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Export Controls

Gone are the days when Canadian companies could take an attitude of indifference toward export control laws, international trade attorneys Thad McBride, Sheppard Mullin, Washington, D.C., and Jennifer Radford, Borden, Ladner, Gervais, Ottawa, Canada, write in this Bloomberg/BNA analysis piece on Canadian and U.S. export control laws. They describe steps companies should take to deal with the heightened enforcement of Canada's export control regime and avoid running afoul of the even more stringent U.S. export control system, which applies to every Canadian company with existing or potential U.S. business relationships.

What Every Canadian Business that Exports Can No Longer Afford to Ignore: Canadian and U.S. Export Control Law Compliance

BY THAD MCBRIDE AND JENNIFER RADFORD

Although every Canadian company doing business in international trade is subject to export control laws, the general sentiment to date towards these laws has been indifference. Many Canadian companies remain unaware that export controls even apply to their goods or technology, and as such, have not concerned themselves with ensuring compliance to the same extent as they have in other regulated aspects of their business.

Continuing along with this relaxed approach is fraught with risk.

The Canadian export control environment is changing. Historically, Canada has not aggressively enforced export compliance laws. With pressure to do so from the United States becoming more and more intense, however, enforcement activity is significantly on the rise. Penalties for non-compliance with Canadian export control laws, including significant fines and imprisonment, are now being imposed.

In one recent case, an individual was sentenced to four years in prison for attempting to export ''pressure transducers'' to Iran without an export permit. Pressure transducers have a wide variety of lawful commercial

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applications (such as medical sterilization or vacuum drying processes), but are also an essential component in the enrichment of uranium. For this reason they are subject to Canadian export controls. We expect this trend of increasing enforcement activity, along with more active imposition of administrative monetary penalties by the Canadian Border Services Agency, to continue.

For Canadian companies with potential or existing relationships with U.S. businesses, the stakes are even higher. To begin with, U.S. export compliance laws often have extraterritorial reach. In addition, the U.S. export control regime is taken extremely seriously by the U.S. government and businesses alike. Breaches of U.S. export controls are aggressively prosecuted, and penalties are—at least by Canadian standards—draconian. As just one example, in August 2010, the U.S. State Department announced that Xe Services had agreed to a civil penalty of $42 million for various export violations, including unauthorized exports of U.S. products and technical data.

Moreover, any Canadian company involved in a merger or acquisition process with a U.S. counterpart can expect that the due diligence exercise will include a review of export compliance. The U.S. party is likely to insist upon understanding the scope of its partner's export activities, any U.S.-origin items or technology the partner has exported, and the role of U.S. persons in the partner's international business. Depending on what is identified during that due diligence process, the U.S. party may advocate for a voluntary disclosure of any violations to the U.S. and Canadian governments. The terms of the deal may also get modified to reflect possible penalties for violations, and the resources the U.S. party will want to commit to improving compliance. In some cases, material insufficiencies could even scuttle the purchase.

With that in mind, let's take a look at the Canadian and U.S. export regimes, some of the compliance challenges that arise under those regimes, and strategies for addressing those challenges.

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Canadian Regime: Controlled Goods, Specific Countries, Require Export Permit

The Canadian *Export and Import Permit Act* allows the minister of international trade to issue an export permit to authorize the export of items (i) specified on an ''Export Control List'' or (ii) to a country specified on an ''Area Control List.'' Without an export permit, items listed on the ''Export Control List'' are prohibited exports, and the export of any item to a country on the ''Area Control List'' is prohibited.

While free trade is a major Canadian priority, export controls have been recognized as essential for a number of reasons:

- To regulate the trade of products and technology sold for military use;
- To prevent the proliferation of chemical, biological and nuclear weapons of mass destruction; and
- To prevent the sale of military products and technologies to countries that are perceived to be a security threat, are subject to United Nations sanctions and/or are abusing human rights.

Many of the goods and technology listed in the ''Export Control List'' are obviously military products and technologies. For this reason, there is no surprise that such items cannot be exported without an export permit. That said, other goods and technologies that have a variety of lawful commercial applications are also subject to export controls.

Scope of Goods Requiring Permit Broader Than One Might Think

The goods and technology subject to the *Export and Import Permit Act,* and the related ''Export Control List,'' are very broad in scope. To this end, ''Dual Use'' goods and technology, which are those that can be used for both military and non-military commercial purposes, represent a large variety of products regularly exported out of Canada. Examples include certain types of:

- Alloyed materials
- Banking equipment
- Cellular communications equipment
- Compressors
- Computers
- Cutting and milling machines
- Digital video recorders and photographic equipment
- Freeze-drying equipment
- Machinery and tools
- Sensors

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- Software containing encryption

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Canada has also regulated the export of certain types of goods to protect vulnerable industries. Export controls apply to items such as:

- Forest products
- Peanut butter
- Products that contain sugar
- Refined sugar
- Textiles and clothing.

This sampling is small. The ''Export Control List'' contains over a thousand items that may require an export permit.

Potential Consequences for Exporting Without Permit are Serious

The Canadian Border Services Agency (CBSA) has broad policing authority under the *Customs Act* and the *Export and Import Permits Act*. It has the power to engage in searches, seizures, detentions, and investigations to ensure that exports are in compliance. Prosecutions of export violations can result in fines (there is no cap on the amount), imprisonment for up to ten years, or both. Moreover, directors and officers of corporations who do as little as ''acquiesce'' to the commission of the offence are personally exposed to conviction and punishment regardless of whether the corporation has been prosecuted or convicted.

Companies may also be subject to the Administrative Monetary Penalty System (AMPS), which authorizes the CBSA to impose monetary penalties for noncompliance with customs laws and program requirements. In this regard, the ''AMP C315'' expressly provides for monetary penalties if an exporter fails to provide a required export permit.

U.S. Export Control Laws: Yes, They Might Apply and Yes, They are Even Scarier

It is also important for Canadian companies to understand their obligations under U.S. export controls regulations. As summarized below, exports of nearly all U.S.-origin items are controlled either by the U.S. State Department—for exports of defense articles, services, and technical data, or the U.S. Commerce Department—for virtually all other goods, software, and technology.[1]

The U.S. State Department, Directorate of Defense Trade Controls (DDTC) administers controls over U.S.-origin defense articles, services, and technical data pursuant to the International Traffic in Arms Regulations (ITAR). Under the ITAR, a ''defense article'' is defined to include any item designated on the U.S. Munitions List (USML). Under the ITAR, DDTC may also exercise jurisdiction over items not specifically enumerated on the USML if DDTC determines that the item has a substantial military utility and has been specifically designed or modified for a military purpose.

DDTC takes the position that the ITAR controls any item, regardless of where manufactured, that contains any U.S.-origin defense article. Thus, for example, a defense article manufactured in Canada that contains an ITAR-controlled component, no matter how small, would likely be controlled for export under the ITAR (in addition to any controls imposed on the item under Canadian law).

The ITAR also governs defense technical data, *i.e.*, information that is required for the design, development, production, manufacture, assembly, operation, repair, testing, maintenance, or modification of defense articles. Under the ITAR, technical data may take the form of plans, diagrams, engineering designs, drawings, photographs, instructions, or other forms of data. Certain kinds of data are not controlled by the ITAR, however, including information in the public domain, *e.g.*, information which is published and which is generally accessible or available to the public.

As noted above, exports of ''defense services'' also are controlled under the ITAR. A ''defense service'' is defined as ''[t]he furnishing of assistance (including training) to foreign persons, whether in the United States or abroad in the design, development, engineering, manufacture, repair, maintenance, modification, operation, demilitarization, destruction, processing or use of defense articles.''

Under the ITAR, a license or other specific authorization from DDTC is required to export a defense article (or defense service or technical data) to most destinations. In addition, the United States imposes arms embargoes on approximately 30 countries, including China.

Virtually all U.S.-origin items not subject to the ITAR are controlled for export under the Export Administration Regulations (EAR) administered by the U.S. Commerce Department, Bureau of Industry and Security (BIS). (A very few items are subject to the exclusive jurisdiction of some other export control agency.)

While the coverage of the EAR is broad, unlike under the ITAR, most items controlled pursuant to the EAR can be exported to most destinations and most end users without a license. Where a license is required, the licensing determination is based on the item's technical characteristics, destination, end-user, and end-use.

EAR jurisdiction applies to several categories of items, as follows: (i) items physically located in the United States, regardless of where manufactured; (ii) items wholly manufactured in the United States, wherever located; (iii) foreign-origin items with more than *de minimis* U.S.-origin content, and certain technology related to those items; and (iv) foreign-origin items that are considered to be a ''direct product'' of certain controlled U.S.-origin technology or software.

Thus, as with the ITAR, certain goods manufactured in other countries, where the good includes some U.S.-origin parts or components, are controlled for export under the EAR (in addition to any controls imposed on the item by the country in which it was manufactured). Likewise, U.S.-origin goods are controlled for export under the EAR regardless of where the export occurs, *e.g.*, if a U.S.-origin item is exported from Canada to England, even if the item is controlled for export under Canadian law, it is also controlled for export under the EAR.

[1] While it is outside the scope of this article, it is important to note that the United States also maintains economic sanctions programs against a number of countries, governments, entities, and individuals. Many of these sanctions programs include prohibitions or restrictions on exports to sanctions targets.

Also like the ITAR, the EAR regulates exports of technology and software related to controlled commodities. Controlled ''technology'' may include plans, specifications, design information, technical data, and manufacturing know-how. Certain types of information—as under the ITAR—are excluded from control under the EAR, including technology that is ''publicly available'' and other information, such as information published in a newspaper or other such publication.

The EAR imposes controls on exports made in any form, such as by email, facsimile, or in other soft-copy form, as well as the ''release'' of technology or software to a foreign national, including through oral or visual disclosure. Such disclosure of controlled technology to a foreign national is considered a ''deemed export'' even if the disclosure takes place within the United States. For example, if a Canadian national graduate student is in the United States on a legitimate student visa and receives EAR-controlled technical data while working in a research laboratory, the sharing of that data with the student is considered an export and must be authorized under a license or license exception.

Significant penalties can be imposed for violations of U.S. export controls. Civil penalties can be as high as $500,000 per violation, while criminal penalties can be as high as $1,000,000 and/or up to 10 years of imprisonment per violation. In certain cases, the U.S. government may also suspend or terminate a party's export privileges.

Ensuring Compliance: Key Strategies

There are two key steps that companies should take to promote export compliance:

■ Conduct an internal compliance review. This should assess whether any of the export items are subject to the *Export Control List* or are considered U.S.-origin goods, and whether any of the export destinations are subject to the Area Control List or United Nations economic sanctions. This will enable the company to identify and prioritize its risks, then take appropriate steps to address those risks.

■ Implement an internal export compliance program. The internal compliance program should identify an export compliance manager, establish a recordkeeping policy and an internal audit procedure, set out internal training requirements, and confirm the processes related to export permit applications. To the extent that the Canadian company has operations in the United States, or subsidiaries in the United States, the compliance program should address the export control laws applicable in both countries.

Too Late? Key Strategies for Fixing Non-Compliance

If an export control violation is identified after the fact, a voluntary disclosure process can be commenced. Typically, unless a company has a history of repeated export control violations, the Canadian government will not immediately impose monetary penalties for voluntarily disclosed export control offences.

The U.S. government has a similar process; depending on the nature of the export violation, the disclosure will be made to either the State Department (for ITAR violations) or the Commerce Department (for EAR violations). Even in the case of a voluntary disclosure, however, the U.S. government frequently imposes penalties, though those penalties will likely be mitigated based on the disclosure.

Whether making a voluntary disclosure in Canada or the United States (or in both countries), the disclosure should be accurate, contrite and in compliance with regulatory requirements. An appropriate level of review must be undertaken to ensure that relevant facts and potential violations are identified and disclosed in full. Mitigating facts should also be presented, along with corrective actions taken.

The voluntary disclosure process is key. A flawed process has the potential to undermine a company's credibility not only with respect to the facts surrounding the particular export control violation, but also overall export compliance. This will increase the risk of financial penalties and increased scrutiny in the face of subsequent applications for export permits.

Conclusion

Gone are the days where companies can turn a blind eye to export control compliance. In Canada, the government has demonstrated a new resolve to investigate and prosecute violations of Canadian export control laws. That, matched with the U.S. government's aggressive enforcement of U.S. export laws, mean that exporters wherever located should assess the adequacy of their internal compliance programs.

Such an internal review, while initially time consuming, will pay dividends in the long term. During either a voluntary disclosure assessment or a formal investigation, the government will often look first at the existing processes and procedures in place to ensure export control compliance. To be credible with the government, such processes and procedures must be effective in preventing and detecting violations.

When conducting an internal compliance review, most Canadian companies will require guidance from both Canadian and U.S. legal counsel. When searching out expertise in this area, make sure that you identify counsel who are familiar with both the Canadian and U.S. export control regimes. In the best case scenario, hire Canadian and U.S. legal counsel who have previously worked together on compliance matters. This will lead to a more efficient internal review and, correspondingly, a much stronger compliance program.

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