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EXPORT CLASSIFICATION – THE CORNERSTONE OF ITAR COMPLIANCE

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August 12, 2014

In reviewing the numerous Directorate of Defense Trade Control (“DDTC”) enforcement cases over the past year,² one practice stands out above all else as the root of ITAR compliance problems – improper classification. Export classification is the process of: (i) determining if a company’s product or service is subject to the jurisdiction of the State Department (under ITAR) or the Commerce Department (under the Export Administration Regulations (“EAR”)); and then (ii) identifying the specific sub-category of the U.S. Munitions List (“USML”) or the Commerce Control List (“CCL”) that applies to the product or service.

This is an especially important time for companies to review their export classifications due to Export Control Reform (“ECR”). Under ECR, the State and Commerce Departments are jointly revising the USML and CCL on a category-by-category basis. As a result of these new amendments, many export classifications that companies previously performed will no longer be valid - companies will be required to reclassify their products and services based on these changes. The amendments are being adopted on a staggered basis - the first of these changes (for aircraft, aircraft parts and gas turbine engines) have already become effective,³ and others such as military electronics and satellites will become effective over the next few months.⁴ Now is the time for companies to confirm and update their export classifications.

Since the legal requirements that arise in transferring controlled products, technical data, software and performing defense services flow from the classification of the items in question,

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² See, for example, DDTC Proposed Charging Letter In the Matter of Intersil Corporation, available on DDTC website; DDTC Proposed Charging Letter In the Matter of Esterline Technologies Corporation, available on DDTC website; DDTC Proposed Charging Letter In the Matter of Meggitt-USA, Inc., August 19, 2013, available on DDTC website; DDTC Proposed Charging Letter, In Re Aeroflex, Inc., July 25, 2013, available on DDTC website.

³ Revised USML Category VIII – Aircraft and Related Articles, and XIX – Gas Turbine Engines and Associated Equipment, along with the companion categories on the CCL, became effective on October 15, 2013.

⁴ Category XI -Military Electronics will become effective for most items on December 30, 2014 and Category XV - Spacecraft will become effective for most items on November 10, 2014.

classification is the foundation of ITAR and EAR compliance – companies must get this right for the rest of their compliance efforts to be effective.

Classifications By Companies That Perform Services In the Defense Industry. For companies that perform services for government customers, especially in the defense industry, it is essential that, for each new contract, task order and other new activity, the company review the proposed new activity to determine if requirements will arise under ITAR and EAR. These could include the requirement to obtain Technical Assistance Agreements (“TAA’s”) for the performance of defense services, obtain licenses for selling or transferring controlled equipment, technical data and software and other requirements. Determining the classification of defense services under these contracts is an important part of the compliance process. This review should be undertaken on a formal basis at the beginning of the contract and periodically throughout the performance of the project. ITAR requirements can also arise even before a new contract is awarded – licenses may be required if a company is transferring ITAR-controlled or EAR-controlled technical data in marketing proposals or presentations to foreign parties. Consequently, the company should also conduct its ITAR analysis at the marketing stage to assure no violations occur at this stage of the project.

Manufacturers and Second- and Third-Tier Suppliers. Classification is also an important step for manufacturers of products, including end items as well as parts, components, accessories, attachments and software used in defense systems. Companies are advised to conduct their analysis in a specified order: (i) first, analyze if the item is listed on the USML and subject to ITAR; and if not (ii) then analyze the classification under the EAR and other federal regulations. DDTC advises that manufacturers should not rely on Commerce Department classification guidance to determine if an item is subject to ITAR, but rather rely solely on review of the USML and commodity jurisdiction guidance from DDTC to determine if an item is subject to ITAR. While parties are permitted to “self-classify” their products under ITAR, a commodity jurisdiction determination by DDTC will provide written confirmation of the jurisdiction and ITAR classification by DDTC. In one recent enforcement case charging letter, DDTC emphasized this point:

The proper classification of a particular article or service as subject to the Department of State or Department of Commerce jurisdiction is critical to avoid potential export violations. The DDTC commodity jurisdiction (“CJ”) procedure of ITAR § 120.4 is the only U.S. government method of determining whether an article or service is covered by the USML. Respondent, to include its subsidiaries, primarily relied on commodity classification guidance from the Department of Commerce in reviewing the export control status of its microelectronics and electronics. Respondent and subsidiaries failed to understand, however, that the Department of Commerce can only properly classify items which are subject to the Export Administration Regulations (“EAR”) (15 C.F.R. Parts 730-774). While companies may self-classify an article or service, it is to their advantage to seek a CJ determination where a company has doubts about whether it is covered by the USML. An item is considered to be a defense article when it meets the criteria in one or more of the categories on the USML. Because an article will meet the criteria at the time of manufacture, it is generally recognized that specific defense articles

are considered to be on the USML at the time of manufacture. Improper classification by the manufacturer would not change the jurisdiction of the article. (Emphasis added.)⁵

The Importance of “Specially Designed”. As part of ECR, many parts, components and attachments of defense items will continue to be regulated under either ITAR or EAR. To assist companies in applying these controls to parts and components, DDTC and BIS have adopted the specific term “specially designed” for designating these items throughout the USML and CCL. Companies will most likely be required to apply this definition in many of their classification assessments. In reviewing classification issues, companies should recognize that the term “specially designed” has a detailed definition set out in both ITAR⁶ and EAR⁷ – companies should review this term carefully, along with the accompanying Notes and agency “decision tree” guidance, in applying the term and making their classification determinations.

In conducting export classification activities, companies are also advised to maintain written records of their classification decisions to comply with export recordkeeping requirements and as a defense if their classification determinations are ever challenged in the future. DDTC specifically addressed this issue in its April 16, 2013 Final Rule under Export Control Reform:⁸

Consistent with the recordkeeping requirements of the ITAR and the EAR, licensees and foreign persons subject to licenses must maintain records reflecting their assessments of the proper regulatory jurisdiction over their items. License holders unable to ascertain the proper jurisdiction of their items may request a CJ determination from DDTC through the established procedure.

Similarly, provisions in other sections of ITAR and EAR, such as the definition of “Specially Designed” at 22 CFR § 120.41 and EAR Part 772, also set forth requirements for required documentation to support classification decisions.⁹

Steps For Classification. The following are a number of steps to consider for conducting export classifications for products (including end-products, systems, parts, components and accessories), technical data, software and defense services:

- Start by determining if the item is listed on the US Munitions List and subject to ITAR. Review the provisions of the USML carefully to see if your item is identified on the list. In addition, review the newly adopted ITAR “Order of

⁵ See DDTC Proposed Charging Letter, In Re Aeroflex, Inc., July 25, 2013, available on DDTC website.

⁶ The ITAR definition of “Specially Designed” is set out at 22 CFR § 120.41.

⁷ The EAR definition of “Specially Designed” is set out at EAR Part 772.

⁸ See Federal Register Vol. 78, No 73, page 22750, April 16, 2013.

⁹ See, for example, 22 CFR Section 120.41, Note 1 to Paragraphs (b)(4) and (5), which provides as follows: “For a defense article not to be specially designed on the basis of paragraph (b)(4) or (5) of this section, documents contemporaneous with its development, in their totality, must establish the elements of paragraph (b)(4) or (5). Such documents may include concept design information, marketing plans, declarations in patent applications, or contracts. Absent such documents, the commodity may not be excluded from being specially designed by either paragraph (b)(4) or (5).”

Review” set forth at 22 CFR § 121.1(b) and the recently revised legal standard set forth at 22 CFR §§ 120.3 and 120.4.

- For parts, components and accessories you may be required to review whether the item fits within the ITAR version of the definition of “Specially Designed” set forth at 22 CFR § 120.41¹⁰. When reviewing this definition follow the procedure set forth in 22 CFR § 121.1(d) and also review the “Notes” that accompany the definition as they provide further details regarding the application of the definition, including records to be reviewed. If necessary, review the “Decision Tree” guidance provided by DDTC for both (i) the Order of Review; and (ii) Specially Designed.¹¹
- To obtain a written confirmation of whether the item is on the USML and subject to ITAR, apply for a commodity jurisdiction determination from DDTC.
- If the item is not subject to ITAR, assess if it is subject to the EAR or the jurisdiction of other federal agencies (See EAR § 734.3). To assess classification under the EAR, begin by reviewing EAR § 734.3(a) and related provisions, the Commerce Control List and the CCL Order of Review set out at EAR Part 774 Supplement No. 4. Under the EAR Order of Review, 600 Series items and the 9x515 ECCN items are given a higher priority in the classification process than other items on the CCL – review the 600 series and 9x515 ECCN items first, then review the rest of the CCL. Follow the BIS Order of Review to determine the item’s export control classification number (“ECCN”) or if it is EAR99.
- As part of this process you may be required to review the EAR definition of “Specially Designed” set out at EAR Part 772.¹² You should also review the “Notes” included in this definition of Specially Designed as they provide important details in the application of this term. You may also want to review the BIS Decision Tree for Specially Designed.¹³
- If you wish to obtain written confirmation of the classification of the item under the EAR from the Bureau of Industry and Security (“BIS”), you can submit a request to BIS for a Commodity Classification Automated Tracking System (“CCATS”) determination. It should be noted, however, that BIS classification guidance is not binding on determining whether an item is subject to ITAR – only the State Department can provide guidance on whether an item is subject to ITAR.

¹⁰ 22 CFR §121.1(d)(2) provides in pertinent part: “If your commodity or software is not enumerated on the U.S. Munitions, it may be controlled because of a specially designed control parameter. If so, begin any analysis with §120.41(a) and proceed through each subsequent paragraph....”

¹¹ Available on the DDTC website.

¹² As part of this process you may be required to review “Specially Designed” for the 600 Series items first and then again for the remainder of the CCL.

¹³ Available on the BIS website.

- To assess if the item is subject to the jurisdiction of other federal agencies (for example, the U.S. Nuclear Regulatory Commission or the Department of Energy), refer to EAR §734.3(b) and such other agencies' regulations as might apply to the specific item in question.
- For all export classifications (including under ITAR, EAR and other regulations), maintain written records of your determination to comply with the export recordkeeping requirements and as a defense if your classifications are ever challenged in the future.

Export classification determinations can sometimes be complex decisions, and the above list is not a complete list of steps to take to arrive at proper classifications. The exact steps must be determined by the company and its counsel based on the facts of the specific situation – other steps may include consulting directly with DDTC and BIS officials, reviewing DDTC's Commodity Jurisdiction Final Determinations¹⁴ and other steps – one size does not fit all, and you should adopt the procedure that is appropriate for your company and products.

Export classification is just one step in the full spectrum of proper ITAR and EAR compliance. Other steps include: (i) appointment of a compliance officer within the company to oversee ITAR and EAR compliance; (ii) adopting a written ITAR/EAR Compliance Program; (iii) conducting employee training; (iv) obtaining requisite licenses and authorizations as required, (v) performing proper administration of licenses, agreements and other authorizations; (vi) conducting annual internal compliance audits; and (vii) complying with export recordkeeping requirements.

Please note: This article contains general, condensed summaries of actual legal matters, statutes and opinions for information purposes. It is not meant to be and should not be construed as legal advice. For more information, please visit our website at www.williamsmullen.com or contact Thomas B. McVey, 202.293.8118 or tmcvey@williamsmullen.com.

¹⁴ Available on the DDTC website.