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State Department Publishes Interim Final Rule to Clarify Defense-Broker Requirements

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Section 38(f) of the Arms Export Control Act requires the registration of brokers of defense articles and defense services, pursuant to regulations currently published in Part 129 of the International Traffic in Arms Regulations ("ITAR"). Although these regulations have been in place for decades, their scope and reach have not been clearly defined. New regulations published on August 26, 2013, are the culmination of a multi-year effort on the part of the U.S. Department of State, Directorate of Defense Trade Controls ("DDTC") to clarify the brokering rules.

DDTC published a proposed revision of ITAR Part 129 on December 19, 2011 (76 Fed. Reg. 78578)("Proposed Rule"). The Proposed Rule would have greatly expanded the broker registration requirements, particularly with respect to foreign companies engaged in activities outside the United States. Also in 2011, DDTC settled a major enforcement case involving a large number of Part 129 violations in which DDTC appeared to adopt new interpretations of Part 129 requirements.

Many in the business community commented on the Proposed Rule, noting that the expansion of the brokering requirements was at cross purposes with the direction of the Obama Administration's export control reform initiative. Since then, DDTC has significantly reworked the Proposed Rule and on August 26, 2013, published an Interim Final Rule, effective October 25, 2013 (78 FR 52680). The Interim Final Rule positively addresses many of these comments, clarifying the scope of brokering activities, registration and prior approval requirements. DDTC may consider further changes before publishing a final rule. Interested parties are invited to submit comments on or before October 10, 2013.

Brokering Activities

The Interim Final Rule generally covers the same types of activities that would be considered brokering under the current Part 129, but steps back from the expansive wording of the Proposed Rule. Brokering generally involves acting to "facilitate" the manufacture, export, permanent import, transfer, re-export or retransfer of U.S. or foreign defense articles and defense services. The payment of a "fee, commission or other consideration" has been removed from the current definition. However, in contrast to the Proposed

Rule, which erased the distinction that brokering meant acting as an "agent for others," the Interim Final Rule includes the requirement that the activity must be "on behalf of another." This revision alleviates a concern that businesses acting on their own behalf when purchasing, selling or transporting defense articles could have been considered brokers.

An important change is that the Interim Final Rule excludes from the definition of brokering those activities performed by an affiliate on behalf of another affiliate. For these purposes, an affiliate of a registrant is defined as a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such registrant. This means that foreign subsidiaries of U.S. companies would not be engaged in brokering when selling their parent company's ITAR-controlled products to foreign customers. However, registration would still be required if they are selling a non-affiliated company's products, unless the transaction is on behalf of the parent.

Also excluded from brokering are activities that do not extend beyond acting as an end-user of a defense article or defense service exported pursuant to a license or other approval, or subsequently acting as a re-exporter or retransferor of such article or service under such license or other approval. This would mean, for example, that a foreign company such as an aircraft maintenance, repair and overhaul facility that receives defense articles from a U.S. company pursuant to a DDTC license would not be considered a broker if it re-exports the items to an ultimate end-user pursuant to a DDTC authorization. Such activity arguably would have been captured by the Proposed Rule, which included brokering activities "by any foreign person located outside the United States acting on behalf of a U.S. person."

Like the Proposed Rule and current Part 129, the Interim Final Rule provides that brokering activities include financing, transporting or freight forwarding defense articles and defense services. The Interim Final Rule adds insuring to the list of brokering activities. ITAR §129.3(b)(2) continues the exemption for banks and freight forwarders involved exclusively in financing, transporting, freight forwarding or customs services in relation to defense articles or defense services. However, providing such services while involved in the transaction in any other way could constitute brokering, such as a finance party holding title to defense articles even when it does not have physical custody of them.

The Interim Final Rule excludes certain other types of activities from the definition of brokering activities. Tracking the Proposed Rule, these activities include those that do not extend beyond administrative services, such as providing or arranging office space and equipment, hospitality, advertising, or clerical, visa, or translation services, collecting product and pricing information to prepare a response to a request for proposal and generally promoting company good will at trade shows. The new definition also excludes providing legal advice to "clients," which may include entities other than brokers, as provided in the Proposed Rule.

The Interim Final Rule continues the current exemption for domestic sales that do not involve exports. The Interim Final Rule also clarifies that activities by regular employees acting on behalf of their employer are excluded from the definition of brokering activities.

Brokers and Broker Registration Requirements

The Interim Final Rule defines "broker" at ITAR § 129.2(a) to include the following when engaged in the business of brokering activities: (1) any U.S. person wherever located, (2) any foreign person located in the United States, and (3) any foreign person outside the U.S. that is owned (more than 50 percent) or controlled by a U.S. person. This means that majority-owned foreign subsidiaries of U.S. companies could be considered brokers, although (as noted above) they would not be engaged in brokering activities if they are acting on behalf of a U.S. parent registered with DDTC.

Currently, Part 129 subjects foreign persons to the broker registration requirement if they are engaged in brokering activities involving U.S. or foreign-origin defense articles and are otherwise subject to U.S. jurisdiction. The Proposed Rule would have subjected foreign persons located outside the United States to the broker registration requirement if the transaction involved a U.S.-origin defense article or defense service, the import of a defense article or defense service, or activity on behalf of a U.S. person. This requirement potentially had broad extraterritorial reach. For example, a foreign person outside the United States would have been required to register as a broker for any transaction involving U.S. defense articles or defense services, or even for foreign defense articles or defense services, if acting on behalf of a U.S. person, whether or not the foreign person was "otherwise subject to U.S. jurisdiction."

The Interim Final Rule considerably narrows the jurisdictional scope of the brokering regulations. The explanatory preamble to the Interim Final Rule states that the only foreign persons required to register as brokers are those that are in the United States and those foreign persons outside the United States that are owned or controlled by a U.S. person. Also, as noted above, ITAR § 129.2(a)(3) includes in the broker definition only those foreign persons outside the United States that are owned (more than 50 percent) or controlled by a U.S. person.

There is some ambiguity in the language of the rule, however. ITAR §129.3(a) provides that any "person" who is engaged in brokering activities involving defense articles or defense services is required to register. ITAR § 120.14 defines "person" to include both U.S. and foreign persons, and ITAR § 120.44 in the Interim Final Rule defines "defense articles" and "defense services" to include both U.S. and foreign defense articles and services. Thus, it seems the registration requirement could capture a foreign person brokering sales of foreign defense articles without any connection to the United States. Since this does not appear to be the intended result, some drafting adjustments may be required to make it clear that foreign persons engaged in brokering activities outside the United States involving foreign defense articles are not required to register.

Consolidated Registration and Prior Approval

ITAR § 129.3(d) rationalizes the broker registration requirements for companies that are involved in both manufacturing and brokering activities. The Interim Final Rule no longer requires separate brokering registrations for U.S. persons who are already registered as exporters or manufacturers with DDTC. This includes any subsidiary or affiliate which the registrant owns (50 percent or more) or otherwise controls. In the next annual renewal of their manufacturer/exporter registration within a year of the Interim Final Rule, companies are instructed to combine their brokering registrations where appropriate and to ensure that subsidiaries or affiliates not meeting or no longer meeting the definition of ownership or control are excluded.

The Interim Final Rule lists with greater specificity than the current Part 129 the items that are subject to prior approval before undertaking brokering activities. Prior approval is required whether or not the broker is registered. ITAR § 129.8(e) in the Interim Final Rule extends to both U.S. and foreign broker registrants the ITAR § 122.4(b) sixty day advance written notice requirement when there is an intended sale to a foreign purchaser of any parent, subsidiary or other affiliate listed in the broker registration statement.

Finally, the Interim Final Rule provides a means to seek guidance on whether an activity constitutes a brokering activity within the scope of Part 129 by submitting detailed information about the transaction to DDTC.

Companies and individuals engaged in brokering or who may be affected by these changes should carefully review the Interim Final Rule and monitor DDTC's expected future issuance of a final rule for any further changes.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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