

## Inside New ITAR Rules For US Defense Service Providers

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Non-U.S. companies (including affiliates of U.S. entities) employing U.S. persons abroad to provide “defense services” as that term is defined under the U.S. International Traffic in Arms Regulation should pay careful attention to a new proposed rule by the U.S. State Department, as should U.S. parents of such companies and the individual U.S. persons themselves. The State Department is seeking public comments on the rule by July 27 before it goes into effect.

On May 26, 2015, the U.S. Department of State Directorate of Defense Trade Controls released a proposed rule to amend the International Traffic in Arms Regulations with respect to the provision of defense services by U.S. persons working for, or on behalf of, non-U.S. entities (including non-U.S. affiliates of U.S. companies).

The proposed rule reflects the DDTC’s effort to clarify and codify a position which it has adopted in practice over the past several years, but has not previously addressed clearly in its regulations. The proposed rule would require U.S. “natural persons” who provide defense services while employed by non-U.S. employers to register with the DDTC and subsequently obtain ITAR authorization, subject to certain limited exemptions proposed by the agency. These requirements would apply even when the U.S. natural person’s non-U.S. employer is already an approved party on an ITAR authorization (e.g., a technical assistance agreement, manufacturing license agreement, etc.) and even where the employee’s activities are limited to those described in that authorization.

The State Department has opened a comment period on the proposed rule until July 27, 2015. The State Department is specifically interested in comments from “foreign persons who currently employ or are contemplating engaging U.S. persons as regular employees or independent contractors, as well as from current or future employees and contractors themselves.” This article provides an overview of the proposed rule and analyzes the issues it presents for U.S. persons and non-U.S. employers who furnish or receive defense services.

### The Proposed Rule



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## Individual Registration Requirement

The DDTC's proposed rule would revise the ITAR to include an explicit statement that U.S. persons (including natural persons), wherever located, who furnish defense services<sup>[1]</sup> must register with the DDTC. The proposed rule suggests that the coverage applies to U.S. person employees of non-U.S. person employers, whether abroad or in the United States. However, the draft regulatory language, as currently formulated, could apply more broadly, including with respect to U.S. individual contractors who are not employees.

The proposed rule features only one exemption where an individual registration would not be required: a covered U.S. person employee of a non-U.S. company is deemed to be registered if the non-U.S. employer is listed on the ITAR registration of a U.S. parent or other U.S.-affiliate entity. Consequently, U.S. person employees directly employed by a non-U.S. subsidiary or affiliate controlled by a U.S. registrant may not be required to have an independent registration. However, this proposed exemption contains limitations as it is currently worded. For instance, joint ventures, consortia and minority-owned assets of the U.S. registrant may not fit within the exemption because applicability of the registration exemption would turn on whether there is "control." The DDTC views control as a fact-specific issue, but presumes control where the registrant owns at least 25 percent of the voting securities and no other party controls an equal or greater share.

For parties without a pre-existing "control" relationship, the DDTC has proposed a path for U.S. registrants and foreign parties to establish a control relationship by written agreement. While the DDTC does not define with specificity its expectations for such an agreement, its definition of control suggests a requirement that the agreement establish the U.S. registrant's "authority or ability to establish or direct the policies or operations of the [non-U.S.] firm with respect to compliance with [the ITAR]."

In addition, the DDTC has not extended the possible benefits of the exemption to the U.S. person employees of non-U.S. person employers who are not controlled by or otherwise affiliated with a U.S. entity, even where the non-U.S. employer has received and is acting under an ITAR approval (e.g., a TAA or MLA).

## Authorization/Licensing Requirement

Separate from the issue of registration, the proposed rule clarifies the DDTC's expectations regarding when a U.S. person employee must obtain specific authorization from the agency before providing defense services to a non-U.S. party and when the employee can rely on an authorization provided to the U.S. registrant or that registrant's affiliate. Registration is a prerequisite to authorization, including the use of the ITAR exemptions described below.

Unless exempt from the licensing requirement, the proposed rule sets forth the following possibilities under which a U.S. person can perform defense services while employed by a non-U.S. person:

- **Authorization through an individual DSP-5 license.** This will require individual filing by and in the name of the U.S. person employee and regular maintenance of the DSP-5; or
- **Authorization through a U.S. registrant's ITAR agreement.** The DDTC proposes that a covered U.S. person employee can be authorized through an ITAR agreement (e.g., a TAA or MLA) between a registered U.S. company and a non-U.S. employer under two conditions. First, the non-U.S. employer must be listed on the U.S. company's ITAR registration as a subsidiary or affiliate as described above.

Second, the DDTC requires that the U.S. company “accepts responsibility for, and demonstrates ability to ensure, the natural U.S. person’s compliance” with the ITAR.

Notably, the rule does not explicitly address other possible approaches which the agency has in practice been willing to consider and approve of other possible approaches to authorizing U.S. person employees of non-U.S. entities to provide defense services. For example, the formation of a U.S. subsidiary by a non-U.S. company would be one way of allowing for a single ITAR registration and licensing covering all employees. The new rule neither explicitly provides for or precludes such a model.

As discussed below, the DDTC proposes two possible exemptions from this licensing requirement:

#### ***License Exemption for U.S. Person Employees of NATO/EU+4 Countries***

Under the proposed rule, U.S. person employees of non-U.S. person employers located in the following countries may qualify for a licensing exemption: any NATO or EU member state, Australia, Japan, New Zealand or Switzerland (“NATO/EU+4”). However, non-U.S. employers, U.S. registrants and the affected U.S. person employee must be aware of certain conditions and limitations before relying on this licensing exemption.

In particular, this licensing exemption only applies where:

- the end user(s) of any associated defense articles (as well as the non-U.S. employer) are located in a NATO/EU+4 country;
- the defense services are provided only within these countries;
- the employee does not provide U.S.-origin defense articles, including technical data, to his/her employer without separate authorization;
- the employee does not transfer any technical data that is classified, identified as significant military equipment or subject to missile technology controls pursuant to the Missile Technology Control Regime, even if separately authorized; and
- the employee maintains records of his/her activities and complies with the ITAR’s registration requirements, as applicable.

#### ***License Exemption for Certain FMS-Related Activities***

The proposed rule introduces another potential licensing exemption for U.S. natural persons providing defense services in support of an active Foreign Military Sales Program under 22 CFR §126.6, subject to the following conditions:

- the defense services are provided in support of an active FMS contract and are identified in an executed letter of offer and acceptance (LOA);
- the employee does not provide U.S.-origin defense articles to his/her employer without separate authorization;

- the defense services are not provided to a proscribed country (as identified in section 126.1 of the ITAR);
- the employee does not provide technical data that is classified or identified as SME to his/her employer, even if separately authorized; and
- the employee maintains records of his/her activities and complies with the ITAR's registration requirements, as applicable.

### **Possible Issues For U.S. Employees of Non-U.S. Entities**

The proposed rule provides a number of paths to mitigate the compliance burden for U.S. persons employed by a subsidiary or affiliate of a U.S. registrant, including an exception to the registration requirement and a streamlined authorization process via a TAA or other ITAR agreement. The proposed rule also purports to make these streamlined procedures available to employees of non-U.S. companies that are not affiliated with a U.S. registrant by proposing that a U.S. registrant and otherwise unaffiliated non-U.S. entity enter into a "control" agreement whereby the U.S. company must "accept responsibility for and demonstrate ability to ensure" ITAR compliance on the part of the non-U.S. company's U.S. employees.

As a practical matter, it is not clear how or why U.S. companies would accept this burden when dealing with an otherwise unaffiliated non-U.S. entity in a commercial, arms-length relationship. In the absence of non-U.S. entities that are willing to cede compliance responsibilities to their U.S. business partner and U.S. registrants that are willing to accept such responsibility and the associated liability exposure, U.S. employees of unaffiliated non-U.S. companies are disproportionately impacted by this proposed rule. While the compliance burden for entities employing fewer employees may be relatively limited, the proposal rule does not provide a practical path to compliance for such unaffiliated non-U.S. companies employing more significant numbers of U.S. persons in roles involving the furnishing of defense services.

Additional considerations in this regard as applied to the registration and authorization requirements are discussed in further detail below.

### **Registration Requirement**

Where an affiliate relationship is not established through a "control" agreement or otherwise, U.S. employees furnishing defense services are left with no option under the proposed rule other than to individually apply for and maintain an ITAR registration, which must be renewed annually. Based on the DDTC's current fee structure, this involves a minimum cost of \$2,250 per individual registration per year, although the proposed rule states that the DDTC is considering a reduced fee.

Additionally, the DDTC's registration process is not currently designed to handle registrations from individuals, as opposed to organizations. For example, the DDTC's own "DS-2032 Statement of Registration" currently requests a "Legal Business Name," "Doing Business As Name," "Registrant's Organizational Type" and several other fields clearly demonstrating that the form was created for entities, rather than individuals, to complete. The DDTC has not indicated whether and how it will simplify the registration process or redesign its statement of registration to be better suited for completion by natural persons.

As a practical matter, in addition to the costs and logistics involved, non-U.S. companies managing this

process on behalf of their U.S. employees can expect to face staggered renewal deadlines for their employees that could extend the administrative burden year-round, as well as a requirement to obtain special approval in order to pay registration fees from a non-U.S. bank account.

The DDTC could address the majority of these concerns by introducing a consolidated application procedure whereby U.S. person employees of a non-U.S. entity apply jointly and pay a nominal fee per individual. The DDTC should also consider a streamlined amendment process in the event of U.S. person employee additions or departures to address the issue of staggered employee departures in connection with such consolidated filings.

### **License Exemptions**

After registering, employees may be exempt from applying for a license if they fall within the purview of either of two new license exemptions.

One of the license exemptions applies only to individuals located in NATO/EU+4 countries under specific circumstances, including that all of the following must be located in a NATO/EU+4 country: the non-U.S. employer, the defense services furnished and end users of any associated defense articles. It is unclear how this license exemption would benefit a U.S. person employee that works on a particular military platform on behalf of multiple end users, some of which are located in a NATO/EU+4 country and some of which are not.

The second license exemption applies to U.S. persons furnishing defense services in support of an active FMS contract under specific circumstances, including that the defense services are identified in an executed LOA. It is unclear from the wording of the exemption whether the non-U.S. employer must be party to the LOA or whether the benefit of the exemption extends to subcontractors and other third parties associated with the program. It is also unclear the extent to which defense services — particularly aftermarket services — would be routinely identified in an LOA and whether they would be covered by the exemption if they are not.

### **Licensing Requirement**

U.S. person employees who do not meet the requirements of one of the new ITAR exemptions would need to submit a DSP-5 license application to authorize the scope of defense services they intend to provide to their employers. In order to obtain a DSP-5 authorization, individuals will need to establish a D-Trade account, purchase a digital certificate and separately apply for and maintain/renew a DSP-5 license. As with the registration submission process discussed above, these authorization tasks have typically been the purview of corporate registrants and will likely be unfamiliar territory for most U.S. person employees.

The requirement that each individual U.S. person employee obtain a DSP-5 does not seem practical where a company has more than a small number of U.S. person employees and the DDTC should consider mechanisms to reduce the compliance obligations on non-U.S. companies with large numbers of U.S. person employees. For example, the DDTC may consider explicitly allowing DSP-5 applications for multiple U.S. person employees playing similar roles within an organization, rather than requiring DSP-5 authorizations for each individual employee.

The proposed rule also raises questions with respect to individuals employed by non-U.S. companies that are affiliated (through a control relationship or otherwise) with a U.S. registrant. Employees of such

non-U.S. companies are eligible under the proposed rule to seek authorization through a single ITAR agreement, rather than individual DSP-5 licenses, although it is not clear what the DDTC's expectations will be for defining the scope of the agreement and assessing a value. The valuation point is particularly noteworthy because agreements rising above a certain threshold trigger congressional notification, a process which can significantly delay approval turnaround times. We expect that the DDTC will address these types of concerns in revisions to its Guidelines for Preparing Electronic Agreements concurrently with publishing a final rule on this issue.

### **Defense Services Proposed Rules**

As reviewed above, the proposed rule applies only to U.S. persons who furnish "defense services," which, as currently defined, includes any "assistance (including training) to foreign persons, whether in the United States or abroad in the design, development, engineering, manufacture, production, assembly, testing, repair, maintenance, modification, operation, demilitarization, destruction, processing or use of defense articles" and any "military training of foreign units and forces."

It is important to note that the DDTC has, on a number of occasions, characterized this definition as "overly broad" and "capturing certain forms of assistance or services that no longer warrant ITAR control." To address this, the DDTC proposed revisions of the "defense service" definition on April 13, 2011 (76 FR 20590), May 24, 2013 (78 FR 31444), and again on June 3, 2015 (80 FR 31525), after issuing this proposed rule on U.S. persons employed abroad. The contemplated revisions to the defense service definition would reduce the scope of ITAR regulated defense services and thus reduce the scope of U.S. persons affected by this proposed rule.

Although the sets of rules do not reference one another, the DDTC may consider delaying implementation of a final rule on U.S. natural persons furnishing defense services until it has appropriately clarified its definition of defense services that "warrant ITAR control."

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[1] The ITAR defines the term 'defense service' broadly to include a range of activities including certain assistance/training to foreign persons with respect to the development, production or use/employment of defense articles as well as military training of foreign units. As discussed below, the definition of "defense services" under the ITAR is also currently the subject of a proposed rulemaking by the State Department.