



The US End User Review Committee checks whether endusers engage only in commercial, non-military activity.

# The Struggles of Shipping Dual-Use Goods to China

*Two US Department of Commerce programs encourage exports to China but also add red tape for both sides.*

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**US** exports to China have risen rapidly in recent years, totaling \$69.7 billion in 2008, up nearly 30 percent from 2006. As demand fell during the global economic slowdown, US exports to China dropped but still accounted for 6.2 percent of total US exports, up from 5.5 percent in 2008. China's importance to the United States as an export market continues to

grow despite sometimes-onerous US export control restrictions. US export controls are more stringent than those of competitor nations, in part because of their complexity and resulting potential to delay transactions.

Though the value of US exports to China is increasing, the US-China trade deficit continues to expand, reaching \$268 billion in 2008, a 3.7 percent increase year on year.

The best way to remedy this imbalance is to increase exports to China, where the economy expanded even as the global economy soured.

The United States faces fierce competition as emerging markets with inexpensive labor compete on price for sales of commodity goods and developed countries compete for sales in value-added sectors. Even in the high-tech sector, where the United States enjoys a competitive advantage, stringent US export controls hamper growth.

To ease regulatory burdens for US exporters that seek to tap the enormous China market, the US Department of Commerce Bureau of Industry and Security (BIS) recently introduced two programs: the Validated End User (VEU) authorization program, which began in June 2007, and the proposed Intracompany Transfer License Exception program. Though these new initiatives could make life easier for US exporters and boost US exports to China, they expose participants—especially Chinese end users—to heightened US government scrutiny and increased administrative burdens. Whether companies perceive the risks and burdens as outweighing the programs' benefits remains to be seen, but early indications are not promising.

### VEU authorization program

BIS requires goods and technology that may be used for commercial and military purposes—referred to as dual-use items—to be licensed before they are exported to China. (The US Department of State controls goods used primarily for military purposes, including most satellite and aerospace technology and parts.) Because of concerns about PRC military involvement with private-sector technology firms in China, BIS heavily scrutinizes licensing applications for dual-use exports to China. This causes uncertainty, delays, and opportunity costs for US producers.

In June 2007, BIS implemented the VEU authorization program to ease the regulatory burden on US exporters and third-country re-exporters that ship approved technology to pre-authorized Chinese end users. The program requires the Chinese end user to apply to BIS for approval by the End User Review Committee, an inter-agency panel consisting of representatives from the US departments of Commerce, Defense, Energy, State, and other US agencies. The committee reviews the end user's records to ensure that it engages in only commercial, non-military-related activity and complies with US export controls. It also reviews the end user's relationships with US and other companies. If the committee approves the application, exporters may ship certain items designated by BIS to the end user without a license. The approval does not expire or require renewal. In return for VEU sta-

tus, however, the end user must allow BIS to conduct on-site audits and inspect records of all transactions that use this authorization.

The VEU program has several limitations. First, the End User Review Committee allows only goods, software, and technology with certain BIS export control classification numbers to qualify for license-free authorization. Certain items, such as those used in missiles or crime control, are ineligible for approval. Second, items exported under VEU authorization may be used only by the VEU or at the VEU's facility. Any further domestic or international transfer of the items requires separate BIS authorization. Finally, the authorization may be subject to company-specific limitations and conditions that are not disclosed to the general public.

### Quick Glance

- The Validated End User (VEU) program and the proposed Intracompany Transfer License Exception aim to make it easier to export dual-use items to China.
- Red tape, opposition in the US Congress, and reluctance in China have hindered use of the VEU program.
- If these problems can be resolved, the programs could help boost US exports to China.

### Objections to the VEU program

Challenges have plagued the VEU program since its inception. The PRC government objected at the outset to the program's requirement that VEUs allow BIS to conduct on-site audits, an objection that effectively suspended the VEU program and threatened to end it before it began. In early 2009—more than 18 months after the program began—the PRC Ministry of Commerce (MOFCOM) agreed to allow BIS on-site access to Chinese VEUs on the condition that the audits be arranged through MOFCOM and conducted were under its watchful eye. As *CBR* went to press, all indications were that no on-site audits have been conducted. Whether this sensitive, extra-judicial “validation” process can be implemented effectively remains uncertain.

Opposition in the United States has also threatened the VEU program. During US congressional hearings on the subject in 2008 and 2009, the nongovernmental organization Wisconsin Project on Nuclear Arms argued that the committee review process is faulty and dangerous. The organization alleged that two of the initial five VEUs approved by BIS have ties to the Chinese military and noted that another approved VEU shares an address with the China National Electronics Import and Export Corp., an entity sanctioned by the US State Department from 2006 to 2008.

Under the weight of criticism from both sides of the Pacific, the VEU program nearly collapsed at the end of 2008. BIS reportedly stopped accepting new applications in mid-2008 and disbanded the office that coordinated the End User Review Committee's work. But MOFCOM's agreement in early 2009 to allow BIS site visits in China appears to have given new life to the program: BIS approved an additional Chinese VEU in April and expanded the program to India, approving the first Indian VEU in July 2009.

**Benefits of the VEU program still uncertain**

The VEU program aims to reduce licensing burdens for US exporters. Though BIS boasts that up to 90 percent of licensed US exports to China will eventually be covered by VEU authorizations, the volume of exports shipped to approved VEUs under the program remains negligible. The VEU program may give Chinese end users easier, faster, and perhaps lower-cost access to US exports, but it also subjects them to greater US government oversight than standard licensing procedures. Some VEUs have stated that although they expect the authorization to help them in the future, they have not yet used it to import US products.

The process also exposes US exporters to BIS scrutiny: Exporters that use the VEU authorization must collect and maintain end-user certifications from VEUs and submit annual reports to BIS, and BIS may audit exporters' records of transactions with VEUs under the program. US exporters also bear compliance risk, because BIS reveals the company-specific conditions and limitations on VEU authorizations only to the VEUs and not to the exporter. BIS regulations compound this uncertainty by providing US companies with little guidance on procedures and requirements for shipping to a VEU.

**Intracompany Transfer License Exception**

BIS does not currently have a special licensing provision for export and re-export shipments among affiliated entities. In October 2008, BIS proposed the Intracompany Transfer (ICT) License Exception, which would allow an approved parent company and its approved wholly owned or controlled subsidiaries and branches to export, re-export, and transfer controlled items and technology among themselves without a BIS license. BIS has not yet implemented the exception.

The ICT would be similar to the Special Comprehensive License, which also covers multiple export transactions. The ICT, however, would have fewer and different limitations: It would allow unlimited shipments between approved entities for an unlimited amount of time and place fewer restrictions on the types of items that may be authorized for shipment. Only encryption technology and items controlled as "significant equipment" would be ineligible for shipment under the ICT exception.

The ICT exception has two important limitations. First, to be eligible for the exception, parent companies would have to be incorporated or have their principal place of business in the United States or one of 37 other BIS-designated countries. Parent companies based in China would not be able to use the exception, but Chinese subsid-

aries of approved non-Chinese parent companies would be eligible. Second and more significant, items shipped under the ICT exception would have to be used internally and could not be retransferred outside the approved company without separate BIS approval.

The ICT exception would reduce the licensing burden for approved companies, but similar to the VEU authorization, companies that use the exception would subject themselves to greater government scrutiny. To secure BIS approval, ICT applicants would have to develop and submit an internal control plan that complies with BIS regulations. The plan would also have to include a self-evaluation of compliance efforts and disclose any deficiencies that the applicant company may have. This mandatory "voluntary" self-disclosure requirement would subject the applicant company to increased US government scrutiny and potential fines and penalties. Applicants would also have to disclose the identities of significant shareholders and agree to biennial and spot audits of themselves and their subsidiaries.

**Assurances needed**

The perceived risk-reward imbalance, especially for Chinese end users, has so far kept the VEU program from easing the process of exporting dual-use items to China. If companies perceive the cost of more government scrutiny to outweigh the benefits of license-free internal transfers, the proposed ICT exception may reduce constraints on exports to China only modestly. Furthermore, uncertain cooperation from PRC authorities and resistance in the US Congress may hamper the growth of both programs.

To ensure that the VEU authorization and ICT exception free a significant volume of US exports to China from bureaucratic red tape, BIS will need to reassure exporters and Chinese end users that these programs will not expose them to significantly greater compliance risks and burdens. At the same time, BIS will need to assure domestic critics of its ability to perform due diligence on applicants to these programs. For now, US and PRC companies should consult with BIS and compliance counsel before deciding whether to take advantage of these programs. 完

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