group:

Peter Lichtenbaum	+1.202.662.5557	plichtenbaum@cov.com
Kimberly Strosnider	+1.202.662.5816	kstrosnider@cov.com
Peter Flanagan	+1.202.662.5163	pflanagan@cov.com
Corinne Goldstein	+1.202.662.5534	cgoldstein@cov.com
David Addis	+1.202.662.5182	daddis@cov.com
Eric Sandberg-Zakian	+1.202.662.5603	esandbergzakian@cov.com