

**RECORD OF COMMENTS: REVISED “KNOWLEDGE” DEFINITION, REVISION OF  
“RED FLAGS” GUIDANCE AND SAFE HARBOR**

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# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF COMMERCE

### Bureau of Industry and Security

15 CFR Parts 732, 736, 740, 744, 752, 764, and 772

[Docket No. 040915266-4266-01]

RIN 0694-AC94

#### Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor

**AGENCY:** Bureau of Industry and Security, Commerce.

**ACTION:** Proposed rule.

**SUMMARY:** This proposed rule would revise the knowledge definition in the Export Administration Regulations to incorporate a "reasonable person" standard and to replace the phrase "high probability" with the phrase "more likely than not." It also would update the "red flags" guidance and would provide a safe harbor from liability arising from knowledge under that definition.

**DATES:** Comments must be received by November 12, 2004.

**ADDRESSES:** Send comments on this proposed rule to: the Federal eRulemaking Portal: <http://www.regulations.gov>, via e-mail to [rpdl2@bis.doc.gov](mailto:rpdl2@bis.doc.gov), fax them to 202-482-3355, or on paper to Regulatory Policy Division, Office of Exporter Services Room 2705, U.S. Department of Commerce, Washington, DC 20230. Refer to Regulation Identification Number 0694-AC94 in all comments.

**FOR FURTHER INFORMATION CONTACT:** For further information regarding this proposed rule, contact: William Arvin, Office of Exporter Services, at [warvin@bis.doc.gov](mailto:warvin@bis.doc.gov), fax 202-482-3355 or telephone 202-482-2440

#### SUPPLEMENTARY INFORMATION:

##### Background

##### Knowledge Definition

The current definition of "knowledge" in § 772.1 of the EAR

encompasses "not only positive knowledge that a circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence. Such awareness is inferred from evidence of the conscious disregard of facts known to a person and is also inferred from a person's willful avoidance of facts." This proposed rule would amend the definition of knowledge in four ways, incorporating a "reasonable person" standard, replacing the phrase "high probability" with the phrase "more likely than not," adding the phrase "*inter alia*" to the description of the facts and circumstances that could make person aware of the existence or future occurrence of a fact, and eliminating the phrase "known to the person" from the sentence in the knowledge definition that states that knowledge may be inferred from "conscious disregard of facts known to the person." The proposed rule also limits the applicability of the definition to certain actors in transactions subject to the Export Administration Regulations (EAR) and excludes certain usages from the definition.

BIS believes that incorporating the reasonable person standard into the definition will facilitate public understanding of the definition, particularly as it applies to knowledge-based license requirements, and restrictions on use of License Exceptions. Under this revised definition a party would have knowledge of a fact or circumstance if a reasonable person in that party's situation would conclude, upon consideration of the facts and circumstances, that the existence or future occurrence of the fact or circumstance in question is more likely than not.

BIS believes that replacing the phrase "high probability" with the phrase "more likely than not" is not a change from current policy and practice. The phrase "more likely than not" is better understood than "high probability." Moreover, companies with a strong compliance commitment are unlikely, even under the current definition, to proceed with transactions if they conclude that the circumstance of concern is "more likely than not."

Adding the phrase "*inter alia*" to the description of the circumstances under which knowledge may be inferred

emphasizes that the factors cited in the definition, *i.e.* the conscious disregard or willful avoidance of facts are not the only factors from which knowledge may be inferred.

Removing the phrase "known to the person" from the sentence in the knowledge definition that states that knowledge may be inferred from "conscious disregard of facts known to the person" would eliminate the use of the defined term in the definition.

Other proposed changes to the definition address the scope of its application. The phrase "When referring to an actor in a transaction that is subject to the EAR" would be added to the beginning of the definition, and language would be added to specify that the definition concerns knowledge of a fact or circumstance relating to such a transaction. These changes would make clear that the definition would not apply to provisions of the EAR in which "knowledge" and related terms are used: (1) To refer to technology; (2) to "personal knowledge" or to knowledge of the EAR; (3) to describe the basis for an agency or official to take an enforcement or administrative action; (4) to indicate an alternative name (as in the phrase "also known as"); (5) in explanatory text that has no legal effect; (6) in a requirement that a party certify that a statement is true to the best of its knowledge; or (7) when referring to the requirements or prohibitions of a law other than those implemented by the EAR. Finally, language would be added excluding from the definition the use of "knowledge" terms in the description of criminal liability in Section 764.3(b). The proposed definition, like the current definition of "knowledge" in § 772.1, would also not apply to Part 760 of the EAR (Restrictive Trade Practices or Boycotts).

##### Enhanced Red Flags

BIS is proposing to update and augment the "red flag" guidance and to increase from 12 to 23 the number of circumstances expressly identified as presenting a red flag. The revised guidance would reflect experience gained since the existing red flags and guidance were developed in the mid-1980s. The "red flags" would continue to provide guidance that BIS believes is useful in preventing the diversion of items that are subject to the EAR to proliferation related purposes as well as

other potential violations of the EAR. Although the "red flags" provide guidance, this rule would also incorporate them by reference into the proposed safe harbor and the Internal Compliance Programs requirements of Special Comprehensive Licenses. To clarify the role the red flags would play under this rule, BIS is proposing to add a statement that the red flags and know your customer guidance do not derogate from obligations imposed elsewhere in the EAR and to remove the statement "This guidance does not change or interpret the EAR" from supplement No. 3 to part 732.

BIS believes that many conscientious participants in export transactions are following the current "red flag" guidance. BIS anticipates that the added benefit of the safe harbor provision would encourage more parties to take these measures and thereby prevent diversions to proscribed or inappropriate end-uses.

#### *Safe Harbor*

BIS is proposing to create a safe harbor from liability arising from knowledge-based license requirements, knowledge-based restrictions on use of License Exceptions, and other knowledge provisions in the EAR that are subject to the proposed definition of knowledge described above. Under this safe harbor, parties who take steps identified in a new § 764.7 will not have knowledge imputed to them by application of the "reasonable person" standard stated in the new definition. Parties who report to BIS's Office of Enforcement Analysis, prior to shipment, all material information regarding the existence, assessment, and satisfactory resolution of the red flag(s) and who do not otherwise have "knowledge," as defined in § 772.1, will be eligible for a safe harbor from any enforcement action arising from the red flag(s) that they have addressed.

The steps to be listed in § 764.7 are:

(1) Comply with any item and/or destination-based license requirements and other notification or review requirements;

(2) Determine whether parties in the transaction are subject to a denial order or to certain sanctions, whether they appear on the Entity List or the Unverified List, whether the transaction is governed by a general order issued by BIS; and

(3) Follow the procedures for identifying and resolving red flags set forth in Supplement No. 3 to Part 732.

If BIS concludes that a reported transaction involves unresolved red flags, it will so advise the submitting party. If a party has actual knowledge or

awareness that the fact or circumstance in question is more likely than not, then even if the party receives BIS concurrence (based on a report to the Office of Enforcement Analysis) that red flags are resolved, the party will not be eligible for the safe harbor nor will BIS concurrence bind a subsequent enforcement action or prosecution, because the report would have misstated or withheld relevant information.

BIS expects to respond to most such reports within 45 days of receipt. BIS will acknowledge in writing receipt of all reports and will provide a telephone number for the reporting party to call to learn the status of the report if it has not heard from BIS by the date stated in the acknowledgment. BIS may consult with other government agencies before responding to the party submitting the report. However, until receiving written confirmation from BIS or contacting BIS after the date specified in the acknowledgment and learning that BIS will not be responding to the report, the party is not entitled to conclude that BIS concurs in the party's assessment that any red flags have been successfully resolved.

Parties who have filed such reports may not file a license application relating to the same situation while the report is under review by BIS. Such license applications will be returned without action. In addition to language in the new § 764.7, § 748.4(f) would be modified to implement this prohibition.

#### *Other Clarifying Amendments and Conforming Changes*

The proposed rule would also amend the EAR in the following ways:

(1) Removal of Superfluous or Potentially Confusing Uses of a "Knowledge" Term

The proposed rule would revise three provisions of the EAR to clarify that they refer to all requirements under part 744, not just to requirements based on knowledge. These amendments would not change the substance of any provision. The provisions to be amended in this way are:

- General Prohibition Five, which references the recipient and end-use based export and reexport requirements of part 744 and which is found at § 736.2(b)(5);
- The prohibition on using License Exception AGR for transactions in which a license is required by part 744 found at § 740.18; and
- The prohibition on using Special Comprehensive Licenses to meet license requirements imposed by part 744 found at § 752.9(a)(3)(ii)(H).

#### (2) Consolidation of "Red Flags" Terminology

—The recitation of the text of the "red flags" that are currently described as " \* \* \* signs of potential diversion \* \* \*" in § 752.11(c)(13)(i) would be replaced with a reference to supplement No. 3 to part 732.

#### *Request for Comments*

BIS is seeking public comments on this proposed rule. BIS will consider comments about all aspects of this proposed rule, but is particularly seeking comments on whether the proposed changes to the definition of the term "knowledge" will increase the burden on small entities and whether the economic impact of the proposal will be significant and on whether the "safe harbor" provision is likely to be useful. The period for submission of comments will close November 12, 2004. BIS will consider all comments received before the close of the comment period in developing a final rule. Comments received after the end of the comment period will be considered if possible, but their consideration cannot be assured. BIS will not accept public comments accompanied by a request that a part or all of the material be treated confidentially because of its business proprietary nature or for any other reason. BIS will return such comments and materials to the persons submitting the comments and will not consider them in the development of the final rule. All public comments on this proposed rule must be in writing, including fax or e-mail, and will be a matter of public record, available for public inspection and copying. The Office of Administration, Bureau of Industry and Security, U.S. Department of Commerce, displays these public comments on BIS's Freedom of Information Act (FOIA) Web site at <http://www.bis.doc.gov/foia>. This office does not maintain a separate public inspection facility. If you have technical difficulties accessing this web site, please call BIS's Office of Administration at (202) 482-0637 for assistance.

#### *Rulemaking Requirements*

1. This proposed rule has been determined to be significant for purposes of E.O. 12866.

2. Notwithstanding any other provision of the law, no person is required to respond to, nor shall any person be subject to a penalty for failure to comply with a collection of information, subject to the requirements of the PRA, unless that collection of information displays a currently valid

OMB control number. This proposed rule involves a collection-of-information requirement approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act (PRA). The OMB control number for this collection is 0694-0088, which relates to BIS's application forms. This proposed rule also would create a new information collection in which private parties provide the government information about suspicious circumstances they encounter and how they resolve them. This information collection would require OMB approval before being implemented.

3. This rule does not contain policies with Federalism implications as this term is defined in Executive Order 13132.

4. The Chief Counsel for Regulation of the Department of Commerce has certified to the Counsel for Advocacy that this proposed rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

To estimate the number of small entities that would be affected by this rule, BIS evaluated its licensing database to determine the number of businesses that applied for export licenses where "knowledge" of a particular circumstance concerning the end-use or end-user triggers a license requirement. A total of 149 entities applying for such licenses in 2003 were identified. BIS then conducted an Internet search of those businesses to determine which of those businesses disclosed their sales or employment levels on Web sites. BIS compared those sales or employment levels to those found in the Small Business Administration's Table of Small Business Size Standards Matched to North American Industry Classification System published on its Web site at <http://www.sba.gov/size/sizetable2002.html>. That table provides maximum sales or employment levels that constitute a small business for a number of industries. BIS does not have similar industry classification for the entities in its licensing database so it adopted a conservative approach and used the maximum sales and employment values from the SBA table. Those values were \$28.5 million and 1500 employees, respectively. BIS excluded any entity that it could identify as exceeding either of these values. Forty-three entities were excluded by this method, leaving a total of 106 that might be small entities. All of these entities would be subject to this rule. In addition, this rule would not increase the number of entities that are subject to the Export Administration

Regulations or to the provisions of those regulations under which knowledge triggers a requirement to act or refrain from acting.

BIS does not have data to indicate how many enforcement proceedings under the Export Administration Regulations apply to small entities. However, in its Fiscal Year 2003 Annual Report, BIS reported the criminal "conviction of 21 individuals and businesses" and "34 administrative enforcement settlements" for the fiscal year. In addition, there were three administrative proceedings that resulted in denials of export privileges. Some of these actions probably did not involve small entities and there may be some overlap in cases where a single entity received both criminal and administrative sanctions.

Assuming that all of BIS's FY 2003 enforcement actions were against small entities and that 106 of the 149 entities that applied for a license in FY 2003 were all small entities, the rule would affect a substantial number of small entities. However, although there would be a substantial number of small entities affected by this rule, this rule will not have a significant economic impact on a substantial number of small entities because the overall economic costs associated with this rule are minimal. As discussed below, BIS does not believe that businesses will see this change as imposing a materially different standard on their compliance activities.

Although this proposal has the potential to impact a substantial number of small entities, BIS does not believe that it will have a significant economic impact on the affected small entities. Fundamentally, BIS does not believe that moving to a "more likely than not" formulation increases a company's responsibility with respect to knowledge. Rather, as stated in the rule, we see this as a clarification of the current standard and as consistent with existing BIS and industry practice.

From a practical perspective, based on BIS's experience with industry compliance with the existing standard, BIS believes that companies treat facts that are "more likely than not" as creating a "high probability" of the fact. In other words, in our experience, companies would take the position that there is a "high probability" of a given fact if the fact is "more likely than not." Those who must comply with these regulations are in businesses engaged in exporting and reexporting and must make decisions quickly based on practical considerations. The likely scenarios are that either (1) the party has knowledge of some facts that suggest a

proliferation end-use, an obligation to disclose or a possible violation of law and with that knowledge decides to either apply for a license or to forego the business, or (2) that the party has no knowledge of any such facts, and would not be required to obtain a license under either the old or the new definitions. Thus, even if there were a distinction between the terms "high probability" and "more likely than not," the distinction would be unlikely to affect the decision making process of a business person who is deciding whether to proceed with a sale. Stated otherwise, if a party preparing to undertake an export transaction encounters a reason to believe that a fact or circumstance exists that implicates a licensing requirement under the Regulations, that party can reasonably be expected either to apply for a license or forego the transaction, regardless of whether "knowledge" is defined by reference to a "more likely than not" or "high probability" formulation.

To the extent that a business engages in this kind of legal analysis, use of the term "more likely than not," which is a well known legal standard, will reduce uncertainty among those who make these decisions, and thereby will reduce the economic impact of the control and the necessity of legal counsel. In addition, BIS does not believe that small entities will incur additional costs due to training or legal counseling to comply with the new requirements. BIS provides a number of opportunities for counseling or training to assist businesses in their compliance efforts at no charge or at a reasonable cost. BIS maintains telephone advice lines in California and Washington to provide timely answers to people who have questions concerning its regulations. It also provides an e-mail address where such questions may be submitted. BIS gives written advisory opinions concerning its regulations. BIS provides training seminars in cooperation with trade associations and other groups around the country. The costs of this training ranges from \$75 to \$350 depending on the nature, length and location of the program. However, one should not attribute the entire training cost or even a significant portion of it to this proposed rule. Even if one did, BIS does not believe that \$350 would constitute a significant economic impact.

In terms of the costs of the inquiry that BIS recommends companies conduct in response to red flags, BIS does not believe that the costs will significantly increase when compared to the company's responsibility under the existing rule. Companies are currently

expected to make inquiries before proceeding when information indicating a proliferation end-use, an obligation to disclose, or a violation of law comes to their attention. The Regulations currently provide an illustrative list of red flags, but do not limit any duty to inquire to the circumstances on that list. By increasing the number of circumstances that are specifically called out as "red flags," BIS is reducing any uncertainty that a company faces in determining what information provides such indications. BIS expects that, under the proposed rule, the cost of the inquiries performed by companies will not increase and will continue to be reasonable given the information that the company has received and the items involved in the transaction. The proposed rule makes this point clear by stating that:

You are expected to conduct an inquiry that is reasonable for a party in your circumstances. Thus, if you are exporting specially ordered equipment that you manufactured as part of a negotiated sale to an end-user in an industry with which you do a substantial part of your business, you may be expected to conduct a more thorough and better targeted inquiry than a distributor exporting off-the-shelf equipment that is used in a wide range of commercial and industrial contexts.

The purpose of the rule is to clarify responsibilities and provide greater certainty to parties involved in export transactions when confronted with indications of a proliferation end-use, an obligation to disclose or a possible violation of law.

Finally, in assessing the possible economic impact of this rule, one should look at it in its entirety. The rule contains a safe harbor provision that enables a business to learn, before proceeding with the transaction, whether BIS concurs that its actions qualify for the safe harbor. This opportunity to avoid fines and penalties mitigates the impact of this rule.

Accordingly, the Chief Counsel for Regulation of the Department of Commerce has certified to the Chief Counsel of Advocacy that this proposed rule will not have a significant economic impact on a substantial number of small entities. BIS invites comment on this certification, including, but not limited to whether the proposed changes to the definition of the term "knowledge" will increase the burden on small entities and whether the economic impact of the proposal will be significant.

#### List of Subjects

15 CFR Parts 732, 740, 748, and 752

Administrative practice and procedure, Exports, Reporting and record keeping requirements.

15 CFR Parts 736, and 772

Exports.

15 CFR Part 744

Exports, Reporting and record keeping requirements.

15 CFR Part 764

Administrative practice and procedure, Exports Law enforcement, Penalties.

Accordingly, parts 732, 736, 740, 744, 752, 764, and 772 of the Export Administration Regulations (15 CFR 730–799) are amended as follows.

#### PART 732—[AMENDED]

1. Revise the authority citation for part 732 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; E.O. 13026, 61 FR 58767, 3 CFR, 1996 Comp., p. 228; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

2. Revise supplement No. 3 to part 732 to read as follows:

Supplement No. 3 to part 732—BIS's Know Your Customer Guidance and Red Flags

(a) Introduction. Several provisions of the EAR are applicable if a party has knowledge (as defined in § 772.1 of the EAR) of a particular fact or circumstance. Examples include § 764.2(e), which prohibits taking certain actions regarding an item that is subject to the EAR with knowledge that a violation has occurred, is about to occur or is intended to occur with respect to that item and § 744.4, which requires a license to export or reexport any item subject to the EAR if the exporter or reexporter knows that the item will be used in the design, development, production, stockpiling, or use of chemical or biological weapons in or by any country. The following guidance is provided with respect to these knowledge standards. It is also useful with respect to other EAR requirements because a heightened awareness of the signs of potential diversion can help to prevent violations. This guidance and the red flags are also incorporated by reference in § 764.7 (Safe Harbor from Certain Knowledge-based Requirements) of the EAR. The red flags are incorporated into the system for screening customers that is

part of the internal control program required of Special Comprehensive License holders and consignees and described in § 752.11(c)(13)(i) of the EAR. The "red flags" and know your customer guidance do not derogate from obligations imposed elsewhere in the EAR.

(b) *Know Your Customer Guidance.*

(1) Look out for red flags. In all transactions subject to the EAR, look out for any abnormal circumstances that indicate that the transaction may involve an inappropriate end-use, end-user or destination or otherwise violate the EAR. Such circumstances are referred to as "red flags." Red flags may be presented by information provided by a customer or information obtained from another source (*e.g.*, a credit report that you might run on a new customer wishing to place a large order).

(i) Red flags point to a heightened risk of a problem with the transaction. Most commonly, red flags indicate a heightened risk that a claimed end-use, end-user or ultimate destination is not the actual one. Red flags of this type thus can point to the possibilities that the export or reexport is actually destined for an embargoed country, an end use that triggers a license requirement under part 744 of the EAR, a person denied export privileges under part 764 of the EAR, a person on the Entity List in supplement No. 4 to part 744, specially designated global terrorists (*see* § 744.12), specially designated terrorists (*see* § 744.13), designated foreign terrorist organizations (*see* § 744.14), persons on the list of specially designated nationals identified by the bracketed suffix IRAQ2 (*see* § 744.18), a transaction that would violate a BIS General Order (*see* supplement No. 1 to part 736), persons on the Unverified List published by BIS, or an end-use or end-user that is restricted under part 744.

(ii) What constitutes a red flag depends on the context. A fact or circumstance that raises a red flag for an export of one type of item, to a given destination, or a particular business model may be innocuous for an export involving a different item, a different destination, or different business model. The role that you are playing in a transaction is also relevant to what facts or circumstances you are expected to recognize as red flags. For example, a manufacturer who is exporting one of its products will be expected to be highly familiar with the configurations or specifications required for an end-use stated by a customer. Thus, a manufacturer should be able to recognize when a deviation from such parameters is indicative of an end-use

other than what is stated. Similarly, if a freight forwarder is better able than an exporter to recognize that the location of an intermediate consignee is incongruous with the claimed ultimate destination, then such information could be regarded as a red flag for the freight forwarder, but not the exporter. The general rule is that you should treat a fact or circumstance as a red flag if it would cause a reasonable person in your situation (e.g., manufacturer/exporter, freight forwarder, distributor/reexporter) to suspect that a transaction may involve an inappropriate end-use, end-user or destination, or otherwise violate the EAR.

(iii) Red flags may also be raised in exports that have been licensed by BIS; for example, information you receive after obtaining an export license may suggest a risk of diversion. Parties should identify and respond to red flags in all transactions, including ones for which an export license has been obtained.

(2) *Make those who act on your behalf aware.* Your employees and others acting on your behalf (for example, a contractor hired to perform export-related functions) need to know how to take the steps described below, especially identifying and responding to red flags. If such persons have knowledge or reason to know a fact or circumstance, that knowledge or reason to know can also be imputed to employers or other principals, so that the latter are also liable for a violation. Thus, it is especially important for firms to establish clear policies and effective compliance procedures to ensure that knowledge about transactions can be evaluated by responsible senior officials. Failure to do so could be regarded as a form of self-blinding (see paragraph (b)(5) of this supplement No. 3 and § 772.1, definition of *knowledge*).

(3) *If there are red flags, inquire.* When there is a red flag, you have an affirmative duty to inquire into the circumstances giving rise to the red flag and whether they in fact present a heightened risk of an inappropriate end-user, end-use or ultimate destination, or of some other possible violation of the EAR. In so doing, your object is to verify or substantiate whether the concerns indicated by the red flag are really present (e.g., the real end-use, end-user or ultimate destination). This duty of heightened scrutiny is present in all transactions subject to the EAR involving red flags. Absent red flags (or an express requirement in the EAR), you do not have an affirmative duty to inquire, verify, or otherwise “go behind” the customer’s representations. Thus, if there are no red flags, you can

rely upon representations from your customer in preparing and submitting export control documents and any license application that may be required.

(i) In responding to red flags, you are expected to conduct an inquiry that is reasonable for a party in your circumstances. Thus, if you are exporting specially ordered equipment that you manufactured as part of a negotiated sale to an end-user in an industry with which you do a substantial part of your business, you may be expected to conduct a more thorough and better targeted inquiry than a distributor exporting off-the-shelf equipment that is used in a wide range of commercial and industrial contexts.

(ii) The following are means of inquiry that, depending on particular circumstances, you should pursue in response to a red flag:

(A) Seek further information or clarification from the customer, the ultimate consignee, and/or end-user.

(B) Conduct searches of relevant publications or public information on the Internet for additional information or to confirm representations you have received.

(C) Where appropriate for a particular industry or commercial context, consult standard references or official sources. For example, the International Atomic Energy Agency (IAEA) makes available information about what nuclear facilities are under IAEA safeguards, which is relevant to determining whether export or reexport for use at a particular nuclear facility requires a license under § 744.2.

(4) *Reevaluate all of the information after the inquiry.* The purpose of your inquiry is to provide a basis for making an honest, well-informed assessment of whether the concerns indicated by the red flag are really present in your transaction. One way of making this assessment is to determine that the red flag is in fact explained by circumstances that, in the context of your transaction, do not present the concerns generally associated with the red flag. For example, a sudden change in delivery instructions can present a red flag, but the red flag could be resolved by establishing that the facility to which the items were originally to be delivered had been recently damaged by fire. If the result of your reasonable inquiry and reevaluation is that this red flag does not point to a risk of diversion or concealed end-use, you could proceed with the transaction. On the other hand, if after evaluating in good faith all of the facts and circumstances you have ascertained, you believe that the export is actually destined for a

country, end-user or end-use for which an export license is required, you should not proceed with the transaction without complying with that license requirement. In making such an assessment, you are expected to bring to bear whatever relevant background or expertise you have.

(5) *Do not self-blind.* Throughout the process of identifying and responding to red flags, you must honestly take into account the facts and circumstances presented to you. Do not cut off the flow of information obtained or received in the normal course of business. For example, do not instruct the sales force to tell potential customers to refrain from discussing the actual end-use, end-user, and ultimate destination for the product your firm is seeking to sell. Do not put on blinders that prevent learning relevant information. An affirmative policy of steps to avoid “bad” information would not insulate a company from liability, and would be considered evidence of knowledge or reason to know the facts in question.

(6) *If there are still reasons for concern, refrain from going forward with the transaction or contact BIS.* If you continue to have reasons for concern after your inquiry and reevaluation, then you should either refrain from going forward with the transaction or submit all of the relevant information to BIS in the form of an application for a license or in such other form as BIS may specify. You have an important role to play in preventing exports and reexports contrary to the national security and foreign policy interests of the United States. BIS will continue to work in partnership with the private sector to make this front line of defense effective, while minimizing where possible the regulatory burden on legitimate participants in export transactions. If you have any question about whether you have encountered a red flag or what steps you should take in response to a red flag, or if you decide to refrain from the transaction, but believe you have information relating to completed or attempted violations of the EAR, you are encouraged to advise BIS’s Office of Export Enforcement through BIS’s Web site or at 1–800–424–2980 or the Office of Exporter Services at (202) 482–4811.

(c) *Red Flags: Examples.* As described below, BIS has identified a number of red flags that apply in different contexts. This discussion is not all-inclusive, but is intended to illustrate the types of circumstances to which you should be alert. BIS may supplement this description of red flags in future guidance on its Web site. Examples of red flags in various situations include:



1. The customer or purchasing agent is vague, evasive, or inconsistent in providing information about the end-use of a product.

2. The product's capabilities do not fit the buyer's line of business or level of technical sophistication. For example, a customer places an order for several advanced lasers from a facility with no use for such equipment in its manufacturing processes.

3. A request for equipment configuration is incompatible with the stated ultimate destination (e.g., 120 volts for a country with 220 volts).

4. The product ordered is incompatible with the technical level of the country to which the product is being shipped. For example, semiconductor manufacturing equipment would be of little use in a country without an electronics industry.

5. The customer has little background in the relevant business. For example, financial information is unavailable from ordinary commercial sources and the customer's corporate principal is unknown.

6. The customer is willing to pay cash for an expensive item when the normal practice in this business would involve financing.

7. The customer is unfamiliar with the product's performance characteristics, but still wants the product.

8. Installation, testing, training, or maintenance services are declined by the customer, even though these services are included in the sales price or ordinarily requested for the item involved.

9. Terms of delivery, such as date, location, and consignee, are vague or unexpectedly changed, or delivery is planned for an out-of-the-way destination.

10. The address of the ultimate consignee, as listed on the airway bill or bill of lading, indicates that it is in a free trade zone.

11. The ultimate consignee, as listed on the airway bill or bill of lading, is a freight forwarding firm, a trading company, a shipping company or a bank, unless it is apparent that the ultimate consignee is also the end-user or the end-user is otherwise identified on the airway bill or bill of lading.

12. The shipping route is abnormal for the product and destination.

13. Packaging is inconsistent with the stated method of shipment or destination.

14. When questioned, the buyer is evasive or unclear about whether the purchased product is for domestic use, export or reexport.

15. The customer uses an address that is inconsistent with standard business

practices in the area (e.g., a P.O. Box address where street addresses are commonly used).

16. The customer does not have facilities that are appropriate for the items ordered or end-use stated.

17. The customer's order is for parts known to be inappropriate or for which the customer appears to have no legitimate need (e.g., there is no indication of prior authorized shipment of system for which the parts are sought).

18. The customer is known to have or is suspected of having dealings with embargoed countries.

19. The transaction involves a party on the Unverified List published by BIS in the **Federal Register**.

20. The product into which the exported item is to be incorporated bears unique designs or marks that indicate an embargoed destination or one other than the customer has claimed.

21. The customer gives different spellings of its name for different shipments, which can suggest that the customer is disguising its identity and/or the nature and extent of its procurement activities.

22. The requested terms of sale, such as product specification and calibration, suggest a destination or end-use other than what is claimed (e.g., equipment that is calibrated for a specific altitude that differs from the altitude of the claimed destination).

23. The customer provides information or documentation related to the transaction that you suspect is false, or requests that you provide documentation that you suspect is false.

**PART 736—[AMENDED]**

3. Revise the authority citation for part 736 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; 22 U.S.C. 2151 (note), Pub. L. 108-175; E.O. 12938, 59 FR 59099, 3 CFR, 1994 Comp., p. 950; E.O. 13020, 61 FR 54079, 3 CFR, 1996 Comp. p. 219; E.O. 13026, 61 FR 58767, 3 CFR, 1996 Comp., p. 228; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; E.O. 13338, 69 FR 26751, May 13, 2004; Notice October 29, 2003, 68 FR 62209, 3 CFR, 2003 Comp., p. 347; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

4. In § 736.2, revise paragraph (b)(5) to read as follows:

**§ 736.2 General prohibitions and determination of applicability.**

\* \* \* \* \*

(b) \* \* \*

(5) *General Prohibition Five—Recipient and end-use license requirements.* If a license is required

because of the recipient or end use as specified in part 744 of the EAR, you may not export or reexport without such license.

\* \* \* \* \*

**PART 740—[AMENDED]**

5. Revise the authority citation for part 740 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; Sec. 901-911, Pub. L. 106-387; E.O. 13026, 61 FR 58767, 3 CFR, 1996 Comp., p. 228; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

6. In § 740.18, revise the last sentence of paragraph (c)(4) to read as follows:

**§ 740.18 Agricultural commodities (AGR).**

\* \* \* \* \*

(c) \* \* \*

(4) \* \* \* (Note that the fact that you have been advised that no agency has objected to the transaction does not exempt you from other license requirements under the EAR, including those based on recipient or end-use in part 744 of the EAR.)

\* \* \* \* \*

**PART 748—[AMENDED]**

7. Revise the authority citation for part 748 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; E.O. 13026, 61 FR 58767, 3 CFR, 1996 Comp., p. 228; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

8. In § 748.4, revise paragraph (f) to read as follows:

**§ 748.4 Basic guidance related to applying for a license.**

\* \* \* \* \*

(f) *Redundant submissions prohibited.* You may not submit a license application for a transaction if:

(1) You have already submitted a license application for that transaction and the license application is still pending before BIS; or

(2) You have submitted a safe harbor report for the transaction pursuant to § 764.7(c) of the EAR and the BIS decision is still pending.

\* \* \* \* \*

**PART 752—[AMENDED]**

9. Revise the authority citation for part 752 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; E.O. 13020, 61 FR 54079, 3 CFR, 1996 Comp. p. 219; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

10. In § 752.9, revise paragraph (a)(3)(ii)(H) to read as follows:

**§ 752.9 Action on SCL applications.**

- (a) \* \* \*  
(3) \* \* \*  
(ii) \* \* \*

(H) A notice that the consignee, in addition to other requirements may not sell or otherwise dispose of any U.S. origin items under the SCL if a license is required by part 744 of the EAR.

\* \* \* \* \*

11. In § 752.11, revise paragraph (c)(13) to read as follows:

**§ 752.11 Internal Control Programs.**

\* \* \* \* \*

- (c) \* \* \*

(13) A system for screening customers and transactions to identify any circumstances ("red flags") that indicate an item might be destined for an inappropriate end-use, end-user, or destination. This system must:

(i) Be able to identify, as a minimum, the red flags in paragraph (c) of supplement No. 3 to part 732 of the EAR, and;

(ii) Function in conformance with the "know your customer" guidance provided in paragraph (b) of supplement No. 3 to part 732 of the EAR:

\* \* \* \* \*

**PART 764—[Amended]**

12. Revise the authority citation for part 764 to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

13. Add § 764.7 to read as follows:

**§ 764.7 Safe harbor from knowledge-based requirements.**

Parties involved in exports, reexports or other activities subject to the EAR who meet the requirements of this section can avail themselves of a "safe harbor" against being found to have had knowledge of a fact or circumstance under the definition of *knowledge* in § 772.1. The safe harbor can apply only to requirements or prohibitions of the EAR that incorporate knowledge, as defined in § 772.1, as an element.

(a) *You must not have actual knowledge or actual awareness that the fact or circumstance at issue is more likely than not.* The safe harbor is available only to parties who do not have actual knowledge or actual awareness that the fact or circumstance in question is more likely than not. For example, if you are about to export an item subject to the EAR and are aware that it is more likely than not that the

item will be used in the design, development, production, stockpiling, or use of chemical or biological weapons in any country, § 744.4 of the EAR requires you to obtain a license for that export and the safe harbor will not relieve you of that license requirement.

(b) *You must take the following steps.*

(1) *Comply with item and/or destination-based license requirements and other notification or review requirements.* Determine whether a license is required because of the destination and the item's status on Commerce Control List and comply with any such license or other review requirements. If you are an exporter or reexporter, you must either make a good faith effort to classify the item or you must obtain a classification from BIS. You must obtain any licenses required to send the item to the destination you intend to send it to. If the item's reason for control on the Commerce Control List is EI, you must comply with any requirements to notify the U.S. government or to obtain U.S. government approval prior to export or reexport.

(2) *Determine whether the parties to the transaction are subject to a denial order, or to certain sanctions, and whether they appear on the Entity List or Unverified List, and whether the transaction is governed by a BIS General Order.* If you are an exporter or reexporter, or a freight forwarder or other party acting on an exporter's or reexporter's behalf, determine whether the parties to the transaction fall within any of the following categories:<sup>1</sup>

(i) Persons subject to denial of U.S. export privileges under a BIS order. Such orders are published in the **Federal Register**. BIS also makes available unofficial lists of denied persons on its Web site at <http://www.bis.doc.gov> and in an unofficial version of the EAR, which is published by the Government Printing Office and to which members of the public may subscribe. If an end-user, ultimate consignee or principal party in interest is subject to a denial order that prohibits your proposed transaction, you must not proceed.

(ii) Persons appearing on the Unverified List, which is published by BIS in the **Federal Register** and unofficially maintained on BIS's Web site. The Unverified List identifies

<sup>1</sup> If you find that a party to your transaction has a name or address that is similar, but not identical, to a party within one of the listed categories, you should take reasonable steps to determine whether the party to your transaction is in fact identical to the party within that category, then act in accordance with your determination and this guidance.

persons in foreign countries that were parties to past transactions for which an end-use visit (either a pre-license check or a post-shipment verification) could not be conducted for reasons outside of the control of the U.S. Government. The presence on the Unverified List of an end-user, ultimate consignee or principal party in interest presents a red flag for the transaction, as described in supplement No. 3 to part 732 of the EAR.

(iii) Persons appearing on the Entity List in supplement No. 4 to part 744. To the extent described in that supplement, a license is required to export or reexport items subject to the EAR to persons on the Entity List. See § 744.1(c). Any applicable license requirements must be met before you proceed with the transaction.

(iv) Specially designated global terrorists [SDGT], (see § 744.12), specially designated terrorists [SDT] (see § 744.13), designated foreign terrorist organizations [FTO] (see § 744.14), and persons on the list of specially designated nationals identified by the bracketed suffix [IRAQ2] (see § 744.18). License requirements for exports and reexports to such parties are described in the referenced sections of part 744. Any applicable license requirements must be met before you can proceed with the transaction.

(v) The requirements of a BIS General Order. These General Orders, which are published in the **Federal Register** and codified in supplement No. 1 to part 736, may place special restrictions on exports and reexports certain destinations or to named persons. Before you may proceed with the transaction, you must comply with any applicable license requirements or other restrictions imposed by any applicable General Order.

(3) *Identify and respond to red flags.* If you are a party involved in an export, reexport or other activity subject to the EAR, comply with the guidance on how to identify and respond to red flags as set forth in paragraphs (b) and (c) of supplement No. 3 to part 732 of the EAR.

(c) *Report to BIS.* To be eligible for the safe harbor, parties must report the red flags that they identified and how they resolved them. BIS will respond to such reports indicating whether it concurs with the party's conclusion. BIS may consult with other government agencies in developing its response to any such report.

(1) Prior to proceeding with the transaction a party seeking to be eligible for the safe harbor must submit a written report by first-class mail, express mail, or overnight delivery to

the Bureau of Industry and Security, Office of Enforcement Analysis, 14th Street and Constitution Avenue, NW, Room 4065, Attn: Safe Harbor Guidance, Washington, DC 20230. The report must demonstrate that the party has taken the actions described in paragraph (b) of this section. In particular, the report must include all material information relating to the red flags and the steps the party took to resolve the concerns raised by the red flags.

(2) BIS will acknowledge receipt of all reports received and provide the reporting party with a telephone number at which to contact BIS if it does not receive a response by the date stated in the acknowledgement. BIS expects to respond to most reports within 45 days of its receipt of the report. The response shall:

(i) State that BIS concurs with the party's judgement that it has adequately addressed the concerns raised by the red flags;

(ii) State that BIS does not concur with the party's judgement that it has adequately resolved those concerns and describe additional information that would be necessary to resolve them adequately;

(iii) Issue an "is informed" notice (pursuant to §§ 744.2(b), 744.3(b), 744.4(b), 744.6(b) or 744.17(b) of the EAR) informing the party of a license requirement under §§ 744.2, 744.3, 744.4, 744.6, or 744.17(b) of the EAR; or

(iv) state that more time is needed to review the submission.

(3) The party is not entitled to conclude that BIS concurs with the party's judgement that the party has adequately resolved the concerns raised by the red flags until it either receives a response from BIS so stating or contacts BIS at the telephone number indicated in the acknowledgment and is told that BIS will not be responding to this report.

(4) A response by BIS stating that it concurs with the party's judgement that it has resolved the concerns raised by the red flags or a statement by BIS that it will not be responding to the reexport shall, provided the party submitting the report has taken the steps in paragraph (b) of this section, serve as confirmation, based on the information in the party's submission, that the party has adequately resolved the concerns raised by the red flags. However, such confirmation shall not bind a subsequent enforcement action or prosecution if the submitting party had actual knowledge or actual awareness that the fact or circumstance in question was more likely than not, or if the submission misstated or withheld relevant material information.

(5) If BIS responds as described in paragraph (c)(2)(ii) of this section and the party proceeds without taking the additional steps to resolve the concerns, then it will not qualify for the safe harbor.

(6) In this paragraph (c), the date of BIS's receipt of the report shall be the date of receipt by the Office of Enforcement Analysis as recorded in a log maintained by that office for this purpose and the date of BIS's response shall be the postmark date of BIS's response.

#### PART 772—[AMENDED]

14. The authority citation for part 772 continues to read as follows:

**Authority:** 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; E.O. 13222, 66 FR 44025, 3 CFR, 2001 Comp., p. 783; Notice of August 6, 2004, 69 FR 48763 (August 10, 2004).

15. In § 772.1 revise the definition of *knowledge* to read as follows:

#### § 772.1 Definition of terms as used in the Export Administration Regulations (EAR).

\* \* \* \* \*

*Knowledge.* When referring to an actor in a transaction that is subject to the EAR, knowledge (the term may appear in the EAR as a variant, such as "know," "reason to know," or "reason to believe") of a fact or circumstance relating to the transaction includes not only positive knowledge that the fact or circumstance exists or is substantially certain to occur, but also an awareness that the existence or future occurrence of the fact or circumstance in question is more likely than not. Such awareness is inferred, *inter alia*, from evidence of the conscious disregard of facts and is also inferred from a person's willful avoidance of facts. This usage of "knowledge" incorporates an objective, "reasonable person" standard. Under that standard, a party would have knowledge of a fact or circumstance if a reasonable person in that party's situation would conclude, upon consideration of the facts and circumstances, that the existence or future occurrence of the fact or circumstance in question is more likely than not. **Note:** This definition applies to §§ 730.8(a)(4)(iv); 732.1(d)(1)(x); 732.3(m); 732.4(a); Supp. No. 2 to part 732; §§ 734.2(b)(2)(ii); 736.2(b)(7); 736.2(b)(10); Supp. No. 2 to part 736, Administrative Order Two, paragraph (a)(1)(ii)(E); § 740.13(e)(4); 740.13(e)(6); 740.16(i); 740.17(e)(3); 740.5; 740.7(b)(4); 740.9(a)(3)(iii)(B); 742.10(a)(2)(ii); 742.8(a)(2); Supp. No. 6 to part 742, paragraph (d)(1); §§ 744.17; 744.2; 744.3; 744.4; 744.5; 744.6; 745.1(a)(1)(ix); 746.3(a)(4), 746.3(f)(2)(i),

746.7(a)(2)(ii); 748.11(e)(4)(ii)(2); 748.14(g)(2)(vii); 748.3(c)(2)(iii); 748.4(d)(1); 748.9(g)(3); Supp. No. 1 to part 748; Supp. No. 2 to Part 748, paragraphs (g)(2)(iii) and (iv); Supp. No. 2 to Part 748, paragraph (j)(3)(ii); Supp. No. 2 to Part 748, paragraph (l); Supp. No. 2 to Part 748, paragraph (o)(3)(i); Supp. No. 5 to part 748, paragraph (a)(5)(ii); §§ 750.7(h)(3); 752.4(b); 752.11(c)(12); 752.11(c)(13); 752.4; 754.2(j)(3)(i)(D); 758.3(c); 762.1(a)(2); 762.6(a)(2); 764.2(e); 764.2(f)(2); 764.2(g)(2); Supp. No. 1 to part 764(b), paragraph (d) under the heading "SECOND"; Supp. No. 1 to part 766, III, A paragraphs headed "Degree of Willfulness" and "Related Violations"; and § 772.1 definition of "transfer." This definition does not apply to part 760 of the EAR (Restrictive Trade Practices or Boycotts) or to the following EAR provisions: §§ 730.8(b); 732.1(c); 732.3(n); 734.1(a); 734.2(b)(3); Supp. No. 1 to part 734, questions D(5) and F(1); 738.4(a)(3); 740.11(c)(1)(ii)(C); 742.12(b)(3)(iv)(B)(8); 742.18; Supp. No. 4 to Part 742, paragraph 2; 744.12; 744.14; 745.1(b)(2); 745.2(a)(1); 748.7(a)(2)(ii); 748.11(c)(1); 748.11(c)(3); 748.11(e)(4)(i); 750.8; 752.5(a)(2)(iv); 752.8(d)(9); 754.4(d)(1); 758.7(b)(6); 764.5(b)(5); 764.5(c)(5); 766.3(b); 766.6(b); 770.3(d)(1)(i)(A) and (B); 772.1 definitions of "basic scientific research," "cryptography," "deformable mirrors," "defense trade controls," "expert systems," "multilevel security," "recoverable commodities and software," "technology," and "time modulated wideband"; Supp. No. 1 to part 774, Category 1, ECCN 1C351, Reason for Control paragraph; Supp. No. 1 to part 774, Category 1, ECCN 1C991, Related Controls paragraph; Supp. No. 1 to part 774, Category 2, ECCN 2B119 Note to List of Items Controlled; Supp. No. 1 to part 774, Category 3, ECCN 3A001, N.B. to paragraph 8 of List of Items Controlled; Supp. No. 1 to part 774, Category 3, ECCN 3A002, Related Definitions and List of Items Controlled; Supp. No. 1 to part 774 Category 3, ECCN 3A225, Heading and List of Items Controlled; Supp. No. 1 to part 774, Category 4, ECCN 4A994, List of Items Controlled; and Supp. No. 1 to part 774, Category 6, ECCN 6C004 List of Items Controlled.

\* \* \* \* \*

Dated: October 5, 2004.

**Peter Lichtenbaum,**

*Assistant Secretary for Export Administration.*

[FR Doc. 04-22878 Filed 10-12-04; 8:45 am]

BILLING CODE 3510-33-P

in scope as the Notices of Funds Availability (NOFA) for the grant program published in FY 2003 and FY 2004 and the Agency's current Business and Industry Guaranteed Loan Program forms the basis of the proposed guaranteed loan program, that a 30-day period would be sufficient. The additional 30-day comment period will delay publication of the final rule a commensurate time. The delay in publication will create additional time constraints on applicants. It will also constrain the time for processing the applications, including meeting environmental assessment requirements. RBS is extending the comment period in response to numerous requests from the public for additional time to comment.

Dated: November 5, 2004.

**Gilbert Gonzalez,**

*Acting Under Secretary, Rural Development.*  
[FR Doc. 04-25239 Filed 11-12-04; 8:45 am]  
BILLING CODE 3410-XY-P

## DEPARTMENT OF COMMERCE

### Bureau of Industry and Security

15 CFR Parts 732, 736, 740, 744, 752, 764, and 772

[Docket No. 040915266-4313-02]

RIN 0694-AC94

#### Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor

**AGENCY:** Bureau of Industry and Security, Commerce.

**ACTION:** Proposed rule; reopening of comment period.

**SUMMARY:** This notice reopens the comment period on a proposed rule that would revise the knowledge definition and the "red flags" guidance as well as create a safe harbor from knowledge based violations in the Export Administration Regulations.

**DATES:** Comments must be received by December 15, 2004.

**ADDRESSES:** Send comments on this proposed rule to: The Federal eRulemaking Portal: <http://www.regulations.gov>, via e-mail to [rpd2@bis.doc.gov](mailto:rpd2@bis.doc.gov), fax them to 202-482-3355, or on paper to Regulatory Policy Division, Office of Exporter Services, Room 2705, U.S. Department of Commerce, Washington, DC 20230. Refer to Regulation Identification Number 0694-AC94 in all comments.

**FOR FURTHER INFORMATION CONTACT:** For further information regarding this

proposed rule, contact: William Arvin, Office of Exporter Services, at [warvin@bis.doc.gov](mailto:warvin@bis.doc.gov), fax 202-482-3355 or telephone 202-482-2440.

**SUPPLEMENTARY INFORMATION:** On October 13, 2004, the Bureau of Industry and Security published a proposed rule that would revise the Export Administration Regulations in three ways: Revise the knowledge definition, revise the "red flags" guidance; and create a safe harbor from certain knowledge based violations. The deadline for public comments was November 12, 2004 (69 FR 60829). The Bureau is now reopening the comment period until December 15, 2004, to allow the public more time to comment on this proposed rule.

Dated: November 9, 2004.

**Eileen Albanese,**

*Director, Office of Exporter Services.*

[FR Doc. 04-25309 Filed 11-12-04; 8:45 am]  
BILLING CODE 3510-33-M

## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

26 CFR Part 1

[REG-129771-04]

RIN 1545-BD49

#### Guidance Under Section 951 for Determining Pro Rata Share; Hearing Cancellation

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Cancellation of notice of public hearing on proposed rulemaking.

**SUMMARY:** This document cancels a public hearing on proposed regulations under section 951(a) of the Internal Revenue Code (Code) that provide guidance for determining a United States shareholder's pro rata share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956.

**DATES:** The public hearing originally scheduled for November 18, 2004, at 10 a.m., is cancelled.

**FOR FURTHER INFORMATION CONTACT:** Sonya M. Cruse of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedures and Administration), at (202) 622-4693 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:** A notice of proposed rulemaking and notice of public hearing that appeared in **Federal Register** on Friday, August 6, 2004, (69 FR 47822), announced that a public hearing was scheduled for November 18, 2004, at 10 a.m., in the IRS Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC. The subject of the public hearing is under section 951(a) of the Internal Revenue Code.

The public comment period for these regulations expired on November 4, 2004. The notice of proposed rulemaking and notice of public hearing, instructed those interested in testifying at the public hearing to submit a request to speak and an outline of the topics to be addressed. As of Tuesday, November 9, 2004, no one has requested to speak. Therefore, the public hearing scheduled for November 18, 2004, is cancelled.

**Cynthia E. Grigsby,**

*Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel, (Procedures and Administration).*

[FR Doc. 04-25324 Filed 11-9-04; 3:46 pm]  
BILLING CODE 4830-01-P

## DEPARTMENT OF HOMELAND SECURITY

### Coast Guard

33 CFR Chapter I

[USCG-2004-19615]

#### Exclusion Zones for Marine LNG Spills

**AGENCY:** Coast Guard, DHS.

**ACTION:** Request for public comments; correction.

**SUMMARY:** The Coast Guard published a document in the **Federal Register** on November 3, 2004, requesting comments on a petition for rulemaking from the City of Fall River. That document contained an incorrect docket number for the submission of comments.

**FOR FURTHER INFORMATION CONTACT:** If you have questions on this notice, please call Commander John Cushing at 202-267-1043, or e-mail [JCushing@comdt.uscg.mil](mailto:JCushing@comdt.uscg.mil). If you have questions on viewing or submitting material to the docket, please call Ms. Andrea M. Jenkins, Program Manager, Docket Operations, telephone 202-366-0271.

#### Correction

In the **Federal Register** of November 3, 2004, in FR Doc. 04-24454, on page

**From:** "David Kirby" <davidk@customspoint.com>  
**To:** <rpd2@bis.doc.gov>  
**Date:** Tue, Oct 26, 2004 12:03 PM  
**Subject:** Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor [Docket No. 040915266-4266-01]

To: U.S. Bureau of Industry & Security, Regulatory Policy Division

From:  
David Kirby  
CustomsPoint, Inc.  
3009 Wadsworth Way  
Austin, TX 78748

RE: Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor [Docket No. 040915266-4266-01]

Dear Sir,

I applaud BIS' continuing efforts to make the Export Administration Regulations clear and functional. Most of the currently proposed changes appear to me to be fair, appropriate and useful. However, I believe that the change from "high probability" to "more likely than not" will represent a change to the required standard of care. Most "reasonable persons" who do not have the benefit of a law degree will equate the phrase "more likely than not" with a probably of 51% or greater. This is the common sense literal meaning, translated to a numeric probability range. In contrast, the term "high probability" would commonly be equated with a probability value closer to 100% than to 50% (perhaps an 80% to 100% probability range). Consequently, the change does appear to define a new "level of care" standard that is weaker than the former standard. Since the proposed rule change document explicitly states that no change to the underlying standard of care is intended, I would suggest that aforementioned discrepancy be resolved.

Best regards,

David Kirby

October 31, 2004

To: BIS  
From: Bill Root  
Subject: Red Flags Proposed Rule

The following comments are in the order in which the issues appear in the proposed rule and are, therefore, not in priority order. These comments omit an analysis of new “more likely than not” wording in the proposed definition of “knowledge” (other than to observe that this is a subjective, rather than an objective, standard), in the expectation that others are commenting more fully on this subject.

Supplementary Information: Enhanced Red Flags, end of 1<sup>st</sup> para, comments on the proposed removal of the statement from 732 Supp. 3 that “This guidance does not change or interpret the EAR”  
(Guidance which does change or interpret the EAR should be in part 764 rather than part 732, since most of part 732 neither changes nor interprets the EAR.)

Supplementary Information: Safe Harbor, last para notes that license applications filed while a safe harbor report is under review by BIS will be returned without action  
(This would slow the processing of license applications and would not be necessary if BIS were simply to establish communication between safe harbor reviewers and license application reviewers.)

732 Supp. 3 para (a): For consistency with revised 772.1 definition of “knowledge”, red flags should, in addition to 744.4, relate with equal validity to the following other parts of 744: 744.2, 744.3, 744.5, 744.6, and 744.17 and to other sections of the EAR to which the new “knowledge” definition would apply (see comments below as to which sections that definition would logically apply).

732 Supp. 3 (b)(1): Delete “inappropriate” and change “otherwise” to “other factor which would”  
(The inherently vague word “inappropriate” adds nothing except confusion.)

732 Supp.3 (b)(1)(i): If red flags are relevant to 744.13, .14, .16, and to 744 generally, 772 should not state the non-applicability of the “knowledge” definition to 744.14 and omit 744.7, .8, .9, .10, .13, .15, and .16 from both the “applies” and the “does not apply” lists (see comments below as to which sections that definition would logically apply).

732 Supp. 3 (b)(1)(ii): Delete “inappropriate” and change “otherwise” to “other factor which would”  
(The word “inappropriate” adds nothing except confusion.)

732 Supp. 3(b)(2) delete “or reason to know” (twice)  
(The 772 definition of “knowledge” states that the term may appear as a variant, such as “reason to know”; but inclusion of “or reason to know” after “knowledge” suggests something broader than the definition of “knowledge.”)

732 Supp. 3(b)(3) delete “inappropriate”

732 Supp. 3(b)(3) last sentence: There are gaps in information available from IAEA as to what nuclear facilities are under IAEA safeguards.

732 Supp. 3(b)(5) last line delete “or reason to know”

732 Supp. 3(c)(17) An exporter of parts should not be held accountable to provide an “indication of prior authorized shipment of system for which the parts are sought.” Parts are often usable in more than one system and parts exporters are often not the same as system exporters.

732 Supp. 3(c)(18) before “dealings” insert “illegal”

732 Supp. 3(c)(19) A transaction which “involves a party on the Unverified List” should not, for that reason, be regarded as a violation. That is the distinction between a denied party and a party on the Unverified List.

736.2(b)(5) Recipient and End-use.

(No justification is given for changing “end-user” to “recipient”. If such a change is made in 736, it should also be made throughout 744. In addition, both the existing and the proposed 736.2(b)(5) make 736.2(b)(7) redundant.)

740.18(c)(4) change “recipient” to “end-user”

748.4(f) delete (2) You have submitted a safe harbor report ...

(This would slow the processing of license applications and would not be necessary if BIS were simply to establish communication between safe harbor reviewers and license application reviewers.)

752.11(c)(13) delete “inappropriate” and after “destination” insert “in violation of the EAR”

764.7(a) delete “or actual awareness” and change “are aware” to “know,” since awareness is part of the definition of “knowledge”

764.7(b)(2) and (b)(2)(ii) - See comment above re 732 Supp. 3(c)(19). 764.7(b)(2)(ii) omits the “must not proceed” wording from (i, iii, iv, and v) but would seem to have the same effect unless there was some basis for proceeding even if a party on the Unverified List was somehow involved.

764.7(c) An exporter exercising due diligence concerning red flags should enjoy a safe harbor even in the absence of a report to BIS to this effect. A report to BIS should be optional, in the event that an

exporter wishes to obtain BIS confirmation that enough has been done.

764.7(c)(4) delete “or actual awareness”

764.7(c)(5) presumably after (c)(2)(ii) it was intended to insert “or (iii) or (iv)”

#### 772.1 Red Flags “Knowledge”

The proposed rule under review could better differentiate when the “knowledge” definition should be applied and when it should not. In particular, it should not apply to classification determinations.

The Supplementary Information states the intent to apply the definition “when referring to an actor in a transaction that is subject to the EAR” concerning “knowledge of a fact or circumstance relating to such a transaction.” 732 Supp. 3(a) states: “Several provisions of the EAR are applicable if a party has knowledge (as defined in 772.1 of the EAR) of a particular fact or circumstance. Examples include ...” And the 772.1 definition states “When referring to an actor in a transaction that is subject to the EAR, knowledge ... of a fact or circumstance relating to the transaction includes ...”

The words “actor in a transaction” and “fact or circumstance relating to the transaction” cover every conceivable use of the word “knowledge” within the context of the EAR. Therefore, they are inconsistent with several of the examples in the subsequent list of instances when the term does not apply and with the numerous EAR citations in the definition for which the term would not apply. The meaning is not narrowed by the non-definitive words “Examples include” in the red flags introduction nor by what follows “includes” in the “knowledge” definition.

The “knowledge” definition includes “awareness that ... the fact or circumstance ... is more likely than not.” This subjective test is not suitable for classification determinations related to the CCL. The CCL is supposed to be drafted with technical precision so that license requirements may be based on objective technical facts. Ambiguous CCL words, such as “specially designed,” can be tolerated only by applying unequivocal historical interpretations which are objective rather than subjective.

The only apparent purpose of the Red Flags and of the “knowledge” definition concerns two sub-sets of determinations as to whether there is a basis to conclude that facts (not circumstances) concerning the destination, parties, or end-use or end-user intended by the importer differ from those facts as stated by the importer. The two sub-sets are (1) the intended facts would require a license whereas the stated facts would not; or (2) the intended facts would result in a license denial whereas the stated facts would result in a license approval. Given the proposal to remove the statement that “This guidance does not change or interpret the EAR”, exporters would be better protected from unexpected applications of the definition if the EAR explicitly limited the applicability of the red flags and of the “knowledge” definition incorporated by reference therein along the lines described above for what appears to be their intent.



Therefore, I suggest:

1. At the beginning of the definition of “knowledge” change “When referring to an actor in a transaction that is subject to the EAR,” to:
 

When determining whether an exporter or reexporter is “acting with knowledge of a violation” (see 764.2(e)) or otherwise engaged in a violation described in 764.2 because an importer is mis-stating facts concerning destination, parties, or end-use which would affect either license requirements or licensing policy,

and change “of a fact or circumstance relating to the transaction includes” to:

means

(Corresponding changes in “Supplementary Information” “Background” “Knowledge Definition” 4<sup>th</sup> paragraph 2<sup>nd</sup> sentence should also be made.)
2. In the definition delete “objective”
 

(A “reasonable person” “more likely than not” standard is not objective, or at least not as the word objective should be used in describing how to determine CCL-based license requirements.)
3. Revise the first two sentences of 732 Supp. 3(a) to read:
 

This Supplement provides guidance as to whether an exporter or reexporter is acting with knowledge (see definition of “knowledge” in 772.1) of a violation (see 764.2) because an importer is mis-stating facts concerning destination, parties, or end-use or end-user which would affect either license requirements or licensing policy (see country restrictions in 736.2(b)(1-3, 6, 8), 738, 740, 742, 743, 746, and 752; denied party restrictions in 736.2(b)(4); and end-use or end-user restrictions in 736.2(b)(5, 7) and 744).
4. Delete “Supplementary Information” “Background” “Knowledge Definition” 4<sup>th</sup> paragraph 3<sup>rd</sup> sentence and substitute:
 

These changes would make clear that the definition would not apply to provisions of the EAR in which “knowledge” is used to refer to (1) the classification of items on the Commerce Control List (see 748.3 and 774); (2) an alternative name (as in the phrase “also known as”); or (3) requirements or prohibitions of a law other than those implemented by the EAR.

  - (– The proposed non-applicability to (1) “technology” is changed to classification of items on the CCL, because knowledge of the technical parameters describing commodities and software, as well as those describing technology, should be based on objective rather than subjective considerations.
  - The proposed non-applicability to (2) “personal knowledge” is omitted, because “personal knowledge” is nowhere defined.
  - The proposed non-applicability to (2) knowledge of the EAR is omitted, because there

is no other definition of “knowledge” to apply to an exporter’s obligation to understand the EAR. In the many instances where the EAR is unclear, a “more likely than not” “reasonable person” standard would at least provide some guidance.

- The proposed non-applicability to (3) the basis for an agency or official to take an enforcement or administrative action is omitted, because that would completely undo the safe harbor provisions.
  - The proposed non-applicability to (5) explanatory text that has no legal effect is omitted, because it does not matter what definition is used for parts of the EAR which have no legal effect, such as part 730 (see 730.10). Most of part 732 should also be subject to a 730.10-like disclaimer. Parts with no legal effect should be transferred to informal web-site guidance. The EAR should be limited to provisions which do have a legal effect.
  - The proposed non-applicability to (6) a requirement that a party certify that a statement is true to the best of his knowledge is omitted, because the definition applies to facts for which such certifications are often required.)
5. Revise the lists of sections in 772.1 to which the definition applies or does not apply to read:  
This definition applies to violation determinations pursuant to 764.2 with respect to country restrictions in 736.2(b)(1-3, 6, 8), 738, 740, 742, 743, 746, or 752; denied party restrictions in 736.2(b)(4); and end-use or end-user restrictions in 736.2(b)(5, 7) and 744. This definition does not apply to violation determinations pursuant to 764.2 with respect to classification of items pursuant to 748.3 and part 774.
- (– The lists of sections in 772.1 to which the definition applies or does not apply do not adequately distinguish between potential country, denied party, and end-use or end-user violations, to which it should apply, and potential classification violations, to which it should not apply.
  - It is unclear why neither the existing nor the proposed definition applies to part 760. There is no differing definition of “knowledge” in the 760.1 list of definitions. The word “knowingly” in the 760.2(d) prohibition is not interpreted therein.)

DEPARTMENT OF COMMERCE  
Bureau of Industry and Security  
15 CFR Parts 732, 736, 740, 744, 752, 764, and 772  
[Docket No. 040915266-4266-01]  
RIN 0694-AC94

Revised ``Knowledge'' Definition, Revision of ``Red Flags''  
Guidance and Safe Harbor

AGENCY: Bureau of Industry and Security, Commerce.

ACTION: Proposed rule.

## COMMENTS ON BIS PROPOSED RULE

### Knowledge Definition

The numerous definitions stated as "conscious disregard", "willful avoidance", "inter alia", and "more likely than not", all appear to be definitions intended to exclusively serve the enforcement interests of the BIS rather than to find legitimate actions of willful wrong doing on behalf of the private entities. These definitions seem directed to mislead fact based actions and convert harmless mistakes into willful attempts of violations. The government has the obligation to be supportive of its industry and citizens and should make efforts to give them the benefit of the doubt. These changes point to efforts of persecution rather than prosecution.

### Red Flags

Adding more red flags (from 12 to 23), appears to be a method of creating additional circumstances facilitating added conditions for committing violations.

### Safe Harbor

The concept of safe harbor seems positive in essence, but is complicated in reality and not easy to comply with. Safe harbor has to afford the exporting party the benefit of the doubt that the actions taken are in *good will*, and that party should have a fair chance to demonstrate that good will.

### Rulemaking Requirements

Point number 4 indicates "that this proposed rulemaking is not expected to have a significant impact on a substantial number of small entities". The document further states that "BIS does not believe that businesses will see this change as imposing materially different standard on their compliance activities". We strongly disagree because small entities do not have the financial or human resources to continuously be revising, updating and maintaining records and changes in regulations and statutes. Those efforts are further burdensome because of the continuous changes in the diverse lists such as; the entity list, denied parties, etc. The BIS closed enforcement cases mention at least one small company that was

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forced to close its doors as a result of the enforcement proceedings of the government. This should be unacceptable unless it is determined that the business was dedicated exclusively to conduct illegal business with rogue countries. The government should avoid at all cost enforcement proceeding that result in losses of jobs and job providing companies. As stated by Dan Evans, "the manufacturing industry creates machines and creates jobs". How can we have the American government implementing an American Jobs creation Act conference, then the same government taking action that results in closing or jeopardizing businesses?

Large corporations have corporate attorneys that specialize in this field; large corporations have a compliance department with compliance officers that seek to abide by US export controls. Small entities cannot afford corporate attorneys and in most cases, neither can they afford to have compliance officers exclusively dedicated to this field. These expenditures would jeopardize their existence and conclusively have a negative impact on the competitiveness of the US industry that fights to maintain a strong market presence against international competitors. These international competitors generally have the complete support and many times, even the funding of their governments.

The government and the BIS should consider more lenient enforcement procedures against small companies that do not have the financial resources or the necessary infrastructure to have a full fledged EMS or compliance program in place. Many small companies do not even know of the existence of the BIS. They seek for government help via the Department of Commerce to grow their business without ever imagining that there are risks involved in this field. That is not to mention that other agencies such as OFAC further complicate and endanger these activities.

#### Final Comments

1. The BIS is proposing rules to facilitate its unilateral enforcement interests, and in doing so, gives the impression that it views the US industry as an enemy that it is determined to entrap, rather than as a partner or ally that it seeks to help.
2. The proposals outlined in this document seem to contradict the BIS guiding principals that unmistakably call for a partnership with the industry. Seeking to add and complicate the regulations further contradicts the BIS guiding principals that apparently intend to ensure "the health of the US economy and the health of the US industry".
3. Rather than tightening and focusing on enforcement procedures, the BIS should instead be proactive in efforts to improve its working relationship with the Department of Commerce. As mentioned above, small companies cannot even imagine the complexity of this field. Department of Commerce

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specialists dedicate their full efforts to support the US industry and never mention any applicable export controls, nor the dangers inherent to these activities as they are enforced by their sister agency, the BIS. The Department of Commerce web site has no mention of export controls, other than the EAR regulations, which small companies will never know what they are unless charges are filed against them. More information relative to export controls and warnings of potential dangers should be posted on the Department of Commerce site.

4. In general, the government should seek to visualize the industry as a resource to contribute to the economic growth and health of our economy and the wellbeing of our nation. Finding added means to enforce controls totally defeats that purpose. Efforts and resources should be refocused on prevention by making the export control information more publicly available through the Department of Commerce web site, e-mails, and by instructing the Department of Commerce trade specialists to inform and warn of export control regulations and potential violations. Export control seminars should also appear on the Department of Commerce web site. They serve to learn of the risks of doing business in the international environment, but are only known to large corporations, smaller companies dedicated exclusively to exports, or other companies that have been subject to enforcement proceedings. In addition, other publications such as "Don't let this happen to you" should also appear on the BIS web site.
5. The attitude of the enforcement officers has to change. In an export control seminar, a participant expressed his concern about the potential risks for his small business by making an unwilling mistake. The BIS officer responded that prosecution would only take place if it was proven that the mistake was willful. The response by the engineer was that in the meantime, he would face serious financial losses in attorney fees just to defend himself. The final statement by the BIS officer was; "if he did not want to take the risks that he should go into another business". A deplorable response that apparently reflects the enforcement spirit of the BIS.



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November 12, 2004

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**VIA ELECTRONIC MAIL**

Mr. William Arvin  
Regulatory Policy Division  
Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Washington, D.C. 20230

**Re: Comments Concerning Regulation Identification Number 0694-AC94**

Dear Mr. Arvin:

We file comments on behalf of Computer Associates International, Inc. ("CAI") to the Bureau of Industry and Security's ("BIS") proposed rule concerning the "Revised 'Knowledge' Definition, Revision of 'Red Flags' Guidance and Safe Harbor" in the Export Administration Regulations ("EAR"). 69 Fed. Reg. 60829-60836 (October 13, 2004). The Company commends Government efforts to bring clarity and consistency to processes which are designed to enhance the Country's national security interests, while encouraging the lawful continuation of legitimate business. As with any regulatory change that increases industry responsibilities, an appropriate balance needs to be maintained. In CAI's view, Commerce has partially achieved this balance.

CAI provides the following comments on the proposed rule:

1. the addition of red flag examples to EAR § 732 expands the guidance available to exporters concerning potential red flags and, thus, assists with the identification of such issues, but also unnecessarily duplicates the guidance, thereby diminishing its utility;
2. the revision of the "knowledge" standard in EAR § 772.1 to incorporate a "reasonable person" standard and replace the phrase "high probability" with the phrase "more likely than not" appears to lower the threshold for "knowledge" violations to a "negligence" standard, while continuing to base the standard on the more stringent term "knowledge"; and

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3. the proposed safe harbor provisions in EAR § 764.7, while creating a mechanism for possibly insulating exporters against potential liability, in practical terms, create a second tier of licensing requirements that must be satisfied to obtain such protection.

### **I. Enhanced Red Flags**

In the proposed rule, BIS increases the number of circumstances expressly identified as red flags in EAR § 732 from twelve (12) in the current EAR to twenty-three (23). In CAI's experience, the larger number of potential red flags that are identified by the U.S. Government the greater the understanding and awareness within industry of the types of circumstances addressed by the regulations. Every export transaction presents a unique factual scenario, even where the parties are well-known to one another. It is essential, therefore, that exporters be aware of the different types of facts that may raise questions concerning a transaction. The additional red flag guidance provides exporters with further examples of potential problems that may be highlighted for employees involved in export transactions and assists with the review of proposed export transactions.

Although the red flag guidance is helpful to identify potential problems, the more significant aspect BIS should consider incorporating into the guidance is the importance of context. The context of each export transaction will affect the usefulness of the red flag guidance in preventing diversion of items subject to the EAR. An example of the importance of context is Example 14, which states:

"When questioned, the buyer is evasive or unclear about whether the purchased product is for domestic use, export or reexport."

In one context "unclear" could also mean evasive, but in another scenario, "unclear" could be a result of a particular buyer's language barrier and not being able to understand a certain question. The current red flag examples, therefore, must be evaluated against each export transaction's unique factual circumstance.

### **II. Revisions to the Knowledge Standard**

BIS proposes to revise the knowledge standard included in EAR § 772.1 to incorporate a "reasonable person" standard and replace the phrase "high probability" with the

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phrase “more likely than not”. In the Background section to the proposed rule, BIS describes this change as follows:

Under this revised definition a party would have knowledge of a fact or circumstance if a reasonable person in that party’s situation would conclude, upon consideration of the facts and circumstances, that the existence or future occurrence of the fact or circumstance in question is more likely than not.

BIS further states that: “BIS believes that replacing the phrase ‘high probability’ with the phrase ‘more likely than not’ is not a change from current policy and practice”.

Although BIS suggests in the proposed rule that these changes are intended to merely increase understanding of the existing standard, not alter the standard, these proposed changes appear to implicitly lower the culpability standard for a knowing violation. Black’s Law Dictionary defines “knowledge” as “[a]n awareness or understanding of a fact or circumstance. A state of mind in which a person has no substantial doubt about the existence of a fact.” Black’s Law Dictionary 888 (8<sup>th</sup> ed. 2004). In contrast to this “knowing” standard, Black’s Law Dictionary defines the “reasonable person” standard, the standard proposed in the revised EAR definition, in terms of *negligence*, as “[a] hypothetical person used as a legal standard, esp. to determine whether someone acted with negligence.” *Id.* at 1294.

The definition of a “reasonable man” standard, therefore, more clearly incorporates a negligence standard than a knowledge standard. This is further exemplified in the Black’s Law Dictionary definition of “negligence:”

The failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation, any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregarding of other’s rights.

*Id.* at 1061.

Taken together, the proposed rule’s invocation of the “reasonable man” standard and the incorporation of the “more likely than not” standard appear to reduce the knowledge requirement in the EAR to a negligence standard. At a minimum, such



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language creates ambiguity concerning the applicable standard of culpability because the central terms in EAR § 772 continue to be “knowledge”, “know”, “reason to know” and “reason to believe”. Although BIS may be correct in its statement in the Background to the proposed rule that “companies with a strong compliance commitment are unlikely, even under the current definition, to proceed with transactions if they conclude that the circumstance of concern is ‘more likely than not’”, the proposed changes to the definition appear likely to create additional confusion concerning the applicable standard for knowledge-based violations and to explicitly lower the bar for future potential violations. CAI believes, therefore, that the proposed revisions create more ambiguity than they are likely to resolve.

### **III. Safe Harbor**

BIS also proposes to establish a safe harbor process at EAR § 764.7 that would permit exporters to submit reports to BIS detailing a specific transaction, and in particular, the exporter’s efforts to resolve any red flags associated with the transaction. Although BIS does not explicitly state whether this report must be submitted prior to conducting the export in question, the proposed rule does state that “The party is not entitled to conclude that BIS concurs with the party’s judgment . . . until it either receives a response from BIS so stating or . . . is told that BIS will not be responding to the report.” This language suggests that BIS expects exporters to refrain from conducting a proposed export until BIS responds - *in some fashion* - to the safe harbor report.

This proposed process, therefore, creates a second tier of “licensing” for transactions that raise red flags. In a typical transaction requiring an export authorization from Commerce and raising red flag issues, an exporter would be required to:

1. obtain the necessary export license from Commerce, a process that often takes at least thirty (30) to sixty (60) days;
2. resolve any red flags associated with the transaction; and
3. then submit a safe harbor report to which BIS “expects to” respond within forty-five (45) days.

Although this process may offer an additional level of liability protection for the exporter, the process significantly increases the time required to obtain BIS’

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“authorization” for a transaction. Safe harbor effectively serves as a second round of licensing that may only occur after the exporter has determined and satisfied the licensing requirements for a transaction. Further exacerbating this concern is the language in the Background section to the proposed rule stating that “[p]arties who have filed such reports may not file a license application relating to the same situation while the report is under review by BIS.” It appears, therefore, that licensing must be fully resolved before a safe harbor report is submitted to BIS.

As presently structured, the amount of time required to comply with the safe harbor provisions appears to create a significant burden that may not justify the protection that a favorable determination by BIS may provide. In the context of international trade, an additional forty-five (45) day review period is likely to result in the loss of many opportunities and orders. Consequently, many companies are likely to continue to rely on their own ability to resolve red flags, unless the above-discussed changes to the “knowledge” standard are perceived to increase the likelihood of culpability for knowing violations.

While it is clear that, in certain circumstances, a red flag may not occur until an export is imminent, it would be helpful if BIS would permit safe harbor reports to be reviewed concurrently with license requests, with an explicit requirement that any license application state that a safe harbor report is pending. This would permit the exporter to continue to be responsive to export opportunities while permitting companies to avail themselves of the proposed safe harbor and make an educated decision prior to an export.

Please call me at (703) 744-8075 to discuss these comments further.

Sincerely,

  
Giovanna M. Cinelli

cc: James M. Black II, Esquire

Sun Microsystems, Inc.  
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Mr. William Arvin  
Regulatory Policy Division,  
Office of Exporter Services, Room 2705  
U.S. Department of Commerce  
Washington, DC, 20230

Re: Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and  
Safe Harbor (Regulations Identification No. 0694-AC94)

Dear Mr. Arvin:

Sun Microsystems, the world's leader in networked computing, welcomes the opportunity to comment on the Proposed Rule dealing with the definition of knowledge under the EAR, and related issues. We believe that clarity and simplification in this area are badly needed, and laud BIS on its significant effort to address the problem. However, we also feel that the current draft falls far short of the mark, and in its present form may do more harm than good. As a result, we strongly urge that it not be published in final form without extensive redrafting and additional consultation with affected industry.

#### **1. General Comments on the Proposed Rule**

Sun was an early advocate of reform in standards of "due-diligence" for screening for proliferation end use. In principle, EPCI requirements apply to all items, regardless of their relevance to weapons development, their economic significance, or their volume in international commerce. In practice, the same level of effort cannot be focused on a decontrolled cable as could or should be expended to establish the end use of more significant and relevant controlled equipment.

The EAR in its present treatment of screening due-diligence makes no such distinction, leaving US exporters open to arbitrary enforcement involving high volume, strategically insignificant commodities. Government efforts to unilaterally impose and aggressively enforce extensive end-use screening on low-level items could bring US exports to a standstill.

The Proposed Rule does not address this central problem with EPCI requirements. As the proposal adds complexity to the elements of knowledge and their determination under the EAR, the Rule arguably makes the situation worse. Sun urges that serious consideration be given to clear, simple due-diligence requirements for screening decontrolled commodity items.

## 2. Specific Issues Addressed in the Rule

### Knowledge Definition

In the Proposed Rule, BIS has elected to change the current description of the EAR knowledge standard from “high probability” to “more likely than not.” Sun would point out that both are highly subjective, and as a result the operational implications of both are far from clear. However, what is clear is that the new formulation establishes a higher standard of due diligence.

As there is no guidance in the Rule as to what this new and higher standard should require, we believe that it serves no purpose. The burden should be on the Government to demonstrate that a higher standard in EPCI and other “knowledge” situations has some utility in advancing the purpose of controls, and if it does, to establish what must be done to meet the higher standard.

We do not feel that the new term adds clarity, as BIS asserts, and could serve to add more confusion to an already subjective requirement.

Sun agrees that the incorporation of a “reasonable person” criteria into the knowledge standard is a positive development in some situations. However, it highlights the inherent problems in applying an anthropomorphic concept like “knowledge” to the activities of complex multinational companies.

In reality, most companies obtain and process information on their customers at many points within their organizations. These may or may not relate to an individual transaction, or to any transaction at all (e.g., data collected for marketing reasons).

Under the doctrine of “Corporate Knowledge,” a company is required to simulate, or behave as if it were, an individual (or “reasonable person”). In practice, this means development and maintenance of procedures that will analyze multiple classes of data wherever located within the company, connect them, and effectively stop suspect transactions. In the case of typical US multinational firms, this task can be daunting, affecting the activities of thousands of individual employees operating in 90 or more countries.

Due-diligence standards that are clear and proportional to the strategic value of the commodities involved are urgently needed. Collation of data from multiple corporate sources and its analysis for export control purposes can be so costly for commodity level items that it would make export transactions economically impractical or impossible. Moreover, in areas such as software downloads, the time element involved in such analysis would make speedy execution of orders impossible, paving the way for foreign competitors to supplant US companies.

It is not enough to say that enforcement is unlikely in situations involving “commodity-type” items. Enforcement cases in commodity items can and do occur, and companies must organize and expend resources in a defensive effort to prevent potential violations. Much of this expenditure would be unnecessary if clearer due-diligence guidelines were promulgated by BIS.

#### Enhanced Red Flags

While we again agree that expanded use of red flags can be useful in some circumstances, the burden of applying an increasingly complex investigatory tool of this sort in the context of mass market transactions is excessive and unrealistic.

Many of the new elements cited in the rule provide common-sense elaborations of suspicious behavior that many companies already watch for. However, some raise additional questions which are either inappropriate on their face, or would require unreasonable investigatory effort in many situations.

We believe that red flag No. 18, “The customer is known to have or is suspected of having dealings with embargoed countries,” is neither appropriate nor useful. Many European, Canadian, and other non-US companies conduct legitimate business involving non-US origin items with countries embargoed by the US. Moreover, BIS and OFAC regulations provide for instances where even US items may be exported to such countries under de minimis rules. To cite legal activity as a red flag requiring further investigation is inappropriate.

Another example is item 21, referring to the fact that different spelling of a customer name would constitute a red flag. In normal business circumstances, translations of an organizational name, alternative transliterations (e.g., from Cyrillic, Chinese, Hebrew, Arabic, etc.), variations in subsidiary or business unit, or simple typographical errors occur with some regularity. While an individual “reasonable person” could logically deal with such variants and satisfy the obligation with minimal effort for low volume individual transactions, corporate order management systems dealing with data from thousands of transactions could require sophisticated processes to detect such variations and would require burdensome offline procedures to resolve them.

In total, the proliferation of red flags with the implied responsibility for identifying and investigating each element in every export transaction makes exporters vulnerable to charges of lack of due diligence after the fact.

#### Safe Harbor

Sun fully agrees with the concept of a “safe harbor,” but the approach specified in the proposed rule is of extremely limited use, and is completely irrelevant to the problem of reasonable due-diligence for strategically insignificant mass market items.

We believe that the 45 day review period for end-user confirmation to be excessive. The fact that this period may be extended is also troublesome, especially since there has been a history of extended reviews of questionable end-users in the past. Finally, the fact that license applications may not be submitted if such a red flag report is submitted is arbitrary, and means that the clock must be restarted should a negative response be obtained. Because of these issues, it is our opinion that this proposed safe harbor procedure, if implemented will be rarely used.

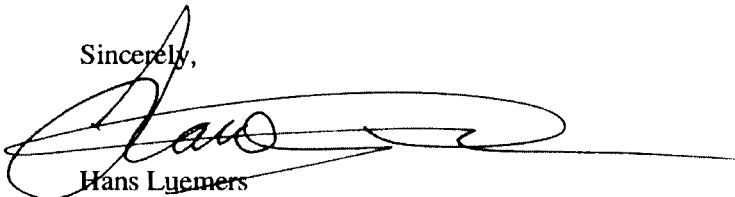
Alternatively, we suggest a “non-reporting” safe harbor procedure that would directly address due-diligence for high volume, low level items. Sun advocates an ECCN-based approach, where low-level items (e.g. EAR 99 and items controlled for AT reasons only destined for non terrorist or non-embargoed destinations) would be subject to clear and reasonable screening based on consolidated lists of denied and restricted parties.

In such circumstances, a safe harbor should be provided to exporters who could demonstrate that such screening was done, with no requirement to inquire further. As in the safe harbor procedure described in the Proposed Rule, enforcement action would not be precluded if the exporter has actual knowledge or awareness of a potential violation. Unlike the proposed safe harbor procedure, there would be no need to validate the fact that requisite screening had been done through application to BIS.

We believe that this approach would provide a practical and realistic level of due-diligence that is proportional to the strategic value of high-volume commodities, and would greatly restrict the possibility of arbitrary enforcement.

Sun welcomes the effort that BIS has devoted to these important issues, and stands ready to work with the Department to develop standards of due-diligence in export screening that are both workable and that protect vital strategic equities.

Sincerely,

A handwritten signature in black ink, appearing to read 'Hans Luemers', with a long horizontal flourish extending to the right.

Hans Luemers  
Director, International Trade Services

# **ICOTT INDUSTRY COALITION ON TECHNOLOGY TRANSFER**

1400 L Street, N.W., Washington, D.C. 20005 Suite 1000 (202) 371-5994

December 14, 2004

## **VIA ELECTRONIC MAIL AND FIRST CLASS MAIL**

Regulatory Policy Division  
Office of Exporter Services  
Room 2705, U.S. Department of Commerce  
Washington DC 20230

**Re: Proposed Rule—Revised “Knowledge” Definition, Revision of “Red Flags” Guidance and Safe Harbor, 69 Fed. Reg. 60829 (Oct. 13, 2004)—Regulation Identification Number 0694-AC94**

Gentlemen/Ladies:

The Industry Coalition on Technology Transfer (ICOTT) is pleased to provide its comment on the above-captioned proposed rule. We commend the Department for reviewing this issue but recommend that the proposal not be implemented in its current form.

The proposal would make three basic changes in the existing Export Administration Regulations (EAR). One would revise the definition of “knowledge,” a second would revise and augment the existing “red flags” guidance, and the final revision would establish a safe harbor procedure for exporters seeking the Department’s views on proposed exports that may have raised one or more red flags.

The Enhanced Proliferation Control Initiative (EPCI) regulations, promulgated in 1991, decontrolled a number of items while imposing a requirement that an exporter having “knowledge” that otherwise decontrolled items are destined for a proliferation end use or end user seek a license from the Department before making the export. The process that has led to the proposed rule began as an industry effort to ameliorate several onerous and possibly unforeseen results of the EPCI rules. One is that exporters suddenly had to worry about controlling low tech, low cost items that are sold in high volume (e.g., computer cables), are not controlled, and are readily available in dozens of other countries. Moreover, exporters whose products are not controlled for technological reasons—products that are as benign and freely available as shoelaces, hammers, and nails—suddenly found that they had to establish

compliance programs for fear that someone in their organization might have heard some stray fact that the government would contend gave the exporter knowledge that the end user was improper. The burden of maintaining compliance programs for such items far outweighs any benefit to the government from “preventing” proliferators from obtaining such items.

ICOTT and others in industry accordingly asked the Department of Commerce to consider various potential means of easing and better focusing the burden imposed by the EPCI regulations. Among the suggested solutions was a rule under which items whose cost fell below a modest threshold would be excluded from the knowledge rule, either altogether or in the absence of *actual* knowledge on the exporter’s part of a prohibited end use or end user. Another suggestion was a policy under which an exporter that employed a reasonably capable automated system to check high volume, low value export sales would be accorded a “safe harbor” if a sale were made to a prohibited end user (e.g., a denied party).

One reason for industry’s concern was the explosion of electronic commerce. E-commerce programs check whether customers are from embargoed countries and whether their names appear on U.S. government blacklists (e.g., the Denied Persons List, Entity List, or OFAC list of denied parties). They cannot, however, reasonably be expected take into account snippets of rumor that might be in the minds of various people in a far-flung company. The safe harbor that industry seeks would provide that if a party in a non-embargoed country purchases an uncontrolled, low value item and that party is not listed by the United States government, the seller would not be liable absent *actual* knowledge.

Regrettably, the proposal that has emerged adopts none of these suggestions and would, if adopted, increase the burdens on United States exporters far more than it would relieve them. As currently constituted, the proposal will not accomplish the worthy aim that originally actuated the exercise.

### **“Knowledge”**

The EPCI regulations deliberately adopted the definition of “knowledge” employed in the 1988 amendments to the Foreign Corrupt Practices Act (FCPA).<sup>1</sup> The FCPA definition had replaced the prior “reason to know” standard.<sup>2</sup> As used in the EAR, the term currently—

includes not only positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a *high probability* of its existence or future occurrence. Such awareness is inferred from evidence of the

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<sup>1</sup> See Foreign Corrupt Practices Act Amendments of 1988, Pub. L. No. 100-418, §§ 5003(a), (c), 102 Stat. 1415, 1418, 1423-24 (codified at 15 U.S.C. §§ 78dd-1(f)(2), 78dd-2(h)(3)).

<sup>2</sup> Eric L. Hirschhorn, *Foreign Corrupt Practices Act Narrowed, Significantly Clarified*, Nat’l L. J., Dec. 26, 1988, at 16.



conscious disregard of facts known to a person and is also inferred from a person's willful avoidance of facts.<sup>3</sup>

The proposal would alter the definition of "knowledge" to provide that it includes not only "positive" (presumably actual) knowledge "that the fact or circumstance exists or is substantially certain to occur, but also an awareness that the existence or future occurrence of the fact or circumstance in question is *more likely than not*."<sup>4</sup>

ICOTT knows of no evidence that the existing standard has been a problem in terms of exporters' internal compliance programs or BIS's enforcement efforts. The proposal offers no such evidence, nor even claims that a problem exists. Instead, the proposal insists that the change "is not a change from current policy and practice."<sup>5</sup> We respectfully disagree.

This proposed change would lower substantially the threshold for finding knowledge—and recall that for the most part, these rules apply to items that ordinarily do not require export licenses. The existing criterion—"high probability"—is equivalent to the well known standard of "clear and convincing evidence," which means evidence "so clear as to leave no substantial doubt' [and] 'sufficiently strong to command the unhesitating assent of every reasonable mind.'"<sup>6</sup> This is, for example, the typical standard for judging whether it is in an incompetent's best interest to withhold life-prolonging treatment.<sup>7</sup> Plainly it far exceeds fifty-one percent. By comparison, "more probable than not" is equivalent to the lower, civil litigation standard of "a preponderance of the evidence" and in practice may soon come to approximate the rock-bottom strict liability standard (i.e., liability without even a showing of negligence) for civil penalties.

Another important aspect of the FCPA "knowledge" standard—an aspect that perforce was incorporated into the EPCI "knowledge" standard—is that mere negligence does not constitute knowledge.<sup>8</sup> This requires the application of a subjective standard—i.e., what *this* actor (as opposed to a theoretical "reasonable" actor) actually knew or deliberately avoided learning. The proposed substitution of a "reasonable person" standard effectively would turn mere negligence, which by definition is a failure to do what a reasonable person would do, into "knowledge." We do not see how such a change fairly can be characterized as merely a clarification and do not believe that it is sound from a substantive or policy standpoint.

The proposal also would add the phrase, "inter alia," to the knowledge standard.<sup>9</sup> The addition would leave open the possibility that an exporter who (1) did not have actual knowledge of a problem, (2) did not block information from flowing to it, and (3) did not ignore relevant facts nevertheless could be found to have "knowledge." We cannot imagine a circumstance

<sup>3</sup> 15 C.F.R. § 772.1 (2004) (emphasis added).

<sup>4</sup> 69 Fed. Reg. 60836 (prop. to be codified at 15 C.F.R. § 772.1) (emphasis added).

<sup>5</sup> 69 Fed. Reg. 60829.

<sup>6</sup> *In re Wendland*, 28 P.3d 151, 173 (2001).

<sup>7</sup> *Woods v. Commonwealth of Kentucky*, 142 S.W.3d 24, 43-44 (Ky. 2004)

<sup>8</sup> H.R. Conf. Rep. 100-576, reprinted at 134 Cong. Rec. H1863, H2116 (daily ed. Apr. 20, 1988).

<sup>9</sup> 69 Fed. Reg. 60836 (prop. to be codified at 15 C.F.R. § 772.1).

where this would be fair and believe that the addition could be a source of considerable confusion—and consequent anticompetitive effect—in the exporting community. The phrase should not be added to the definition of “knowledge.”

### “Red flags” guidance

The proposal would expand the existing list of twelve red flags to twenty-three. Two proposed red flags and one existing red flag raise particular concerns.

Proposed Red Flag No. 18 is that “[t]he customer is know to have or is suspected of having dealings with embargoed countries.”<sup>10</sup> Because the four existing United States embargoes are unilateral,<sup>11</sup> by definition *every* significant customer outside the United States likely will raise this red flag. If virtually every foreign customer raises a red flag, the concept will verge on the silly and its sole purpose will be to enable the Office of Export Enforcement to point to an ignored red flag in almost every transaction it investigates. To paraphrase Justice Potter Stewart, when everything is a red flag, then nothing is a red flag.<sup>12</sup>

Another problem is presented by proposed Red Flag No. 14, which is identical to existing Red Flag No. 12: “*When* questioned, the buyer is evasive or unclear about whether the purchased product is for domestic use, export or reexport.”<sup>13</sup> Use of the word “when” could be read to imply that such questioning is mandatory for all exports, though the regulations elsewhere make clear that such is not the case. Substitution of “if” for “when” should do the trick.

Proposed Red Flag No. 17 is that “[t]he customer’s order is for parts known to be inappropriate or for which the customer appears to have no legitimate need (*e.g.*, there is no indication of prior authorized shipment of [the] system for which the parts are sought).” This may be useful in the limited circumstance where the parts are fairly sophisticated, the parts are available only from the manufacturer and not from independent distributors or third-party manufacturers of after-market parts, the original equipment is sufficiently complex, high tech, or costly that it bears a serial number and the manufacturer has a record of who purchased that particular serial number, and the would-be purchaser of parts needs to supply the model number and/or serial number to ensure that it receives the correct parts. In most cases, however, these circumstances are not all present. New goods can be sold by independent distributors who may or may not furnish the serial numbers and customers’ names to the manufacturer. Legitimate purchasers of new equipment frequently do not mail in manufacturers’ warranty postcards (assuming such cards even are provided). The exporter of the parts may be someone—such as a

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<sup>10</sup> 69 Fed. Reg. 60834 (prop. to be codified at 15 C.F.R. pt. 732, supp. 3, ¶ (c)(18)).

<sup>11</sup> These are against Cuba, Iran, Sudan, and Syria.

<sup>12</sup> *New York Times Co. v. United States*, 403 U.S. 713, 729 (1971) (Stewart, J., concurring) (“[W]hen everything is classified, then nothing is classified, and the system becomes one to be disregarded by the cynical or the careless, and to be manipulated by those intent on self-protection or self-promotion”).

<sup>13</sup> 69 Fed. Reg. 60834 (prop. to be codified at 15 C.F.R. pt. 732, supp. 3, ¶ (c)(14)) (emphasis added).

dealer in used systems or a manufacturer of after-market parts—who is not than the original system manufacturer, such as a seller of used systems or a manufacturer. This red flag will be useful so rarely, and the likelihood that it erroneously will lead exporters to believe that they are required to confirm the customer’s legitimate need for the parts before making any export so great, that the item (or, at a minimum, the parenthetical) should be deleted from the final proposal.

### **Safe harbor**

The safe harbor in the proposal bears no resemblance to the kinds of safe harbors that ICOTT and others suggested in requesting the Department to look into improving the EPCI regime. Among the many infirmities of this aspect of the proposal are:

- By making the device unavailable to an exporter who—under the proposed definition of “knowledge”—has a significant concern about a potential export, the proposal is self-defeating. This exclusion means that only an exporter who harbors no significant doubts about a proposed transaction can use the device. This brings to mind the old saw that a bank will lend you money only if you can prove that you don’t need it.
- The sixty to ninety day wait for an export license already places United States exporters at a considerable disadvantage in the global marketplace. The proposal would prevent anyone employing the safe harbor device from applying for a license until the government tells the exporter whether the transaction qualifies for safe harbor protection. This would be bad enough if the safe harbor device carried a reasonable deadline (forty-five days is far too long) that becomes a “no objection” if not met. It is intolerable given the Department’s position that “BIS *expects* to respond to *most* such reports within 45 days of receipt.”<sup>14</sup> A shorter period, perhaps twenty calendar days long, should be established for responses, and an exporter who doesn’t receive a *definitive* answer within that time should be entitled to treat the government’s silence or inaction as a “no objection.” Moreover, “receipt” should mean the physical delivery of the request to the Department of Commerce.
- The proposal should, but does not, provide that if BIS informs an inquirer that a proposed customer is questionable or should not be dealt with, the customer’s name promptly will be made known to the entire exporting community (e.g., by publication in the Federal Register or on the BIS web site). This omission, if not corrected, will penalize an exporter who uses the safe harbor procedure while leaving its competitors free to continue selling to the customer in question. Were

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<sup>14</sup> 69 Fed. Reg. 60830 (emphasis added). Further, “receipt” is not defined in the proposal, leaving one to wonder whether it means the time the request is physically received at the Department or the time—possibly as much as a week later—when the request is logged in by BIS.

the government's reluctance to publish such names due to intelligence concerns, the information would not be given to the individual inquirer, either. The other likely explanation—State Department concern about diplomatic embarrassment—is not a sufficient reason to punish the vigilant while rewarding the indifferent.

- The proposed rule should indicate that no adverse inference will be drawn from an exporter's decision not to utilize the device.
- Finally, the proposal overlooks the fact that much of the reason for requiring export licensing in the first place is to allow the government to consider whether the proposed end use and end user are acceptable. We expect that few if any exporters will employ the safe harbor device, with its guaranteed extra delay of between forty-five days and forever, when they can accomplish the same end by filing a license application that sets out their concerns about the transaction and that ordinarily will be acted upon in between sixty and ninety days.

\* \* \*

Again, we appreciate the chance to comment on this proposal. With regret, we suggest that in given its considerable shortcomings, the proposal be withdrawn unless the Department is prepared to adopt most or all of the foregoing recommendations.

Founded in 1983, ICOTT is a group of major trade associations (names listed below) whose thousands of individual member firms export controlled goods and technology from the United States. ICOTT's principal purposes are to advise U.S. Government officials of industry concerns about export controls, and to inform ICOTT's member trade associations (and in turn their member firms) about the U.S. Government's export control activities.

Sincerely,



Eric L. Hirschhorn  
Executive Secretary

**ICOTT Member Associations**

American Association of Exporters and Importers  
Semiconductor Equipment and Manufacturing International  
Semiconductor Industry Association

cc: Hon. Peter Lichtenbaum



December 15, 2004

***Sent via email and fax***

Regulatory Policy Division,  
Office of Exporter Services, Room 2705  
U.S. Department of Commerce  
Washington, DC, 20230

**Re: Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor (Regulations Identification No. 0694-AC94)**

Dear Sir or Madam:

AeA, America's largest high-technology association, welcomes the opportunity to comment on the Proposed Rule dealing with the definition of knowledge under the EAR, and related issues. We wish to extend our thanks to BIS on this effort to address a serious problem for US high-technology exporters. However, AeA members feel that the current draft does not add substantial clarification, and in its present form may do more harm than good. We urge that the proposal not be published in final form.

Basic EPCI requirements apply to all items, regardless of their relevance to weapons development, their economic significance, or their volume in international commerce. As it has been a longstanding position of the Department that a decision on "material contribution" cannot be made by the exporter, "high-technology" exporters clearly must consider that their products, technology, software and components are subject to EPCI end-use restrictions.

Despite this, many items subject to end-use screening that are routinely shipped across borders are commodities or simple components of more complex products. This poses a serious operational problem for high-technology exporters. In practice, the same level of effort cannot be focused on an insignificant decontrolled component as can be expended to establish the end use of more significant and relevant controlled equipment.

The EAR in its present treatment of screening due-diligence makes no such distinction, leaving US exporters open to arbitrary enforcement involving high volume, strategically insignificant commodities. The Proposed Rule does not

address this important problem. Moreover, the Rule adds red flags and complexity to the elements of knowledge and their determination under the EAR. This could make the situation worse.

### **Knowledge Definition**

In the Proposed Rule, BIS has elected to change the current description of the EAR knowledge standard from “high probability” to “more likely than not.” While still highly subjective, the new formulation appears to establish a higher standard of due diligence, without providing guidance as to what the new standard requires. AeA members believe that there is no evidence that the current formulation has any negative impact on EPCI compliance and should be retained.

### **Red Flags**

AeA members recognize that the current list of “red flags” is in need of update, and that many of the new elements cited in the proposal point to suspicious behavior that many companies already watch for. However, some raise additional questions and may not be appropriate.

The primary example is Red Flag No. 18, “The customer is known to have or is suspected of having dealings with embargoed countries.” Most large European, Canadian, and other non-US companies conduct legitimate business involving non-US origin items with countries embargoed by the US. Due to de minimis rules, some of these exports may have some US content yet be permissible under US law. AeA strongly feels that retaining this element as a red flag could place a heavy burden on US exporters, and could be used for arbitrary prosecution after the fact. It should simply be deleted.

In total, the significant expansion of red flags with the implied responsibility for identifying and investigating each element in every export transaction makes exporters vulnerable to charges of lack of due diligence after the fact.

### **Safe Harbor**

AeA members have long advocated the creation of a “safe harbor,” for EPCI due-diligence, but the approach specified in the proposal is of extremely limited use and completely ignores the problem of reasonable due-diligence for strategically insignificant items.

We believe that the 45 day review period for end-user confirmation to be excessive. The fact that this period may be extended is also troublesome, especially since there has been a history of extended reviews of questionable end-users in the past. Finally, the fact that license applications may not be

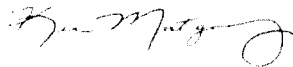
submitted if such a red flag report is submitted is arbitrary. Application for licenses and/or the safe harbor should be left to the discretion of the exporter.

Alternatively, we suggest a “non-reporting” safe harbor procedure that would directly address due-diligence for high volume, low level items. Low-level items (e.g. EAR 99 and items controlled for AT reasons only destined for non-terrorist or non-embargoed destinations) would be subject to clear and reasonable screening based on consolidated lists of denied and restricted parties.

This safe harbor would be provided to exporters who could demonstrate that such screening was done. As in the Proposed Rule, enforcement action would not be precluded if the exporter had actual knowledge or awareness of a potential violation. However, there would be no need to submit an application to BIS. We believe that this approach would provide a practical level of due-diligence that is proportional to the strategic value of high-volume commodities, and would greatly restrict the possibility of arbitrary enforcement.

AeA and its Export Controls Committee stand ready to work with BIS to refine the knowledge standard and develop practical standards of due-diligence for EPCI screening. Please contact me by phone at: (202) 682 – 4433 or via e-mail at: Ken\_Montgomery@aeonet.org if I can be of further assistance.

Sincerely,



Ken Montgomery  
Director, International Trade Regulation

December 15, 2004

**VIA ELECTRONIC MAIL AND FAX**

William Arvin  
Senior Export Policy Analyst  
Regulatory Policy Division  
Office of Exporter Services, Room 2705  
Bureau of Industry and Security  
U.S. Department of Commerce  
Washington, DC 20230

Re: Request for Comments on Revised “Knowledge” Definition,  
Revision of “Red Flags” Guidance and Safe Harbor  
69 Fed. Reg. 60829 (Oct. 13, 2004)(Regulation Identification  
Number 00694-AC94)

Dear Mr. Arvin:

On behalf of The Semiconductor Industry Association (“SIA”), the following comments are offered on the proposed revision to the definition of “knowledge” within the Export Administration Regulations (“EAR”). The SIA is the leading voice for the semiconductor industry and has represented U.S. semiconductor companies since 1977. SIA member companies comprise more than 85% of the U.S. semiconductor industry.

**SUMMARY**

The proposed rule would make three principal changes:

- Revise the knowledge definition in the Export Administration Regulations (EAR) to replace the phrase “high probability” with the phrase “more likely than not;”
- Expand the “red flags” guidance; and
- Create a safe harbor from liability arising from EAR provisions utilizing the new definition of knowledge.

With respect to the new definition of knowledge, the Department of Commerce (“Department”) provides no explanation, no findings and no evidence of why a change is needed in the interests of national security, foreign policy or otherwise. Instead, it justifies the change by merely alleging that it (i) will “facilitate public understanding of the definition [of knowledge],” (ii) does not in essence represent a change from current



policy or practice, and (iii) will not affect companies with strong compliance commitments.

SIA believes that each of the contentions put forward by the Department to support the proposed change is unfounded. First, the new definition is sure to result in complexity and confusion for exporters because it is counter to the common sense meaning of the word knowledge; it is different from how the term is used in most other regulatory schemes and the Criminal Code; and it is replete with limitations, exclusions and qualifications within the EAR itself.

Second, to say that “more likely than not” is no different from “high probability” lacks credibility. For SIA member companies the difference between these standards will be stark and substantial. High probability represents a small, manageable and well understood extension of the actual knowledge of exporter personnel. More likely than not is on the edge of flipping a coin, encompassing far more uncertainty than high probability and providing no margin for error between what qualifies as known and what does not. When coupled with the other proposed changes, the more likely than not standard becomes akin to proving a negative -- that a company has no knowledge that its export will be used or diverted contrary to the EAR.

Finally, in the face of the new knowledge definition, maintaining the same exposure to liability as under current regulation will prompt responsible exporters to engage in a major expansion in effort, resources and the assessment of available information. Yet no matter how much they invest to meet the new standard or how much information they collect, companies will face greater uncertainty and exposure to liability under the more likely than not knowledge standard.

SIA companies are uniformly committed to full compliance with U.S. export regulations. The new burden on U.S. companies to comprehensively recalibrate their compliance responsibilities demands a full and careful balancing with respect to U.S. national interests. The mere assertion of increased public understanding cannot sustain such a fundamental change in regulation. This is especially true when the new definition conflicts with the meaning of knowledge in the underlying enabling statute and implicates civil and perhaps even criminal penalties for exporters. A legislative authorization, let alone a public record justifying the change in terms of the purposes of the regulations, is surely needed as a predicate to any revision of the definition.

In short, SIA sees the proposed redefinition of knowledge as a major shift in compliance responsibility whose purpose and need have not been publicly justified.

With respect to the expansion of red flags, SIA would caution that the proposed language could create confusion about the legal impact of the Department’s position. SIA recommends that the language be clarified to preserve the advisory nature of the guidance.

With respect to the proposed safe harbor, SIA believes it provides no useful benefit to exporters, and SIA does not expect that its member companies would use it. The need for red flags resolution, the reporting requirement and accompanying potential for delay and the continuing liability for any misstep with respect to application of the new knowledge standard make the safe harbor far too complicated and risky relative to simply applying for a license. In any event, the safe harbor is not a meaningful offset to the burdens of the new knowledge definition.

In these circumstances, SIA urges the Department to suspend consideration of the proposed rule.

Before embarking on a sweeping change that cuts across most export regulation, SIA recommends that the Department undertake a public examination of the effectiveness of the existing regulations and whether there is any need for change based on the national security, foreign policy and other interests of the United States. Should such a review identify deficiencies in the current export controls and hence a need for change, the Department should make explicit changes to export licensing requirements rather than seek change through a complex distortion of the definition of knowledge.

#### PROPOSED KNOWLEDGE DEFINITION

The Existing Definition Of Knowledge In The EAR Is Well Settled.

Knowledge is generally understood to mean “the fact or condition of being aware of something.” *See Webster’s Ninth New Collegiate Dictionary* 665 (9<sup>th</sup> ed. 1985). Knowledge consists of a person’s actual or positive awareness. The Department’s existing definition goes slightly beyond positive knowledge to include a high probability of the existence of a fact or circumstance. This is in keeping with the approach of a legal framework that must take account of knowledge not just as an abstract principle, but as applied to people’s behavior. Thus both the Foreign Corrupt Practices Act 15 U.S.C. §§ 78dd-1(f)(2), §§ 78dd-2(h)(3) (1998), where the Congress most recently considered a knowledge definition in depth and the Model Penal Code § 2.02(1) (Proposed Official Draft 1962), which is designed to apply to criminal activity broadly, utilize a comparable definition.

For SIA member companies, knowledge encompassing a high probability can be taken to mean facts and circumstances that are not necessarily true as an absolute matter but are true as a practical matter. It is knowledge that is based on common sense. A high probability of a fact expands the scope of a person’s knowledge by only a small margin beyond one’s actual understanding. This margin is not so broad as to require an elaborate or precise assessment of all the uncertainties that can surround whether something is known or not.

Moreover, under the existing definition of knowledge, the principal way in which awareness can be less than absolute but sufficient to have a high probability is by

deliberate blindness. Through training and control systems, SIA companies are well versed in how to prevent deliberate blindness.

The current definition of knowledge therefore is well settled and has not posed a major challenge for SIA member companies. It reflects the intuitive understanding of the term; it is consistent with how SIA companies confront knowledge in other legal regimes, including the Criminal Code; and it does not require any special assessment of uncertainties.

#### Proposed Knowledge Definition Constitutes a Major Departure.

In the proposed definition, the margin between positive knowledge and knowledge based on a more likely than not probability is substantial. For a layman, knowledge does not turn on 50/50 probabilities. A more likely than not standard inevitably necessitates a weighing of probabilities, something that has been generally unnecessary under the existing definition. Moreover, unlike for a high probability, there is no cushion between knowledge of a fact that is more likely than not and knowledge that is less likely than not – these two probabilities are adjacent to one another at 50/50.

#### Reasonable Person Standard is More Elusive in Establishing Knowledge.

The extent of the proposed knowledge definition's departure from absolute knowledge is further compounded by the introduction of a reasonable person standard. By introducing this standard, knowledge is no longer what an exporter actually knows nor what he knows that is more likely than not; instead knowledge becomes what in the same context a reasonable person would know to be more likely than not. Exporters can no longer rely on the good faith awareness of their employees to make assessments of the likelihood of facts and circumstances; these judgments will now have to be independently tested against an always elusive standard of reasonableness. This will inevitably force a prudent exporter to second-guess the probability assessments of its employees in order to ensure that these judgments are reasonable. This not only complicates the finding of knowledge for the exporter but requires additional effort to apply a reasonable person standard.

#### Other Factors Expand Inference of Knowledge.

The proposed definition also adds another uncertainty with the addition of the words *inter alia*. As a result of this addition, the Department opens the door for other factors beyond just deliberate blindness as a basis to infer, under the proposed definition, a more likely than not probability. This change indicates the Department believes there are other ways beyond self blinding in which knowledge can be established even if an exporter does not believe a fact is more likely than not and a reasonable person would reach the same conclusion. The Department, however, does not identify any such factors from which to infer knowledge. This not only leaves exporters in the dark as to what the

Department has in mind, but it prevents them from taking steps to address the new uncertainty, such as they have been able to do with respect to deliberate blindness.

#### Deletion of Personal Knowledge Broadens Scope of Conscious Disregard.

The new definition would further detach “knowledge” from a person’s actual knowledge by deleting in the current definition the phrase “known to the person” as it relates to deliberate blindness, that is, to the “conscious disregard of facts.” Although characterized by the Department as merely a clarification, this deletion would have the effect of extending the conscious disregard of facts to encompass facts of which a person is not actually aware.

When combined with the reasonable person standard, the deletion regarding knowledge of the person would make it risky for an exporter to disregard any public information that could relate to the facts of an export transaction. This risk becomes especially challenging when the knowledge and actions of each employee can be imputed to the exporting company. For companies with a high commitment to compliance, this change will create a strong pressure to investigate information in the public domain about an export transaction so as not to be found to have acted with conscious disregard of the facts.

#### Proposed Definition Includes Numerous Limitations, Qualifications and Exclusions.

The complexity of the new standard does not end with the changes to the definition of knowledge. Seven categories of provisions in the EAR are identified as excluded from the proposed definition. Unlike the current definition, no body of interpretive guidance is available for the proposed definition.

A note to the definition indicates that it applies to 55 separate provisions of the EAR. At the same time, the note sets forth 47 provisions to which the definition does not apply. Finally, there are a variety of places in the regulation where “knowledge” is utilized but the proposed definition is neither made applicable nor made inapplicable, e.g. § 764.5(f)(1) § 765.3(b)(2), § 772.1 definition of “export systems.” The exporter is left to sort out which definition of knowledge applies in a particular circumstance and what are the compliance risks and obligations that flow from it.

The severity of the consequences of the new knowledge definition are nowhere more important than with respect to sections 764.2 and 764.3(b). The proposed knowledge standard would be made applicable to at least four violations in section 764.2<sup>1</sup> which defines specific violations undertaken “with knowledge”. Section 764.3(b) then subjects such knowing violations to criminal penalties including imprisonment when they are committed “knowingly”.

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<sup>1</sup> 15 C.F.R. §§ 764.2 (e) [title and regulation], (f)(2), (g)(2).

SIA recognizes that with an appropriate legislative underpinning the Department could impose civil sanctions on a strict liability basis that encompasses little or no knowledge. However unjustified or undesirable this may be, it is within the bounds of traditional administrative discretion. Criminal sanctions, on the other hand, should demand a standard of knowledge that equates to a willful or deliberate violation, far more than a reasonable person standard of more likely than not. Indeed, knowledge for a criminal penalty must be established beyond a reasonable doubt.<sup>2</sup> Thus SIA would strongly urge the Department to clarify that the new knowledge definition does not apply to section 764.3(b), something it states it will do but has not yet done. In the absence of such a clarification, it is doubtful that the proposed definition could survive constitutional due process protections for criminal prosecutions.

Of course, to the extent the EAR contain a different standard of acting with knowledge for criminal purposes and acting with knowledge for civil purposes the complexity and confusion will be that much greater for the exporting community.

#### Burden From Proposed Definition Will Be Substantial.

Taken together, the principal changes in the proposed definition would broaden and lower the threshold for knowledge with respect to exporter violations. A standard that has generally been based on clear and convincing evidence not requiring special scrutiny would be replaced by much greater uncertainty and much greater exposure to liability. Exporters will need to undertake a more careful and extensive evaluation of uncertainties or, to maintain a significant cushion or margin of error, a much broader assessment of facts, including those that are significantly less likely than not. However exporters would respond, the change is significant and the additional effort in assembling information and assessing information can be expected to be substantial.

The proposed definition would especially impede e-commerce transactions. These transactions typically depend upon automation, established databases and high volumes. Trying to assemble probabilities associated with various facts in a particular export transaction is a difficult and inefficient way to seek to prevent diversion.

Contrary to the Department's assertions that the proposed definition will not affect companies with strong compliance commitments, the proposed knowledge standard will likely cause SIA member companies to consider measures such as:

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<sup>2</sup> See Sandstrom v. Montana, 442 U.S. 510 (1979) (Because it would have violated the Fourteenth Amendment's requirement that the State prove every element of a criminal offense beyond a reasonable doubt, jury instruction was held to be unconstitutional.); In re Winship, 397 U.S. 358, 364 (1970) ("Lest there remain any doubt about the constitutional stature of the reasonable-doubt standard, we explicitly hold that the Due Process Clause protects the accused against conviction except upon proof beyond a reasonable doubt of every fact necessary to constitute the crime with which he is charged."); See also United States v. United States Gypsum Co., 438 U.S. 422 (1977).

- Increased training on the meaning and implications of the new knowledge definition;
- Implementation of new mechanisms to independently assemble and assess information;
- Development of databases to identify new types of information relevant to export transactions;
- Establishment of means to seek publicly available information about customers and transactions.
- Much more frequent resort to export license applications.
- Re-evaluation of sales and distributions processes for all products and services, including EAR99 commodity items. Undertaking this additional burden of compliance will affect customer ordering for “just-in time” inventories and could affect a supplier’s and/or customer’s business model. Where delays result, U.S. business may be faced with lost opportunities in markets where international competitors are not subject to the same conditions.
- Overlay of a manual process to ensure compliance, thereby losing benefits of increased business process automation. E-commerce purchases would be impacted as businesses seek to evaluate additional screening programs to address additional risk.

None of these measures are required of non-US companies. The burden on U.S. companies will create a significant competitive impact; foreign availability will at the same time undermine any protection of U.S. national interests.

#### ENHANCED RED FLAGS

The proposed rule elaborates on how exporters should deal with red flags and nearly doubles the number of red flags. The Department characterizes its action as “updating and augmenting the ‘red flag’ guidance.”

SIA welcomes guidance that can sensitize exporters to recognize improper or illegal conduct and assist in compliance with the EAR. SIA and its member companies are committed to work in partnership with the Department to achieve compliance with the EAR. In this spirit of cooperation, Supplemental No. 3 to part 732, Know Your Customer Guidance and Red Flags, has served as a useful reference tool for SIA companies.

Despite continuing to characterize Supplement 3 as guidance, the Department’s proposed language for Supplement 3 contains many terms and phrases that suggest something more than guidance is being offered by the Department. For example, the Department uses the term “general rule” when referencing how the fact of a red flag should be treated. Similarly, exporters are said to “have an affirmative duty to inquire” into certain circumstances and a “duty of heightened scrutiny is present in all transactions

subject to the EAR involving red flags.” Elsewhere the Department declares: “In responding to red flags, you are expected to conduct an inquiry that is reasonable for a party in your circumstance.”

The mandatory form of this language may be inadvertent and signal nothing more than strong advice. However, for the first time, the red flag guidance would be explicitly incorporated into two provisions of the EAR: the Internal Compliance Programs requirements of Special Comprehensive Licenses and the proposed safe harbor. More importantly, the existing assurance that “This guidance [Supplement No. 3] does not change or interpret the EAR.” is deleted in its entirety. These changes reinforce the impression that the proposed red flag guidance may somehow be more compulsory than advisory.

SIA recommends that the general assurance regarding Supplement 3 be preserved as follows: “Except with the respect to the safe harbor from liability arising from knowledge based provisions and the Internal Compliance Programs requirements of Special Comprehensive Licenses, this guidance does not change or interpret the EAR.”

SIA companies are prepared to cooperate with the Department in preventing regulatory violations and give great weight to its advice. In doing so, they are entitled to have advice from the Department that is clearly distinguished from legal duties or obligations.

As for the red flags themselves, SIA is concerned that the Department’s characterization of certain circumstances as red flags -- *e.g.*, address of ultimate consignee is a free trade zone; customer is vague, evasive or inconsistent about end-use; or customer is known or suspected to have dealings with embargoed countries -- may greatly overstate their cautionary significance. Many SIA customers operate for legitimate economic reasons in free trade zones. It is not unusual for various personnel of customers of SIA member companies to be unaware of and hence vague about ultimate end-use. Similarly, customers of SIA member companies frequently and lawfully deal with countries embargoed under U.S. law.

The proposed revision would suggest that these customers, and the context in which they deal with SIA member companies, raise red flags, which, upon investigation, could be subsequently dismissed. SIA believes, on the contrary, that for such customers, no red flag is raised and there is no need for investigation. Unless the Department can more specifically define the circumstance of concern, these particular red flags should be omitted. To do otherwise only diminishes the significance of all red flags and results in wasteful and unnecessary investigation.

In order to help ensure that the red flags guidance does not generate rigid, make-work responses from exporters, SIA urges the Department to amend the first sentence of sub-section (c) of the Supplement No. 3 to part 732 to read as follows: “As described

below, BIS has identified a number of red flags that apply in different contexts, but may not apply in others.”

## SAFE HARBOR

The Department has asked in particular for comments on “whether the ‘safe harbor’ provision is likely to be useful.” SIA does not believe the safe harbor in its current form is useful or that it would significantly diminish the burdens and exposure that would flow from the proposed knowledge definition.

Several difficulties make the safe harbor unattractive. First, an exporter must go through all the steps it normally would to prepare a license application – identify the transaction in detail, comply with any item and/or destination-based requirements, etc. In addition, it must follow all the procedures for identifying and resolving red flags and prepare a report – a report that is not usually undertaken and could require substantial effort and elaboration by exporter personnel.

Next, the export transaction is delayed until the Department responds to the report. Just as preparation of the report is likely to be an exceptional activity for an exporter, evaluation of the report by the Department will be outside the normal license application process and therefore can be expected to be susceptible to significant delay. And there is no assurance that a Department response will be dispositive for the export transaction.

Finally, and most importantly, the proposed safe harbor does not provide sufficient protection against liability arising from requirements relating to the new knowledge definition. The safe harbor appears to offer protection against knowledge imputed to an exporter under the new reasonable person standard. But it explicitly does not provide protection against knowledge based on the proposed more likely than not standard. But this is the most challenging risk and principal liability of the new knowledge definition for which an exporter would seek protection through a safe harbor.

Protection from liability is, after all, the principal rationale for resorting to a safe harbor. By not providing protection to the central feature of the new knowledge definition – the change from high probability to more likely than not – the safe harbor would offer little value to SIA companies. Indeed, “safe harbor” is a misnomer for what the Department has proposed.

SIA notes that it would support the development of a workable safe harbor in connection with the existing high probability knowledge standard. Such a safe harbor should allow widely available commodity items lacking strategic importance to fall within its scope absent prior government reviews or approvals. In particular, exporters should be able to qualify such items for safe harbor protection based on “is informed”



within its scope absent prior government reviews or approvals. In particular, exporters should be able to qualify such items for safe harbor protection based on "is informed" advice from the government as well as government-published lists of parties of blacklisted parties.

To the extent the proposed knowledge definition and safe harbor are implemented, however, it is far more likely that SIA companies will simply proceed with an export license application.

\* \* \* \* \*

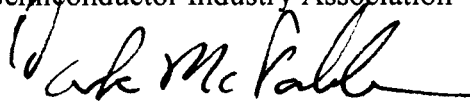
SIA respectfully recommends that, with the exception of the red flags guidance, the proposed rule be withdrawn. SIA is prepared to work with the Department to identify and address any shortcomings in the EAR and cooperate in devising measures to deal with them. A complex and needlessly burdensome alteration of the well established definition of knowledge is not, in SIA's view, a constructive step forward.

SIA appreciates the opportunity to comment on the proposed rule.

Respectfully submitted,

Handwritten signature of Anne Craib in cursive, with the initials "wcn" written below it.

Anne Craib, Director  
International Trade and Government Affairs  
Semiconductor Industry Association

Handwritten signature of W. Clark McFadden II in cursive.

W. Clark McFadden II  
Dewey Ballantine LLP  
Counsel for the Semiconductor Industry Association



December 15, 2004

Sent Via Electronic Mail: [rpd2@bis.doc.gov](mailto:rpd2@bis.doc.gov)

The Honorable Peter Lichtenbaum  
Assistant Secretary of Commerce for Export Administration  
Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Bureau of Industry and Security  
Washington, DC 20230

Re: Regulation Identification Number 0694-AC94, Notice of Proposed Rulemaking on Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor

Dear Assistant Secretary Lichtenbaum:

The Office of Advocacy of the U.S. Small Business Administration (Advocacy) submits this comment to the Department of Commerce, Bureau of Industry and Security (BIS) on its proposed rule to revise the definition of knowledge for determining whether or not an exporter knew that he/she was violating exporting controls. The Office of Advocacy believes BIS has not analyzed properly the full economic impact of the proposal on small entities as required by the Regulatory Flexibility Act (RFA). Advocacy recommends that BIS prepare and publish for public comment an initial regulatory flexibility analysis (IRFA) to assess the economic impact on small entities before proceeding to a final rule.

### **Advocacy Background**

Congress established the Office of Advocacy under Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. Advocacy is an independent office within the Small Business Administration (SBA), so the views expressed by Advocacy do not necessarily reflect the views of the SBA or of the Administration. Section 612 of the RFA requires Advocacy to monitor agency compliance with the Act, as amended by the Small Business Regulatory Enforcement Fairness Act.<sup>1</sup>

On August 13, 2002, President George W. Bush enhanced Advocacy's RFA mandate when he signed Executive Order 13272, which directs Federal agencies to implement policies protecting small entities when writing new rules and regulations. Executive Order 13272 also requires

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<sup>1</sup> Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified at 5 U.S.C. §§ 601-612) amended by Subtitle II of the Contract with America Advancement Act, Pub. L. No. 104-121, 110 Stat. 857 (1996). 5 U.S.C. § 612(a).

agencies to give every appropriate consideration to any comments provided by Advocacy. Under the Executive Order, the agency must include, in any explanation or discussion accompanying the final rule's publication in the Federal Register, the agency's response to any written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.

### **The Proposed Rule**

On October 13, 2004, BIS published a proposed rule on *Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor*.<sup>2</sup> The proposed rule revises the definition of knowledge for determining whether or not an exporter knew that he/she was violating exporting controls. The proposal would revise the Export Administration Regulations to incorporate a "reasonable person" standard. The current regulations require a "high probability" that the exporter knew that he was violating exporting controls. BIS is proposing to replace the phrase "high probability" with "more likely than not." BIS is also proposing to update the "red flags" guidance to increase the number of circumstances identified as expressly creating a red flag of potential violations of Export Administration Regulations. The proposed rule also creates a safe harbor from certain knowledge-based violations if the exporter takes certain steps.

### **Requirements of the RFA**

The RFA requires agencies to consider the economic impact that a proposed rulemaking will have on small entities. Pursuant to the RFA, the agency is required to prepare an initial regulatory flexibility analysis (IRFA) to assess the economic impact of a proposed action on small entities. The IRFA must include: (1) a description of the impact of the proposed rule on small entities; (2) the reasons the action is being considered; (3) a succinct statement of the objectives of, and legal basis for the proposal; (4) the estimated number and types of small entities to which the proposed rule will apply; (5) the projected reporting, recordkeeping, and other compliance requirements, including an estimate of the small entities subject to the requirements and the professional skills necessary to comply; (6) all relevant Federal rules which may duplicate, overlap, or conflict with the proposed rule; and (7) all significant alternatives that accomplish the stated objectives of the applicable statutes and minimize any significant economic impact of the proposed rule on small entities. In preparing its IRFA, an agency may provide either a quantifiable or numerical description of the effects of a proposed rule or alternatives to the proposed rule, or more general descriptive statements if quantification is not practicable or reliable. The RFA requires the agency to publish the IRFA or a summary of the IRFA in the Federal Register at the time of the publication of general notice of proposed rulemaking for the rule.<sup>3</sup>

Pursuant to section 605(a), an agency may prepare a certification in lieu of an IRFA if the head of the agency certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. A certification must be supported by a factual basis.

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<sup>2</sup> 69 Federal Register 60829.

<sup>3</sup> 5 USC §603.

## **Advocacy Disagrees with BIS's Decision to Certify the Proposal**

Rather than prepare an IRFA, BIS certified that the rule would not have a significant economic impact on a substantial number of small entities. BIS did provide a factual basis for its decision to certify; however, Advocacy disagrees with its conclusion. According to BIS, approximately 106 of the 149 entities that applied for export licensing in 2003 were small businesses. Since all of these small entities would have to comply with the new regulations, BIS concluded that the proposed rule would impact a substantial number of small entities. However, BIS contends that the proposal will not have a significant economic impact on these small entities, and therefore, chose to certify the rule.

Advocacy questions BIS's decision that the proposal will not have a significant economic impact on the regulated small entities. We disagree with BIS's contention that moving to a "more likely than not" formulation does not increase a company's responsibility with respect to knowledge. BIS also states that the proposed change is a clarification of the current standard and consistent with existing BIS and industry practice. Advocacy also disagrees with this proposed change.

Changing the definition for determining whether an exporter has knowledge from "highly probable" to "more likely than not" is more than a mere clarification. Courts have stated that from an evidentiary standpoint, a preponderance of evidence means "more likely than not." Clear and convincing evidence is a higher standard and requires a "high probability" of success. In the Matter of Briscoe Enterprises, LTD v. Briscoe Enterprises, 994 F.2d 1160; In re Arnold and Baker Farms, 177 B.R. 648 (9th Cir. BAP 1994), aff'd 85 F.3d 1415 (9th Cir. 1996), cert. denied, 519 U.S. 1054 (1997); Kelley v. Locke, 300 B.R. 11; In re Midland Plaza Associates, 247 B.R. 877 (2000). Although these are bankruptcy cases, Advocacy believes they provide a clear indication that courts do not believe that the terms "highly probable" and "more likely than not" are synonymous.

BIS is changing the definition in a way that lowers the requirements of knowledge, imposing a less stringent test for determining whether a small business should have had knowledge of their potential violation of the export control regulations. Accordingly, small businesses that may not have been liable in the past could be held liable under the new standard. As such, small businesses are more likely to incur legal expenses, fines and penalties than they would have under the current regulations. Small businesses may also incur additional legal expenses by having to hire attorneys to help them understand the implications of the new standard as well as incur costs due to expenses related to employee training (including lost man hours) to assure that employees understand the new standard and the additional red flags proposed by BIS. Indeed, the Small Business Exporters Association is concerned that the proposed rule appears to place small exporters in greater legal jeopardy without BIS's explaining the need for the change.<sup>4</sup>

In addition, Advocacy has spoken with members of the International Law Section of the American Bar Association (ABA) and we understand that the ABA will also provide comments

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<sup>4</sup> Telephone conversation with Jim Morrison, President Small Business Exporters Association, December 13, 2004.

to the BIS stating that changing the definition from “highly probable” to “more likely than not” is more than a mere clarification and that the change may be harmful to small businesses. The ABA is concerned that small businesses may incur additional expenses if they err on the side of caution and apply for a license even if one is not needed. This could be a costly and time consuming process that may lead to a delay in shipment of the export. The ABA has also advised Advocacy that the new red flag provisions will require exporters to resolve the issue as though a license has not been granted even if the issue arises after the license is granted. This may also lead to additional expenses and time for small businesses.

### **Safe Harbor**

BIS is proposing a “safe harbor” provision which would allow businesses to learn whether BIS agrees that the transaction qualifies for a safe harbor. The safe harbor provision is intended to help business avoid fines and penalties, and BIS believes this would therefore mitigate the impact of the rule.

Although Advocacy welcomes the inclusion of the safe harbor provision, BIS does not indicate the amount of time that it will take to provide a small business with an opinion about whether or not the transaction may qualify for a safe harbor. The failure to provide a timeframe could lead to a business waiting an inordinate amount of time for the opinion which could cause a business to lose current and future exporting opportunities. It is Advocacy’s understanding that the International Law section of the American Bar Association may recommend a 30-day time frame for BIS to provide an opinion on whether the transaction qualifies for a safe harbor. Advocacy encourages BIS to give full consideration to this and other suggestions to improve the utility of the safe harbor provision.

In addition, Advocacy understands that the ABA is requesting that the proposal be rewritten to allow for the concurrent consideration of license applications while an exporter’s request is pending a determination through the safe harbor process. The ABA asserts that concurrent consideration will prevent small exporters from losing a transaction due to potential time delays from having to obtain a license after completing the safe harbor process. Advocacy encourages BIS to give full consideration to this and other suggestions that could reduce the potential burden on small entities. Such suggestions and other significant regulatory alternatives should be analyzed and considered by BIS as part of its initial regulatory flexibility analysis.

### **Conclusion**

The RFA requires agencies to consider the economic impact on small entities prior to proposing a rule and to provide the information on those impacts to the public for comment. Advocacy recommends that BIS perform an initial regulatory flexibility analysis to determine the full economic impact on small entities and to consider significant alternatives to meet its objective while minimizing the impact on small exporters. In addition, such an analysis provides the public with insight into the reasons for the change. Because Advocacy believes comments to the record will demonstrate that BIS cannot certify the final rule, publishing an initial regulatory flexibility analysis for comment will provide BIS with the information it needs to prepare a final

regulatory flexibility (FRFA). Courts have held that an agency cannot prepare an adequate FRFA if the agency did not prepare an IRFA at the proposed rule stage.<sup>5</sup>

Thank you for the opportunity to comment on this important proposal and for your consideration of Advocacy's comments. Advocacy is available to assist the BIS in its RFA compliance. If you have any questions regarding these comments or if Advocacy can be of any assistance, please do not hesitate to contact Jennifer Smith at (202) 205-6943.

Sincerely,

/s/

Thomas M. Sullivan  
Chief Counsel for Advocacy

/s/

Jennifer A. Smith  
Assistant Chief Counsel for  
Economic Regulation and Banking

Cc: The Honorable John D. Graham, Administrator, Office of Information and Regulatory Affairs

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<sup>5</sup> Southern Offshore Fishing Association v. Daley, 995 F. Supp. 1411 (M.D. Fl. 1998).

American Association of Exporters and Importers  
1200 G Street, NW, Suite 800, Washington, DC 20005  
Telephone (202) 661-2181 Fax (202)661-2185 Email HQ@aaei.org

December 15, 2004

Ms. Eileen Albanese  
Director  
Office of Exporter Services  
U.S. Department of Commerce  
Washington, DC 20230

RE: Identification Number 0694-AC94  
Public Comment on Revised "Knowledge" Definition,  
Revision of "Red Flags" Guidance and Safe Harbor

15 CFR Parts 732, 736, 740, 744, 752, 764, and 772  
[Docket No. 040915266-4313-02] RIN 0694-AC94

Dear Ms. Albanese,

On November 15, 2004 the Bureau of Industry and Security published in the Federal Register a request for comment on a proposal to revise the "Knowledge" Definition, the "Red Flags" Guidance and Safe Harbor (See Volume 69, Number 219).

We welcome the opportunity to comment. Further, we appreciate your decision to extend the deadline for submitting comments so as to allow sufficient industry input.

The American Association of Exporters and Importers has been the national voice of the international trade community since 1921. Its unique role, speaking for and educating both importers and exporters, is driven by a broad economic base of manufacturers, distributors, retailers and service providers. With promotion of fair and open trade policy and practice at its core, AAEI speaks to international trade, supply chain and customs and border protection issues covering the expanse of legal, technical and policy-driven concerns.

Below are AAEI's comments on specific aspects of the proposed revisions. At this time AAEI members have chosen to restrict their comments to the sections listed below; however, their interest extends to the entire breadth of the proposal. AAEI will continue to monitor and comment on Federal developments in this area on behalf of our members as we deem appropriate.

### Part 732, Supplement No. 3

We endorse the concept extant in the current regulations and continued in the proposed Supplement 3 that absent red flags, there is no affirmative duty to inquire, verify, or otherwise “go behind” the customer’s representations. However, the proposed regulation appears to expand, without explanation, the scope of parties who must be aware of “red flags.” Section (b)(ii) creates a new requirement that would cover every “reasonable person in your situation (e.g., manufacturer/exporter, freight forwarder, distributor/reexporter).” In other words the responsibility for red flag awareness has been extended to parties that have not been defined in the regulations. We request further information about the intent of using the terms “manufacturer/exporter” and “distributor/reexporter.”

### Section 772.1, Definition of Knowledge

The amendments to the definition of knowledge improperly replace a specific intent standard with what amounts to a negligence standard. This is accomplished in several ways. First, the proposal introduces to the knowledge definition an “awareness that the existence or future occurrence of the fact or circumstance in question is **more likely than not** [emphasis added],” rather than the current standard that requires “positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence.” Second, the determination of knowledge will be based on a “reasonable person” standard. That is, knowledge of a fact or circumstance would be imputed to a party “**if a reasonable person in that party’s situation** would conclude, upon consideration of the facts and circumstances, that the existence or future occurrence is more likely than not [emphasis added].” BIS also proposes to eliminate the requirement that conscious disregard of the facts involve facts “known to the person.”

This new definition undermines the longstanding definition of the knowledge standard and is inconsistent with the law. The knowledge standard in the EAR has its foundation in the Export Administration Act language. Clearly, Congress delegated the authority to implement and enforce the law consistent with the longstanding interpretation of the standard. That standard requires voluntary and intentional participation in the proscribed act, with specific intention to act. Knowledge may also be established if a person is aware of a high probability of its existence, unless that person actually believes that the fact does not exist. A person does not act knowingly out of ignorance, mistake, accident or carelessness. **See e.g., United States v. Doyle, 130 F.3d 523 (2d Cir. 1997).** By creating the current negligence standard, the BIS is exceeding its authority in a way never contemplated in the law.



Section 764.7, Safe Harbor

We are concerned that the Safe Harbor provided in the proposed regulations is not practical. The proposal requires that the party first comply with the applicable license requirements for the transaction. Then, after checking to determine whether shipment may be made to the customer (by checking the denied persons lists, the Unverified List, etc.) the party may submit the red flags report. At that point, BIS will have up to 45 days to respond. Without the appropriate BIS response, the Safe Harbor will not apply. This Safe Harbor timeframe is excessive. U.S. exporters cannot be competitive if they cannot satisfy customer orders more expeditiously and if they must hold inventory for lengthy periods. We urge BIS to implement a substantially shorter response period.

We look forward to further action in this proposal. Please feel free to call upon us.

Sincerely,

A handwritten signature in black ink, appearing to read "Hallock Northcott". The signature is written in a cursive, slightly slanted style.

Hallock Northcott  
President



December 15, 2004

William Arvin  
Senior Export Policy Analyst  
Regulatory Policy Division  
Office of Exporter Services  
Bureau of Industry and Security  
U.S. Department of Commerce  
14th Street & Pennsylvania Avenue, NW  
Washington, DC 20230

**Re: Revised “Knowledge” Definition, Revision of “Red Flags” Guidance, and Safe Harbor, 68 Fed. Reg. 60829 (Oct. 13, 2004) (proposed rule)**

Dear Mr. Arvin:

On behalf of the Computer Coalition for Responsible Exports (“CCRE”), we are submitting these comments in response to the above-referenced technology regulations proposed by the U.S. Department of Commerce. We agree with the Commerce Department that there needs to be clear rules governing U.S. export controls, and believe that the proposed rule represents an important effort to update the “red flags” guidance and provide exporters with safe harbor from liability arising under the knowledge definition. However, for the reasons discussed below, we believe that the final rule needs to be reworked to reflect a continuation of today’s “knowledge” standard, which is working well, a more administrable and narrowly-tailored set of “red flags,” and a new, ECCN-based approach to the “safe harbor” provision.

CCRE is an alliance of American computer companies and allied associations established to inform policymakers and the public about the nature of the computer industry—its products, technological advances, and global business realities. Our members include Dell Inc., Hewlett

Packard Company, IBM Corporation, Intel Corporation, Sun Microsystems, Inc., Unisys Corporation, AeA, and the Information Technology Industry Council. Our industry has a long history of cooperation with the U.S. government on security-related technology issues, and we are committed to providing the Department with the information it needs to develop effective export control policies.

Please do not hesitate to contact us if we can be of further assistance.

Sincerely,

A handwritten signature in black ink, appearing to read "Dan Hoydysh". The signature is stylized, with a large, bold "D" and a cursive "an" following it.

Dan Hoydysh  
Chairman, CCRE

Enclosure

## I. INTRODUCTION

The Commerce Department's Bureau of Industry and Security ("BIS") has requested comments on its proposal to revise the "knowledge" definition in the Export Administration Regulations ("EAR"), update and expand its "red flags" guidance, and provide a safe harbor from liability arising from the suggested definition of "knowledge."

The proposed rule seeks to achieve the laudable goal of helping exporters guard against technology diversion that could lead to missile proliferation and the spread of weapons of mass destruction. However, we believe that substantial revisions to the proposal are required to effectively protect U.S. national security without disturbing the conditions that allow U.S. companies to compete and succeed in the global economy.

In general, we believe the proposed revisions are problematic insofar as they do not adequately account for the business realities facing American companies in the global market. The revised "knowledge" standard and expanded "red flags" both raise serious concerns for exporters with regard to administration and compliance. We recommend that BIS adopt clear due diligence standards for companies roughly proportionate to the strategic significance of the items at issue.

As discussed below, the final rule should provide for a "non-reporting" safe harbor procedure for low-level commodity goods using a list-based approach to screening and compliance. Such an approach would more effectively focus public and private sector resources on genuine security threats, while avoiding an undue compliance burden on companies dealing in non-sensitive items that generally do not require a license because they pose no significant proliferation risk.

## II. THE REVISED “KNOWLEDGE” DEFINITION

BIS is proposing to change the “knowledge” definition in the EAR so that an exporter would have “knowledge” of a violation if “a reasonable person” in that exporter’s situation would decide the existence or future occurrence of an illicit export activity is “more likely than not.” This proposal would, for the first time, incorporate a “reasonable person” standard and substitute the phrase “more likely than not” for the phrase “high probability.” CCRE believes the new definition of “knowledge” is actually more subjective and ambiguous than the old one. The “high probability” standard is already well-understood under U.S. law (e.g., Foreign Corrupt Practices Act), whereas the new definition centers on 49/51 probabilities that would require companies to engage in uncertain guesswork.

The proposed “reasonable person” standard highlights an inherent difficulty in applying an anthropomorphic concept such as “knowledge” to the activities of complex business transactions. Companies do not behave as a natural person, reasonable or otherwise. Most large companies obtain and process information about customers and potential business partners at many points within their organizations. In some cases, the data might not even be specific to any given transaction (e.g., data collected for marketing reasons).

Applying a “reasonable person” standard in practice would require companies to devise and maintain procedures to analyze multiple data sets located within possibly remote reaches of a company, synthesize them, and effectively diagnose and suspend suspicious transactions, often in real-time. This task is an especially daunting one for U.S. firms engaged in global commerce, as it potentially affects the activities of thousands of employees scattered over almost a hundred countries. The proposed revision to the definition of “knowledge” does not, therefore, comport with the realities of modern global business.

Rather than implementing a new and impractical knowledge standard, BIS should focus its resources on due diligence standards based on “red flag” and safe harbor mechanisms that are both clear and proportional to the strategic significance of the commodities at issue. Collating and analyzing information from multiple sources around the globe can be so costly for low-value commodities that certain classes of export transactions may become economically impractical for American businesses. A heightened compliance burden in certain information technology areas, such as software downloads, would make the speedy execution of orders virtually impossible, and thus pave the way for foreign competitors to supplant U.S. companies. We therefore recommend that EAR-99 items and commodities controlled solely for anti-terrorism (“AT”) reasons that are shipped to non-terrorist or non-embargoed destinations be exempted from this heightened duty of care.

### **III. UPDATED “RED FLAGS” GUIDANCE**

We agree with BIS that the current list of “red flags” is in need of revision to reflect experience and insights gained since the existing “red flags” were developed back in the mid-1980s. However, the addition of eleven sets of circumstances suggesting heightened risks of diversion and proliferation, to the present list of twelve, threatens to introduce an unreasonable and costly investigative burden on businesses, given the mass-market nature of many transactions. We highlight several problem areas below.

*Red Flag No. 17.* This proposed “red flag” would inappropriately expand General Prohibition 10 so that an exporter would in effect be required to assume a violation has occurred solely based on a lack of positive knowledge of a customer’s prior compliance. Red Flag No. 17 adds a new parenthetical clause which would require the exporter to inquire as to circumstances where “there is no indication of prior authorized shipment of a system for which the parts are

sought.” This language suggests that an exporter providing spare parts needs to review prior shipments of systems made by third parties in circumstances where it is unknown whether BIS authorized such transactions. Otherwise, under General Prohibition 10 under Part 736 of the EAR, an exporter could be found to be proceeding with a transaction with knowledge that a violation has occurred. As a practical matter, an exporter would have serious difficulties determining either whether a customer’s product is, in fact, subject to the EAR (e.g., contains greater than *de minimis* amounts of U.S.-origin content) or regulated under the Commerce Control List. BIS should accordingly delete the parenthetical and clarify that the exporter is permitted to assume that the item for which parts are sought has been lawfully exported, absent any “red flags.” In the alternative, BIS could revise the parenthetical to describe situations where the exporter has knowledge that the system was unauthorized.

*Red Flag No. 18.* This proposed red flag would needlessly deter U.S. companies from doing business with foreign companies who, in other contexts, legally deal with persons in countries embargoed by the United States. Red Flag No. 18 would require U.S. companies to ascertain whether a customer is “known to have or is suspected of having dealings with embargoed countries.” Many of our closest allies—including members of NATO—routinely conduct legitimate business involving non-U.S. origin items destined for countries embargoed by the United States. This proposed “red flag” would make no exception, as is made elsewhere under the EAR, for exports or re-exports of items containing *de minimis* U.S. content. This proposed “red flag” should accordingly be deleted, or in the alternative, be revised to read: “The customer indicates the products will be delivered to an embargoed country.”

*Red Flag No. 21.* This proposed “red flag” would require exporters to investigate circumstances where a customer gives “different spellings of its name for different shipments.” However, in the normal course of international transactions, circumstances producing different

spellings—varying translations of an organization’s name, alternative transliterations (e.g., Arabic, Chinese, Cyrillic, Hebrew, etc.), changing references to different subsidiaries or businesses, or simple typographical errors, to name a few—are relatively commonplace. Of course, a reasonable individual supervising low-volume transactions might cope with this compliance problem with some minimal effort. However, it would be unreasonable to require global businesses to revise their order processing systems so as to recognize customer name variations among thousands of transactions and, furthermore, to dedicate additional personnel resources to review positive results. In our estimation, this additional compliance burden would not be justified given the minimal likelihood that variations in customer names provide an accurate indication of a heightened risk of diversion or proliferation. Accordingly, this proposed red flag should be deleted.

*Red Flag No. 10.* This proposed “red flag”—which covers situations where the consignee on the airway bill or bill of lading is located in a Free Trade Zone (“FTZ”)—describes a commonplace, and legitimate, commercial activity for many businesses, and would result in a compliance burden that is disproportionate to any resulting benefit. Absent a more specific description of activities of concern relating to FTZs, this proposed red flag should be deleted.

In sum, a number of the proposed “red flags” would unduly expand the implied duty to inquire into, and resolve, potentially abnormal circumstances. BIS should ensure that any new “red flags” guidance does not contain open-ended circumstances, such as those identified above, which may unfairly require exporters to undertake costly investigations that provide little or no corresponding value in preventing diversion.



#### IV. “SAFE HARBOR” PROCEDURE

CCRE supports BIS’s effort to create a safe harbor from liability arising from “knowledge”-based licensing requirements and other “knowledge” provisions in the EAR. However, as outlined below, the safe harbor set forth in the proposed rule would offer only marginal benefits in relation to the *status quo*. More significantly, it would NOT adopt clear due diligence standards for exporters that are roughly proportionate to the strategic value of the items at issue. We believe that a final rule should provide for a “non-reporting” safe harbor procedure for low-level items (e.g., EAR-99 items and items controlled solely for AT purposes), as discussed below.

As a threshold matter, it is not clear to us why parties would make use of the “safe harbor” provision, rather than simply file a license application with BIS. Under the current system, many companies take the conservative approach of filing a license application in instances where some ambiguity exists, with the expectation that it will be Returned Without Action (“RWA’d”) by BIS, thus confirming that no license is required. This approach likely still would be preferable today for most exporters, given that parties may need to wait 45 or more days for a response from BIS under the proposed “safe harbor” procedure and that those who have filed a report requesting safe harbor may not file a license application relating to the same situation, while the report is under agency review. BIS’s omission of a more strict time limitation and its sequential approach to licensing are troubling, when viewed against the backdrop of its past, often time-consuming and costly reviews of suspicious end-users. Given that BIS may advise an exporter seeking safe harbor that a license is necessary—after spending 45 or more days to arrive at this conclusion—businesses could have saved time by applying for an export license in the first instance.

CCRE proposes a number of improvements to the “safe harbor” procedure that address these and other deficiencies. We recommend that any “safe harbor” provision reduce the proposed 45-day review period and also allow licenses to be submitted simultaneously with “safe harbor” reports. Furthermore, we suggest that in the event a reporting party receives an “is informed” notice, BIS should promptly add the end-user at issue to the applicable agency blacklist. This step would not only advance U.S. national security and foreign policy objectives, but it would ensure that companies who seek safe harbor are kept on a level playing field *vis-à-vis* their competitors who are subject to the EAR. CCRE also believes BIS should clarify that it would NOT impute knowledge to a party that receives BIS concurrence that “red flags” are successfully resolved, except in situations where that party has actual knowledge or awareness (e.g., positive knowledge) of prohibited end-use/end-user. Finally, BIS should further clarify that the “safe harbor” procedure is strictly voluntary, and applies only to knowledge-based requirements in the EAR.

More fundamentally, while our proposed modifications may increase industry use of a “safe harbor” procedure, CCRE believes that the proposed approach falls short of reform. In our view, BIS’s “safe harbor” proposal somewhat unrealistically asks exporters to investigate and resolve a laundry list of broadly-worded “red flags” and then submit to a complex, uncertain regulatory process if one or more “red flags” are in fact discovered. This process is incongruous with the realities of complex, global businesses in the Information Age. We believe that a company’s standard of care should vary according to the strategic value of the items at issue, and reflect clear, bright-line rules that are easy for exporters to understand and follow.

Accordingly, CCRE proposes a revised procedure that includes a “non-reporting” safe harbor for exporters dealing in high-volume items lacking in technological sophistication or strategic sensitivity (e.g., EAR-99 items and items controlled solely for AT reasons) that are

shipped to non-terrorist supporting or non-embargoed destinations. Under this ECCN-based approach, high-volume, low-value commodity items that do not trigger any technology and/or destination-based licensing rules would be subject to clear and reasonable screening requirements based on a consolidated list of blacklisted parties.

Our proposal would grant safe harbor to exporters trading in such commodity items so long as this list-based screening was satisfied; under this approach, there would be no requirements for an exporter to make further inquiries under these circumstances. At the same time, goods and technology controlled for strategic reasons would fall outside this catch-all category. Such items would accordingly need to follow more extensive procedures for identifying and resolving “red flags,” similar to those set forth in BIS’s proposed rule. These procedures would serve as a precondition to an exporter’s receiving safe harbor from liability. As with BIS’s proposed rule, any agency concurrence or approval would NOT make an exporter eligible for safe harbor in the event it were later found that he/she had actual knowledge or awareness of a potential violation. But with regard to high-volume, low-value items, an important difference is that our proposed “safe harbor” procedure would NOT require an exporter to file a report with BIS and await its findings as to the exporter’s due diligence efforts.

CCRE believes its “safe harbor” proposal would allow BIS to allocate better its scarce compliance resources to areas where the risks of diversion or proliferation are the greatest. At the same time, our approach imposes a more reasonable compliance burden on exporters by recognizing the costs associated with a highly discretionary, non-list based system (in terms of man hours, hiring of dedicated personnel, purchase of compliance systems, transactional delays, and lost business opportunities). Moreover, our proposal offers greater clarity, predictability of outcome, and consistency in application to the exporting community. By tying the amount of due diligence required of an exporter for safe harbor to the strategic significance of the items to

be shipped, our approach forges a middle ground that better serves U.S. national security, while also acknowledging the practical realities facing U.S. businesses that compete in the global economy.

We welcome BIS's efforts to provide a safe harbor from liability arising from the "knowledge" definition and are committed to working with the Department to develop feasible list-based and, as required, non-list based screening systems for businesses that can help safeguard both America's national security and its continued technological and commercial leadership.

# Customs and International Trade Bar Association

December 15, 2004

Via email: [rpd2@bis.doc.gov](mailto:rpd2@bis.doc.gov)

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Honorable Peter Lichtenbaum  
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14<sup>th</sup> Street & Pennsylvania Avenue, NW  
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Attention: Mr. William Arvin  
Regulatory Policy Division  
Office of Exporter Services  
Room 2705

Dear Mr. Secretary:

Re: *Revised "Knowledge" Definition, Revision of "Red Flags"  
Guidance and Safe Harbor, Reg. Id. No. 0694-AC94*

The following comments are submitted on behalf of the Customs and International Trade Bar Association (CITBA) in response to the invitation of the Bureau of Industry and Security (BIS) in the captioned matter. 69 Fed. Reg. 60,829 (October 13, 2004). The Customs and International Trade Bar Association was founded in 1926. Its members consist primarily of attorneys who concentrate in the field of customs law, international trade law and related matters. CITBA members represent United States exporters, importers and domestic parties concerned with matters that involve the United States export laws, customs laws, and other international trade laws, and related laws and regulations of federal agencies concerned with international commerce.

In June 2003, CITBA filed comments applauding BIS for its efforts to identify and publicly debate "best practices" with respect to the transshipment of dual-use items through transshipment hubs. CITBA endorsed the approach to mitigation of penalties in the event that a private entity following the "best practices" nevertheless became involved in a matter in which dual-use items were diverted from the intended end user.

Here again in the context of the red flags and "know your customer" rules, BIS deserves credit for updating its guidance, providing notice to the trade regarding the standards and expectations of the agency, and inviting public debate with respect to these proposals. By elaborating on the situations that create red flags and by providing exporters with a

safe harbor in the event that these circumstances are encountered, the agency provides valuable assistance to exporters.

Nevertheless, a few general issues raised by the proposed regulations cause concern. First, the revised definition of “knowledge” appears to go beyond clarification of current regulations and to adopt a potentially problematic standard for inferring knowledge. Second, the additional red flags include some activities that are in many cases normal or common. By including these activities in the list of red flags, the regulations are likely to create confusion, inviting unintended violations or unnecessarily creating a disincentive to legitimate export trade.

#### The Revised Definition of “Knowledge”

With respect to the proposed definition of “knowledge,” the stated purpose for the proposed changes is to “facilitate public understanding” without changing current policy or practice. 69 Fed. Reg. at 60,829. Yet, the proposed regulations may underestimate the confusion that will be created by this change in terminology. Many responsible companies in the export community consult closely with their attorneys regarding the regulations. Attorneys, including CITBA’s members, will have to inform their clients of the proposed change in the regulations and the new meaning of “knowledge.” The change in meaning and terminology will very likely foster confusion, whether or not BIS intends in fact to lower the standard for finding liability. Moreover, because courts will refer to precedent with respect to the language used in the regulations, any litigation concerning the meaning of “knowledge” may also result in lowering the threshold for liability.

The current BIS regulations define “knowledge” to include “an awareness of a high probability” that a circumstance exists or will occur. *Id.* The proposed regulation would change this standard by replacing “high probability” with “more likely than not.” *Id.* BIS reasons that companies treat any facts that are “more likely than not” as having a “high probability.” That is, according to BIS, the new standard is in practical terms interchangeable with the existing knowledge requirement. BIS thus characterizes its new test as merely a “clarification of the current standard” and, furthermore, asserts that the new language will not increase company responsibility or the costs associated with compliance. *Id.*

CITBA submits, however, that the new “more likely than not” definition will create a lower threshold than the former “high probability” standard. In mathematical terms, “more likely than not” suggests more than 50 percent probable. “High probability,” however, suggests a much higher numerical percentage. This interpretation is consistently evident in legal precedents.<sup>1</sup> At the least, a change in the operative language will cause attorneys and their

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<sup>1</sup> Indeed, a simple Westlaw® search of the two phrases in the Federal cases database turned up literally hundreds of cases in which “more-likely-than-not” was contrasted with “high

clients to question whether the standard for liability has been reduced. This process alone will almost certainly increase costs in the export community.

The current definition, including the references both to “high probability” and to “conscious disregard” of facts, draws on well-established legal precedent with respect to constructive knowledge. For example, when the Federal Trade Commission applies Section 5(a) of the FTC Act to corporate misrepresentations or omissions, “knowledge” is an essential element for determining liability. The FTC’s obligation in that context is “fulfilled by showing that the individual had ‘actual knowledge of the material misrepresentation, reckless indifference to the truth or falsity of such misrepresentations, or an awareness of a high probability of fraud along with an intentional avoidance of the truth.’”<sup>2</sup> Similarly, the Official Draft of the Model Penal Code, at 27, provides that “knowledge is established if a person is aware of a high probability of its existence....”

By removing “high probability” from the definition of “knowledge,” the proposed regulation would be distinguished from these precedents. In the event that a charged violation results in litigation, a court would consider such precedents in interpreting the regulations. Notwithstanding the comments by BIS, a court might not view the new standard as identical to the current standard. Rather, a court might very well consider the new standard to impute knowledge even where a “high probability” was lacking. And, exporters (and their attorneys) anticipating this interpretation would likely modify their behavior.

Stated differently, by referring to “an awareness of a high probability,” the current regulations draw upon well-established legal precedents. Even if BIS portrays this change as a mere clarification of existing policy and practice—rather than a significant lowering of the bar—the change will breed misunderstanding with respect to BIS’s intentions. If its intention is to lower the threshold at which it will infer knowledge, BIS should at least acknowledge that it will be holding exporters to a higher standard. Otherwise, by equating the different standards, BIS will create uncertainty. Ultimately, uncertainty is inimical both to an effective export control system and to promoting U.S. export trade.

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probability.” Case law typically equates the “clear and convincing” standard of proof with evidence that a fact is “highly probable.” See, e.g., *Simpson v. Burroughs*, 90 F. Supp.2d 1108, 1130 (D. Or. 2000) and cases cited therein. “More likely than not” is typically equated with the “preponderance of the evidence” test. See, e.g., *Concrete Pipe & Products of Cal., Inc. v. Construction Laborers Pension Trust for Southern Cal.*, 508 U.S. 602, 622 (1993).

<sup>2</sup> *F.T.C. v. Minuteman Press*, 53 F. Supp.2d 248, 259-60 (E.D.N.Y. 1998) quoting *F.T.C. v. Amy Travel Serv., Inc.*, 875 F.2d 564, 573-74 (7<sup>th</sup> Cir. 1989) (emphasis added).

### Expansion of the List of “Red Flags” and the Duty to Investigate

In the context of an export transaction involving goods or services covered by the EAR, exporters are advised by the current regulations to take affirmative steps to prevent diversion of controlled commodities to improper end-uses. The comments prefacing the draft regulations are explicit: “When there is a red flag, you have an affirmative duty to inquire into the circumstances giving rise to the red flag and whether the circumstances in fact present a heightened risk” of a violation. 69 Fed. Reg. at 60,833 (emphasis added).

However, some of the new red flags are not necessarily unusual or uncommon in export transactions. For example, use of a P.O. Box by a customer can trigger the affirmative duty to investigate. Likewise, if the ultimate consignee listed on the air waybill or bill of lading is a freight forwarder or a trading company, the exporter will have an affirmative duty to investigate, even if it is common for customers in the foreign jurisdiction to conduct international transactions through trading companies or brokers. If the customer’s address is located in a free trade zone, a red flag is raised. Changing delivery terms or delivery to an “out-of-way” location can be a red flag. Or, if the customer has simply never ordered similar parts in the past, the exporter’s duty to inquire may be triggered whether or not the customer is known, for example, to have purchased similar parts from a competitor or to have manufactured such parts in the past. In short, the new red flags listed in the regulations do not always indicate a suspect transaction—or even an uncommon one.

These red flags apparently intend that an exporter should not only “know” the end-user but also determine whether the exported item is likely to be re-exported or incorporated in another product and re-exported.<sup>3</sup> It is reasonable to establish a “red flag” concerning transactions that very likely involve re-exports or resales to unknown users. However, if a dual-use item is incorporated in a permitted downstream manufactured article, it is not clear why there should be any further obligation to investigate whether that finished article is re-exported or resold in a particular country. The guidance provided could usefully identify examples indicating when the exporter’s duty to inquire is at an end.

Moreover, details concerning the end-use of a dual-use article may be trade secrets of the user. End-users will not always be willing to share with their suppliers the details of a specific application. Once it is established that the sale is made to a permissible use and user, the

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<sup>3</sup> The physical nature of the item is also significant. In some cases, the dual-use item may be easily removed or disassembled from the finished article in which it is incorporated. Software installed on a computer may be readily copied or downloaded. In other cases, the dual-use item may not be able to be separated from the further-manufactured article. Controlled chemicals may be used in a manufacturing process that results in a new chemical or plastic, where the process is not easily reversed.



exporter should be deemed to satisfy the standard. Otherwise, the sheer intrusiveness of the monitoring duty may impair the exporter’s ability to sell.

Finally, the fact that a customer may sell products to “embargoed countries” should not be a red flag. Innumerable customers in Canada and Europe have legitimate sales to embargoed countries, such as Iran, that are outside the jurisdiction of United States and legal under their own national laws. If exporters must investigate all such customers or file safe harbor reports, the burden on the trade and on BIS will be enormous.

#### Post-license Red Flags

Proposed Supplement No. 3, paragraph (b)(1)(iii), states that “red flags may also be raised in exports that have been licensed by BIS” and goes on to require exporters to “identify and respond” to such red flags even where an export license has already been obtained. 69 Fed. Reg. at 60,833. It is unclear, though, whether upon identifying such a red flag, the exporter has an affirmative obligation to report the red flag or is even permitted to do so while still taking advantage of the safe harbor.<sup>4</sup> Given the nature and variety of red flags, many concerns may be resolved by the exporter by applying the “Know Your Customer Guidance” under Supplement No. 3, paragraphs (b)(2) – (5).

On the other hand, paragraph (b)(6) indicates that exporters “are encouraged” to advise BIS if they have any question about a red flag or if they decline a transaction based upon information “relating to completed or attempted violations of the EAR.” 69 Fed. Reg. at 60,833. This language suggests that self-reporting of potential violations is not mandatory. At the same time, there is no incentive offered to exporters that do report non-compliance with respect to circumstances arising or made known only after a license was granted and exports have taken place.

By contrast, under the prior disclosure provisions applied with respect to import transactions, an importer that self-reports violations can significantly limit its exposure to penalties. *See* 19 U.S.C. § 1592(c)(4). Indeed, importers have an incentive to disclose and correct potential violations discovered before the Bureau of Customs and Border Protection commences an investigation. Here, by indicating that self-reporting will mitigate any penalty ultimately assessed, BIS could provide a real incentive for exporters to report potential violations.

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<sup>4</sup> Proposed Section 764.7(c)(1) states that to be eligible for the safe harbor, the report must be submitted “[p]rior to proceeding with the transaction ....” The proposed regulation does not address red flags discovered after a license is issued and export transactions are underway.

Indeed, the lack of any provision with respect to mitigation means that there is no incentive to reporting red flags or even attempted violations. For example, if an exporter declines a transaction because of a red flag or an attempted violation, there is no penalty because the transaction did not take place, but there is also no incentive to advise BIS. If the company could be credited with mitigation of potential liability in other export transactions, however, there would be a significant incentive to report to BIS.

#### Safe Harbor Reporting of “Red Flags”

The creation of a “safe harbor” for exporters that encounter and report red flags is a positive development that provides greater certainty to exporters and, therefore, promotes trade. A safe harbor approach will both encourage and reward exporters who share the agency’s goal to prevent problematic transactions. The proposed regulations, however, might be improved and clarified.

First, in Section 764.7(a)(2) of the proposed regulations, an exporter must determine whether (1) BIS has denied export privileges to the exporter’s customer, (2) the customer appears on the Unverified List, (3) the customer appears on the Entity List, (4) the customer is a specially designated global terrorist, terrorist, foreign terrorist organization, or national, or (5) the customer is subject to restrictions under a BIS General Order. BIS would be doing the exporting community a great service if it would publish a consolidated list, rather than putting the onus on exporters to have to check a multitude of lists issued by a variety of governmental departments. Indeed, the use of a consolidated list would better ensure that exporters do not inadvertently overlook that a transaction is contemplated with an improper entity.

Second, it is not particularly helpful to respond to a red flag notice with a letter or telephone call stating merely that BIS “is informed” or that the agency needs more time to address the issue. Given that the safe harbor requires a 45-day wait prior to exportation, a response stating that BIS needs more time may in practical terms cancel the transaction. CITBA thus urges BIS to avoid asking for additional time or issuing an “is informed” response.

Third, the regulations do not address recurring transactions with the same foreign end-user or customer. That is, the regulations apply to “an export, re-export or other activity subject to the EAR....” 69 Fed. Reg. at 60,835. It would reduce the burden both for the agency and for the trade if recurring, identical transactions would be covered by a single report. For example, in the case of multiple shipments of the same item to the same end-user, the exporter should be able to rely upon advice provided with respect to the first such transaction.

Undoubtedly, in the course of commercial transactions, there will be range of “suspicious” transactions of varying degrees. A one-size-fits all response will not be appropriate. Nor should the Best Practice always require contacting BIS or a U.S. law

enforcement agency. The export control compliance specialist may determine that different responses are called for depending upon the particular facts. As a partner with BIS, the trade should not be required to halt shipments upon any suspicious activity but should be allowed to exercise reasonable care in handling the situation and creating an appropriate response.

Finally, the notice indicates that submitting a red flag report and obtaining a "BIS concurs" letter "shall not bind a subsequent enforcement action or prosecution if the submitting party had actual knowledge or actual awareness that the fact or circumstance in question was more likely than not, or if the submission misstated or withheld relevant material." 69 Fed. Reg. at 60,836 (emphasis added). The underscored language suggests that BIS would contemplate bringing an enforcement action against an exporter that did not misstate or withhold relevant material but that should have known some facts were "more likely than not." Indeed, under this standard, BIS would never need to allege or establish "actual knowledge." Liability could be predicated solely upon whether facts were "more likely than not."

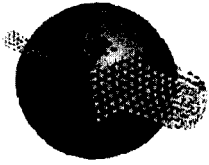
Without precedents or examples, this standard is an improper basis for potential liability. Use of this language will have a chilling effect on U.S. exporters that cannot learn much about their customers (for example, due to trade secrets). A company that in good faith reports red flags and the steps it has taken should be rewarded with a defense to liability, in the same manner that the exercise of reasonable care in the import context provides a defense to Customs civil penalties.

Respectfully submitted,



Melvin S. Schwechter  
President

James R. Cannon, Jr.  
Chairman, International Trade Committee



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## EMERGENCY COMMITTEE FOR AMERICAN TRADE

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December 15, 2004

Regulatory Policy Division  
Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
14<sup>th</sup> and Pennsylvania Ave., N.W.  
Washington, D.C. 20230

**E-Mail:** [rpd2@bis.doc.gov](mailto:rpd2@bis.doc.gov)

Re: Regulation Identification Number 0694-AC94

Dear Sir:

I am writing on behalf of the Emergency Committee for American Trade (ECAT) to provide comments on the proposed rule to revise the Export Administration Regulations (EAR) by redefining “knowledge”, modifying the “red flag” guidance and creating a “safe harbor” from liability.

Founded in 1967, ECAT is an organization of leading U.S. international business enterprises that seek to promote economic growth through the expansion of trade and investment. ECAT’s members account for major segments of the manufacturing and services sectors of the American economy. Their combined exports run into the tens of billions of dollars. Their annual worldwide sales total nearly \$2 trillion, and ECAT companies employ approximately five million persons.

Given the strong export activity of ECAT’s membership, ECAT is, therefore, very interested in providing these comments on the proposed rule of October 13, 2004 of the Bureau of Industry and Security (BIS).

As you know, the proposed changes seek to revise the very complicated EAR and are likely to result in a significant restructuring of industry’s compliance activities. While we understand that this rule has been in development for quite some time, many of the companies that will be directly affected by it have had only the past few weeks to examine the changes being proposed. In light of this complexity, we welcome very much the extension of the comment period beyond and look forward to continuing our consultations on these very important issues.

In the period during which we have reviewed the proposed rules, we have noted several important issues deserving of comment.

## **Failure to Distinguish Between Commodity and Non-Commodity Exports**

Before addressing the specifics of the proposed rule, it is important to highlight a very important opportunity that BIS is missing in its initial proposal. In particular, the proposed rule fails to distinguish between different types of products in identifying what steps an exporter must take to determine whether an export transaction may violate the EAR. Thus, exporters are essentially asked to apply the same level of compliance effort regarding the export of decontrolled commodity items wholly unrelated to weapons development or proliferation (which may be a cable sold in the tens, hundreds or thousands), as they are to apply to more sensitive or significant types of equipment. This failure to distinguish compliance obligations between unrelated commodity items and more sophisticated items that may have a closer relation to weapons development creates an unnecessary and unproductive burden on exporters. Rather than improving U.S. security, this failure to distinguish has the effect of diverting significant energy from the most important compliance activities in which U.S. companies are engaged.

The exporting community had been working with BIS to promote the development of revisions to the EAR to address precisely this issue. The proposed rule, however, fails to create any distinction between commodity and non-commodity items. The proposed safe harbor provision appears to be a time-consuming and laborious process that is not easily adaptable to commodity type sales. As well, the proposed substantive revisions to the “knowledge” standard may make the lack of the distinction between decontrolled commodity items and more sophisticated items much more problematic.

ECAT urges BIS to reconsider the EAR revisions and to work with the exporting community to develop a clear due-diligence screening process for commodity items that would more appropriately address concerns in that area.

## **Revised “Knowledge” Standard**

The proposed EAR revisions would redefine the standard to determine whether an exporter had “knowledge” that an export transaction may violate the EAR. The proposed rule seeks to replace the current “high probability” guidance to a “more likely than not” standard and also would incorporate a “reasonable man” standard, as opposed to examining what an exporter knew or avoided knowing, for determining whether an exporter had knowledge.

Despite BIS’ assertion to the contrary, this change in language appears to represent a substantive change in the threshold for determining an EAR violation in a manner that inappropriately increases the burden on exporters. On its face, the proposed “more likely than not” standard represents a lower threshold for determining whether there is a violation of the export control rules than the current standard. As well, adding the “reasonable man” standard increases the complexity for compliance, adding in a subjective element in reviewing whether a company’s compliance activities were sufficient, rather than looking at what a company knew or avoided knowing.

U.S. exporting companies have made substantial investments in ensuring compliance with U.S. export rules and been a key ally of the U.S. government in promoting national security through their compliance activities. As a result, U.S. companies already face substantial burdens compared to foreign exporters who are not subject to these requirements. The proposed stricter

standard – almost a strict liability standard in application – puts U.S. companies at an even greater competitive disadvantage compared to our foreign competitors. This result is neither justified, nor likely to promote the national security objectives that we all believe are so important.

While proposing this increased burden, BIS has failed to provide any concrete justification or rationale for developing the new proposed standard, other than asserting that it might be more easily understood. While the “high probability” standard is a well-recognized standard, having been derived from the Foreign Corrupt Practices Act, there is little precedent or other interpretative guidance with respect to the proposed “more likely than not” standard, which is likely to create more, rather than less, confusion as to exporters’ obligations. Given the extensive use of the existing “high probability” standard and the fact that the “reasonable man” concept is a very complex concept, particularly when applied to a corporation where different personnel often have different pieces of information, BIS’ assertion is highly questionable. There is no suggestion that the new standard is required for national security reasons and, frankly, we believe it may likely be counterproductive by putting U.S. exporters at an even greater competitive disadvantage.

Furthermore, changing the legal threshold, as BIS suggests, is likely to have significant impact on the compliance efforts of U.S. companies, which are already substantial. The lower threshold would require the internal reexamination of many company compliance systems and, for some companies, may require a full-scale revision of their compliance activities to ensure that their activities would result in compliance under the very strict new standard. Given the EAR’s failure to distinguish between commodity and more sensitive items, the development of a more stringent “knowledge” standard could unnecessarily increase the burden on U.S. exporters, undermining their competitiveness globally, while not better promoting U.S. national security goals.

Given the problems identified above with the proposed rule, ECAT urges BIS to work with the exporting community to determine what, if any, changes in the “knowledge” standard are justified. If changes are justified for national security aims, ECAT urges BIS to develop standards that are workable in a corporate environment and that do not unnecessarily place U.S. companies at an even greater competitive disadvantage vis-à-vis our foreign competitors who are not subject to these rules.

### **Safe-Harbor Reporting Provision**

BIS has also proposed the creation of a safe-harbor reporting provision that would provide exporters a safe harbor from liability in certain circumstances. The concept of a safe harbor represents an important step forward, yet the actual procedure could be improved substantially. As currently drafted, the procedure provides a moratorium on proceeding with a transaction while BIS is reviewing the report that exporters must make to qualify for the safe harbor. The rule indicates that BIS will normally respond to most reports within 45 days, but is not bound by that period and may require longer.

The moratorium on proceeding with a transaction represents a substantial impediment to the use of this safe-harbor provision for exporters. The proposed procedure is likely to create significant delay and uncertainty, resulting in a significant loss of competitiveness for U.S. companies. As a

result, it is not clear that such a procedure would be used, thus diminishing its value to both the exporting community and BIS.

This procedure could be improved in several ways. One option would be to incorporate it into the existing licensing process. Alternatively, the rule could provide BIS with a shortened and strict timeframe –perhaps 10 days – in which to respond initially to an exporter’s report in cases of serious concern or unresolved red flags. If BIS does not respond within 10 days, the exporter could proceed with the transaction, including obtaining a license, and BIS could continue to review for an additional limited period, at which point it would issue or not issue its safe harbor determination. Such a procedure would enable BIS to move quickly if it saw any initial problems or unresolved red flags with the transaction, but take additional time in other cases.

As well, the proposed rule should make clear that the use of the safe harbor provisions are entirely voluntary and that a company’s decision not to use this procedure should not result in any imputed knowledge, liability or additional scrutiny.

### **Enhanced Red Flags**

The BIS has also proposed increasing from 12 to 23 the number of circumstances which would be identified as “red flags.” In general, the red flags provide increased information for exporters of circumstances warranting additional review, although they also expand the burden on exporters in reviewing their transactions.

In reviewing the additional “red flags,” it is clear that one item in particular needs to be clarified; number 18 would create a red flag when a “customer is known to have or is suspected of having dealings with embargoed countries.” This red flag fails to distinguish between “legal” and “illegal” transactions and would raise a red flag with foreign companies, such as many in Europe, who are legally involved in transactions with countries on which the United States has imposed an embargo. This red flag should be deleted.

\* \* \*

Thank you for your consideration of these initial comments on the BIS proposed rulemaking. I look forward to continuing to work with you in efforts to improve the operation and effectiveness of the EAR.

Sincerely,



Calman J. Cohen  
President



December 15, 2004

VIA EMAIL: [RPD2@bis.doc.gov](mailto:RPD2@bis.doc.gov)

Ms. Hillary Hess, Director  
Regulatory Policy Division, Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Washington, D.C. 20230

Re: RIN 0694-AC94; Proposed Rule Regarding Revised "Knowledge Definition, Revision of "Red Flags"  
Guidance and Safe Harbor

Dear Ms. Hess,

This is to provide comments in response to the above referenced proposed rule.

The proposed rule is troubling for the following reasons:

1. Harm to the U.S. Economy. The rule, if implemented, would be harmful to the U.S. economy. The rule would cause exporters to be fearful to export. It suggests that should anything go wrong in an export transaction, the U.S. government will find a way to assign blame to the U.S. exporter. It is important to remember that exports are good for the U.S. economy and jobs. The U.S. government should not promote an attitude of fearfulness toward export trade.
2. Unnecessary requirement for legal counsel. The rule suggests that unsophisticated exporters should not participate in export trade and that a knowledge of legal jargon is necessary. It recommends use of legal counsel in order to participate in export transactions. This runs counter to the policy of this Administration during its campaign in which it was suggested that attorneys should not infiltrate areas of commerce unnecessarily. As stated by this Administration, unnecessary involvement by lawyers is inflationary. In the area of international trade, exports should be administered by companies, not by lawyers.
3. The rule is counterproductive. The stated purpose of the proposed rule is to improve the public understanding of the knowledge definition, and to encourage more parties to take measures to prevent diversions. In fact, the rule would accomplish just the opposite. The current knowledge guidance and red flags is well understood when presented to sales people at an exporting company. The proposed rule is ambiguous and not straight forward. The proposed rule is confusing and will frustrate the efforts of sales people to make legitimate export sales.
4. Safe Harbor is unmanageable. There is already a safe harbor system in place. Exporters have the ability to make a request for guidance under the Enhanced Proliferation Control Initiative. This system is not used by exporters because it is ineffective. It is unlikely that implementing the same system under a different name will work any differently than the current system.





Solution. In addition to stating a purpose, it is necessary to determine a specific goal that is to be reached. If the goal is to prevent illegal exports, then the current language is preferable to the proposed rule. The current rule is easier to understand and implement. If the goal is to create a fearful attitude toward exporting, then the goal is inimical to bolstering the U.S. economy. It is important to note that the U.S. and F.C.S. promotes the practice of exporting to the business community.

It is necessary to determine the desired goal that is to be achieved. Once that goal is determined, I am confident that the U.S. business community, the U.S. and FCS., and the District Export Councils will be willing to assist the BIS in determining the best way to achieve the goal without harming U.S. exports and the economy. Although the proposed rule will affect high tech exports, it will also affect all exports. Therefore, it must be fully vetted within all branches of the U.S. Commerce Department.

I appreciate the opportunity to provide comments.

Sincerely yours,

Catherine E. Thornberry

Catherine E. Thornberry  
President

# MICHAEL G. DEAL

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December 15, 2003

Regulatory Policy Division  
Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Washington, DC 20230.

**Re:** Regulation Identification Number 0694-AC94

Gentlepersons:

These comments are submitted pursuant to notice of rulemaking entitled "Revised ``Knowledge" Definition, Revision of ``Red Flags" Guidance and Safe Harbor" issued on or about October 13, 2004.

First, as a preliminary observation, I note there is no statutory authority for this rule. The Export Administration Act has expired according to its express terms in clear statutory language clearly adopted by Congress. The authority granted by the International Emergency Economic Powers Act, 50 U.S.C. 1701 et seq., is limited to specific, extraordinary particularized threats, and not routine regulation of ongoing commerce.

Second, small business exporters will be disproportionately adversely affected by the proposed rule. The proposed rule increases the complexity of the Export Administration Regulations, and thereby increases uncertainty. The EAR, especially when combined with the various provisions of the disjointed sanctions regimes operated by the Department of the Treasury, already stands as a powerful disincentive for small businesses exporters. Having given and attended seminars for small business exporters for the better part of the past twenty years, I can attest that the complexity and breadth of the EAR routinely scares off (I use the term "scare" literally) small businesses. As a small business exporter from Tullahoma, Tennessee, stated at the conclusion of the Business Executives Enforcement Team meeting recently held by the Office of Export Enforcement in Nashville, "The safest thing to do is just not to export anymore." That company already has a policy of not responding to inquiries from any customers in the Middle East, and is now considering ending all sales to foreign distributors for fear of being held responsible for violating the regulations in the event that its products reach a party on one of the five lists. Its response is not atypical of small manufacturers.

BIS's methodology for determining the adverse effect on small business exporters is seriously flawed. An adverse effect on small business exporters occurs not just when a small business determines that a license is required, but whenever BIS adds yet another layer of complexity and uncertainty requiring small businesses to divine the intent of potential purchasers. The effect of the proposed rule will be to force small business exporters to either go through the exercise of analysing each and every transaction in light of the expanded list of "Red Flags" and other vagaries inherent in the "Know Your Customer Guidance" and memorializing such analysis in some form of documentation or record, or risk later being held accountable if its products ultimately wind up in the hands of a proscribed party. The proposed rule applies not just to "big ticket" items or items that are truly "dual use" that are uniquely available from the United States, but to all products, even where competitive products easily available is absolute foreign availability. Thus, all small business exporters will be adversely affected by the rulemaking. The Small Business Administration

estimates that roughly a third of all exports, by value, are made by small businesses, and that 97% of all exporters are small businesses. Thus, the adverse effect of this rulemaking will be widespread and will significantly and adversely affect the economy, most especially the trade deficit.

The proposed redefinition of the term knowledge from “not only positive knowledge that a circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence” to “more likely than not” is not the minor adjustment alleged by BIS in the preamble. First, the new definition is a significant departure from the commonly understood meaning of the term knowledge, to wit, “ a clear and certain perception of something”. Websters New Twentieth Century Dictionary Unabridged (2<sup>nd</sup> ed. 1987). Second, it is clearly a lower threshold than “high probability”. By lowering that threshold, BIS creates uncertainty, increases the regulatory burden, especially on small businesses, and will cause more small businesses to abandon otherwise innocent potential exports.

Finally, with the possible exception of a potential purchaser who proposes to pay with suitcases full of currency, all of the so-called “Red Flags” are perfectly consistent with modern business practice in which the species of intellectual property known as “trade secrets”, requires that information, in order to be protected as trade secrets, be closely held and not disclosed. Trade secrets include not only technical information, but confidential business information. Thus, it is normal, indeed, expected business practice for purchasers to be evasive about the details of end-use and the end-user. As the other side of the Department of Commerce, the U.S. Foreign and Commercial Service publications expressly recognize, international business is often conducted through intermediaries, and intermediaries typically wish to protect their business by keeping the ultimate buyer secret, in order to keep the seller from circumventing the intermediary. Similarly, technical details regarding the end-use of products are often withheld in order to keep the seller from developing competitive products. The simple fact is that modern business is constantly evolving business models that do not fit the old text-book archetypes, and deviation from those old business models necessarily are not inherently suspicious.

Respectfully submitted,

*Michael Deal*

Michael Deal

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December 15, 2004



Regulatory Policy Division  
Office of Exporter Services  
U.S. Department of Commerce  
Room 2705  
Washington, D.C. 20230

Re: Proposed Rule - Revised "Knowledge" Definition, Revision of "Red  
Flags" Guidance and Safe Harbor,  
69 FR 60829, October 13, 200  
Regulation Identification Number 0694-AC94

Ladies and Gentlemen:

We appreciate the opportunity to provide comments on the above  
referenced proposed ruling by the Department's Bureau of Industry and Security  
(BIS), as follows:

On the subject of changes in the definition of "knowledge" we respectfully  
disagree with BIS that this is not a substantive change, or that "more likely than  
not" is a better understood concept than "high probability." "High probability"  
and "more likely than not" have different meanings, and the meaning of each is  
well understood, i.e., the "more likely than not" concept unmistakably lowers the  
knowledge definition standard. Further, it may be true that in many cases  
exporters may already be operating under the "more likely than not" standard to  
protect themselves from potential compliance challenges; therefore, if the  
standard is lowered, many exporters may feel compelled to operate under an even  
lower threshold to ensure compliance. This will increase, rather than reduce,  
transaction costs and the need to consult counsel on a broader range of  
transactions.

Additionally, while we must agree with BIS that the definition of a term  
should not include the defined term, we believe that deletion of "known to the  
person" removes clarity from the definition. It is true that one logically must  
know a fact in order to disregard said fact, but it is clearer to so state.

We also believe that the "more likely than not" standard could have  
harmful consequences for safety of flight, since it would apply to the service of an

item under Prohibition #10 of the regulations and therefore would require the interruption of service at a lower threshold to an airplane that was an approved export and which could possibly be transporting thousands of international passengers in a single month while under control of its legitimate end user. In fact, we believe that as it relates to safety of flight even the “high probability” standard is too low and should be revisited regarding this issue.

With respect to the new guidance on Red Flags, we have the following concerns:



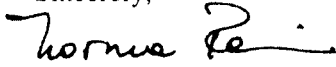
- BIS should clarify the statement that knowledge about transactions be evaluated by responsible senior officials, i.e., the definition of responsible senior official. It would be extremely difficult for large companies to ensure that every single transaction is evaluated by a senior official, if by that reference BIS means an officer of the company.
- Red Flag #5: the second sentence given as an example does not illustrate the concept expressed in the first sentence, “Customer has little background in the relevant business.” Financial information and identity of the corporate principal do not correspond to the customer’s background in the relevant business. One can have a customer well known in a field whose ownership is not public and who does not disclose financial information.
- Red Flag #9: It is unclear why an unexpected change in delivery date should be a red flag. Delivery dates can often change unexpectedly for legitimate business reasons.
- Red Flag #14: Replace first word “when” with “if” since questioning the buyer is not a requirement.
- Red Flag #18: This red flag is too broad; in some instances, dealing with embargoed countries with respect to items under USG jurisdiction could be authorized with proper USG approval (e.g., humanitarian or religious activities allowed under the OFAC regulations). We suggest inserting “improper” between “having” and “dealings” and/or making a reference to the item in question

Finally, regarding the new Safe Harbor provision it is unclear why a license application cannot be submitted in parallel with the Safe Harbor filing (referencing the Safe Harbor). The Safe Harbor process introduces a 45-day delay on top of the time required to obtain a license, and this could cause serious problems to industry. Also, we believe that BIS should respond in writing and within 45 days and are therefore opposed to the BIS proposal to inform industry telephonically that a response will not be forthcoming.

In closing, we want to reiterate our full support of the Department’s efforts to prevent illegal exports and the diversion of items and technologies to countries or

entities of concern. However, BIS should make every effort to ensure that its proposed measures do not put U.S. business at a competitive disadvantage in the international marketplace by discouraging legitimate end users around the world from doing business with American companies.

Sincerely,



Norma Rein  
Manager, Export Policy and Regulatory Reform  
(703-465-3655)





December 15, 2004

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Regulatory Policy Division  
Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Washington, DC 20230

Re: Comments on Proposal to Revise EAR Relating to Knowledge  
Definition, Red Flag Guidance, and Safe Harbor (Regulation Identification  
Number 0694-AC94)

Ladies and Gentlemen:

We are writing on behalf of the Section of International Law of the American Bar Association in response to the request for comments from the Bureau of Industry and Security ("BIS") of the Department of Commerce (the "Department") regarding its proposed revisions regarding (i) the "knowledge" definition, (ii) "red flags" guidance and (iii) a safe harbor in Parts 732, 736, 740, 744, 752, 764 and 772 of the Export Administration Regulations (the "Proposal"). *See Notice of Proposed Rule*, 69 Fed. Reg. 60829 (Oct. 13, 2004). The views expressed herein are presented on behalf of the Section of International Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association.

We believe that the proposed changes set forth in the Proposal, particularly the revisions to the definition of knowledge, are substantive in nature and will have a significant effect both in proceedings before BIS with respect to alleged violations of the regulations and in the magnitude of effort which exporters (and others involved in exporting and re-exporting) will be required to expend in order to assure their compliance with those regulations. Any changes to the existing rule ultimately adopted by BIS could have substantial economic consequences to the exporting community and the ability of American companies to compete effectively in global markets.

We thank the BIS and the Department for this opportunity to provide comments. The Section, along with the exporting community, strongly supports the goal of preventing the proliferation of weapons of mass destruction, and the means of delivering such weapons, through effective controls on exports from the United

States. However, the application of the Enhanced Proliferation Control Initiative (“EPCI”) catch-all rules has been extraordinarily difficult. Some estimate that exporters devote over 80% of their export compliance resources to addressing this rule, but with the result of rarely finding transactions involving weapons of mass destruction. Yet exporters are frequently concerned about possible “second guessing” by regulators if an end-user is later discovered to be involved with such activities. In recent years, exporters have asked BIS for clarity and changes to alleviate the need to screen EAR99 items, low value transactions, and to force hard decisions by government officials so as to make these rules more effective. The Proposal does none of that. Unfortunately, while there are some useful parts of the Proposal, most of it will make export compliance more expensive and risky without improving national security.

We have ordered our comments in accordance with the three aspects of the Proposal.

### Revised “Knowledge” Definition

#### *No Statement of Reason for the Change or Evidence Justifying the Change*

BIS has not indicated why a change in or, as asserted by BIS, a clarification of the definition of “knowledge” is needed to further the goal of preventing proliferation. It may be that BIS has concluded that exporters and other responsible parties are not adequately implementing the current BIS red flags, Know Your Customer Guidance, and other instances in the regulations in which the compliance obligations of an actor are based on its knowledge. However, the Proposal provides no indication of such a problem in implementation. Quite the contrary, the Proposal suggests that the change in the definition of “knowledge” is not expected to alter the conduct of most exporters, including small businesses.

As its justification for the change to the definition of “knowledge,” BIS asserts that the “more likely than not” formulation will reduce uncertainty and “thereby will reduce the economic impact of the control and the necessity of legal counsel.” See Proposal, 69 Fed Reg. at 60831. However, this discussion of the impact of moving to a “more likely than not” formulation is set forth as a conclusion and is not supported by evidence or authority.<sup>1</sup> In fact, as discussed below, BIS’s conclusion is flawed because it misapprehends the significance of the change being proposed and its impact on the compliance burden of all parties to export transactions. As a result, BIS has not met its obligation to provide a good faith estimate of the cost impacts of those increased burdens. BIS also has not addressed at all the potential effects of the other proposed changes to the

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<sup>1</sup> Courts have held that agency action under the International Emergency Economic Powers Act (“IEEPA”) is subject to the Administrative Procedure Act’s (“APA”) judicial review provisions. See *Milena Ship Management Co. v. Newcomb*, 804 F.Supp. 846 (E.D. La.), *sum. judgment denied*, 804 F.Supp. 859 (E.D. La. 1992), *aff’d*, 995 F.2d 620 (5<sup>th</sup> Cir. 1993), *cert. denied*, 510 U.S. 1071 (1994), and *Nuclear Pacific, Inc. v. United States Department of Commerce*, No. C84-49R (W.D. Wash. June 8, 1984) (order denying motion to dismiss); see also John Ellicott, Peter Flanagan, Gregory Williams, “Judicial Review of Administrative Actions Under Export Laws,” *Coping with Export Controls 2002*. Therefore, regardless of the APA standard applicable, the Proposal must be supported by some evidence.



definition of “knowledge,” such as the insertion of the “reasonable person” standard or insertion of the term “*inter alia*” (*see id.* at 60831-32), either individually or in combination with adoption of the “more likely than not” standard.

In sum, BIS has not supplied a reason for, and has failed adequately to justify, the regulatory changes it has proposed. Moreover, in our view, as discussed below, the proposed changes in the definition of “knowledge” appear likely to require substantively greater vigilance and analysis by the private sector. In any event, BIS has not provided an adequate analysis of the expected benefit (in terms of preventing proliferation) vis-à-vis the magnitude of the incremental costs.

*Substitution of “more likely than not” for “high probability”*

BIS asserts that the replacement of the phrase “high probability” by the phrase “more likely than not” is merely a clarification rather than a change of practice or policy (*see id.* at 60829). BIS suggests, without supporting evidence, that “companies with a strong compliance commitment” already equate the two in practice. BIS also states that the change in definition does not increase an exporter’s responsibility (*see id.* at 60831). Other than general references to its “experience,” BIS cites no support for its conclusion that industry generally equates the two terms, and one can legitimately question the conclusion that, in general parlance, someone “knows” as a fact something which is merely “more likely than not.”

BIS has not identified in the preamble any authority or precedent in which a “high probability” is defined as any probability in excess of 50%. In fact, case law supports a contrary view. For example, in *Wendland v. Wendland*, 26 Cal. 4<sup>th</sup> 519, 542, 28 P.3d 151, 173 (Cal. 2001), the California Supreme Court equated a “finding of high probability” with the “clear and convincing evidence” standard rather than the less demanding “preponderance of the evidence standard” embodying a “more likely than not” test. Because the proposed definition is without precedent, it does not appear to be an appropriate interpretation of BIS’s statutory mandate.

Nor has BIS cited precedent from any law or regulation in which one is deemed to “know” a fact which is merely more likely than not. Certainly that is not the standard of knowledge used in the 1988 amendments to the Foreign Corrupt Practices Act (“FCPA”), which is generally recognized as the source from which was derived the current rule governing when a person has knowledge under the Export Administration Regulations (“EAR”). *See* Evan R. Berlack, “End-Use Controls in the Export Administration Regulations,” *Coping with U.S. Export Controls 2003* at 235, 247-250, copy attached at Appendix A. Indeed, the Department has taken care in the past to interpret the word “know” in the EAR as similar (albeit with “nuanced differences”) to the relatively high level of certainty required for “knowledge” under the FCPA (*see id.* at 250). The proposed “more likely than not” standard, however, is a major departure from existing precedent, and from the Department’s intent in 1991, when the current definition was adopted. Moreover BIS has not pointed to a single instance in which another agency, let alone a federal statute, has adopted as expansive a definition of “knowledge” as that in the Proposal.

Indeed, the unusual character of BIS's proposed new definition of "knowledge" is demonstrated by the fact that BIS felt constrained to make that definition inapplicable in the following circumstances: (1) "personal knowledge" in the context of technology; (2) the "knowledge" underlying agency or official enforcement or administrative action; (3) the level of "knowledge" necessary for a party to certify the truth of a statement; and (4) references to knowledge standards used to define criminal violations or the requirements or prohibitions under other laws. See Proposal, 69 Fed. Reg. at 60829. BIS may have a rationale for defining "knowledge" in such a novel manner for purposes of its licensing requirements (*i.e.*, that BIS believes exporters should forego an export in the face of any basis for suspicions of possible diversion), but it has not set forth any such rationale, with an appropriate cost-benefit analysis, as the basis for the changes in the Proposal.

It is also not clear from the Proposal that BIS has adequately considered all circumstances in which the proposed new definition of "knowledge" would come into play. While it is explicitly not applicable to criminal violations, the new definition would become the standard used to establish "knowledge" of particular facts for purposes of determining civil liability (e.g., for monetary civil penalties, for issuing denial orders, and ultimately for debarment from government contracting). The Proposal says nothing about the need for, or the fairness of, punishing an exporter or other person for violations involving a breach of the "more likely than not" standard — a breach which could conceivably occur if an export took place in the face of uncertainty about diversion even if no diversion ever occurred or was ever intended by the customer. Certainly, defending against alleged violations of the EAR in which BIS asserts "knowledge" on the part of the charged party will be made greatly more difficult, if not impossible, by the revision in the Proposal. In addition, the proposed changes to the definition of "knowledge" (*i.e.*, the introduction of the terms "reasonable person," "more likely than not," and "*inter alia*") represent a significant relaxation of the state of mind requirement usually associated with "knowledge," not only in common usage, but also in other regulatory regimes. These changes will mean that there will be little, if any, practical difference between the "knowledge" requirement under the EAR and the strict liability standard under *Iran Air v. Kugelman*, 996 F.2d 1253 (D.C. Cir. 1993), except that the "knowledge" standard may be violated even in the absence of an actual subsequent diversion. Under the proposed definition of "knowledge," the examination would no longer focus solely on what the party "knew," should have known, or avoided knowing at the relevant time. Instead, a party would potentially be held liable as well for having failed to exercise the requisite degree of care — *as adjudged after the fact*.

Eliminating any meaningful differences between the *Iran Air* strict liability standard and the definition of "knowledge" — as the Proposal would do — imposes too great a burden on the exporting community, does not comport with the realities of international business, including e-commerce, and puts parties subject to the EAR — typically U.S. companies — at a disadvantage with competitors worldwide. Moreover, to the extent the new definition affects re-exports by foreign entities, the Proposal may deter those entities' purchase of U.S.-origin goods, where competing non-U.S. goods are available with a lower level of enforcement risk.

In addition, one unintended consequence of the enforcement risks imposed on exporters by the more demanding compliance standard contained in the Proposal is likely to be that smaller companies, lacking substantial resources to investigate facts about their customers, will elect not to export rather than face potential liability for “knowledge” of a fact merely because the Department might later conclude that a hypothetical reasonable person would have considered such fact was “more likely than not” to be true. Even for large exporters, we believe there will be consequences not evaluated in the Proposal. For example, since a larger company has a greater number of employees who may potentially have knowledge of relevant facts, the larger company faces a commensurately greater challenge in ensuring that all relevant information is properly compiled and assessed to assure that red flags are identified and resolved.

The suggestion that most companies already use a “more likely than not” standard in their compliance programs, even if accurate, does not provide persuasive support for the proposition that those companies equate that standard with “high probability.” Instead, companies may have adopted that standard for their internal practice in order to assure themselves of a margin of error for the avoidance of enforcement liability. If “more likely than not” becomes the standard for prosecution, then companies seeking to maintain that margin of error will feel compelled to adopt yet a more demanding standard--perhaps “any evidence” of possible diversion. Indeed, BIS’s suggestion that the only scenario in which a party would be justified in going forward with an export or re-export is that in which it has “no knowledge of any ... facts” that suggest the presence of a prohibited end-use or end-user supports the conclusion that such an “any evidence” test may be exactly what BIS expects that prudent exporters will henceforth apply in practice (*see* Proposal, 69 Fed. Reg. at 60831). This same conclusion is also supported by the preamble’s statement that a party should seek a license or forego the export whenever it “encounters a reason to believe that a fact or circumstance exists that implicates a licensing requirement” under the EAR – a terribly fuzzy standard when applied to exports to a large number of recipient countries. Yet an “any facts” or “any reason to believe” standard obviously does not equate to a “high probability,” making it clear that the proposed standard would place an increased burden on the private sector.

For all of these reasons, the substitution of the “more likely than not” standard of “knowledge” for the “high probability” standard is, at the least, a change from current policy and practice that BIS must justify with an appropriate statement balancing the expected anti-proliferation benefits with the increased costs and other burdens (e.g., the need to engage in customer inquiries, or to impose terms and conditions not required by non-U.S. competitors) to U.S. exporters that will result.

We have been advised that the Department would prefer to review all of the very close cases. However, the vast majority of exports that do not require a license are low level transactions, the review of which is extremely costly relative to their value. In our experience, exporters already bring close cases to the Department for review. Thus, there is no need to lower the standard for prosecution unless BIS can demonstrate that there are exports that are not being reviewed by BIS that should be.

*Removing “known to the person” from the “conscious disregard” portion of the “knowledge” definition*

BIS is proposing to remove the phrase “known to the person” from the “knowledge” definition. That is certainly an appropriate clarification because, as BIS states (*see id.* at 60829), it would eliminate a form of the defined term (i.e., “known”) from the definition of “knowledge.” However, BIS would make an unexplained substantive change if it failed simultaneously to substitute some comparable phrase, such as “of which the person is actually aware,” in place of the deleted phrase. Without some such substitute, the definition can be read to impute knowledge in circumstances in which a person consciously disregards facts which have not actually come to his or her attention, which need not, and ought not to be, the effect of this phrase in the definition.<sup>2</sup> Rather, the definition should clearly state that “conscious disregard” will imply “knowledge” only where the person is aware of the facts so disregarded. The term “conscious” disregard certainly implies that awareness would be required, at least in a general sense. However, the intent of the rule in this regard would be made clearer if it were explicitly stated that such imputation required a demonstration, as part of an enforcement action, that the person involved was actually cognizant of the subject specific fact(s) which he or she then disregarded. Anything less would be a substantive change in the standard of enforcement.

*Reference to “obligation to disclose”*

The Proposal states that “[t]he purpose of the rule is to clarify responsibilities and provide greater certainty to parties involved in export transactions when confronted with indications of a proliferation end-use, *an obligation to disclose* or a possible violation of law.” (*see id.* at 60832) (emphasis added). The EAR has always encouraged “voluntary” disclosure (*see* EAR § 764.5) consistent with the Fifth Amendment protection against self-incrimination and other jurisprudence. We respectfully suggest that BIS delete references to an “obligation to disclose.”

Revision of Red Flags Guidance

BIS is to be congratulated for providing additional explicit guidance concerning the circumstances it will consider to be red flags. Even though these additional instances are only illustrative, they will be helpful in training employees and sensitizing them to the circumstances which require further attention. Certain proposed provisions warrant clarification, however, as outlined below.

*Red flags involving an already-licensed export*

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<sup>2</sup> It should be noted that the definition states that knowledge can be inferred in two distinct circumstances: conscious disregard of facts and “a person’s willful avoidance of facts.” *See id.* at 60836. Our comment here goes only to the first of these two circumstances, as we agree with BIS’s reasoning in making a distinction between the two circumstances, pursuant to which the second circumstance addresses efforts not to become “aware” of relevant facts.

BIS has added, without explanation or comment, a new provision to the Know Your Customer Guidance, stating that, if red flags are raised with respect to an export after a license has been issued by BIS, those red flags must be resolved in the same manner as those in which no license was granted. See proposed revised Supplement No. 3 to Part 732 of the EAR (“Supplement 3”), subparagraph (b)(1)(iii). This new provision appears to go beyond the requirements of General Prohibition 10, and even beyond the obligation, found in EAR § 764.2(g)(2), to correct any material misstatements on a license application. To the extent that the proposed guidance is intended to go beyond the obligations of General Prohibition 10 and §764.2(g)(2), it cannot help but increase the compliance burden of exporters. This is because it will require that exporters provide red flag training not only to their sales personnel and those employees who normally interact with customers before a license is issued, but provide that training and maintain that vigilance more broadly and for greater duration. Even accepting, as we do, that industry has an important role to play in preventing exports which do not comply with the EAR, and that exporters should not blind themselves to post-license indications of a diversion, the Proposal implies that BIS’s own licensing review should provide the exporter no comfort as to the customer’s *bona fides*. There should be some “middle ground,” in which the exporter is entitled to rely upon the license and BIS’s underlying inquiries, unless a threshold is crossed, higher than the existence of just a red flag which, (1) if identified earlier on, would merely have triggered BIS’s licensing process, and (2) may, in any event, already have been considered by BIS in its licensing analysis.

*Deletion of references to “the information that comes to your firm”*

In its proposed revised Supplement 3, paragraph (b)(3), BIS has deleted references to “the information that comes to your firm.” These deletions, absent a definition of “red flag” which explicitly states that a red flag exists only once it comes to the firm’s attention, could leave the reader with the impression that an exporter has an affirmative duty to seek out red flags. (This same misimpression with respect to an affirmative duty could be created by paragraph (b)(1) of Supplement 3, which instructs the exporter to “look out for” red flags, as compared to the existing Guidance, which merely calls upon the exporter to “decide whether” red flags exist in the information that his firm has received.) By deleting reference to only those red flags in “the information that comes to your firm,” the Proposal creates an unintended ambiguity, leaving the reader unsure of whether an exporter has responsibility only to resolve those red flags apparent from information his firm receives or must, in addition, create a structure capable of finding all extant red flags available to the public, but which would not, in the ordinary course, become known to the exporter absent inquiry. For example, must an exporter review the entire website of, and the public literature about, each new customer, and periodically revisit those sources with respect to existing customers, to learn if each customer is engaged, *inter alia*, in the manufacture or sale of missile components or military equipment or has established branches or subsidiaries in countries of concern? Or is it sufficient for an exporter to limit itself to the resolution of only those red flags which, in the ordinary course of business (and absent any self-blinding), are found in information it receives? If the latter, then BIS should make that clear by retaining in its Guidance the phrase “in the information that comes to your firm,” which would also be consistent with the statement in Supplement 3, paragraph (b)(3) that “[a]bsent red flags

... you do not have an affirmative duty to inquire ....” If the former, then this change, in conjunction with the change to a lower, “more likely than not” standard for knowledge, will inevitably lead to a greater burden on the party to the transaction to exhaust all avenues of inquiry in order to reduce the chance of liability.

Two additional considerations exacerbate such a burden. First, information is not always perfect or reliable, especially information available on the Internet. Second, concerns under the EPCI relate to sensitive, proliferation activities of a foreign government that almost always are shrouded in secrecy. Obtaining information about a customer’s activities in this area is extremely difficult, if not impossible, and, if the exporting company is expected to obtain pertinent information, could put that company’s employees at risk of adverse action by the foreign government involved. Thus, if BIS’s intention is to require parties to go beyond “information that comes to your firm,” this will bring more uncertainty, potentially greater use of counsel, greater delay in transactions, and even potential risk of foreign government retribution. BIS officials have advised verbally that there was no such change intended by removing references to “information that comes to your firm.” If so, the deletions do more harm than good, and we respectfully suggest that these references be reinserted in Supplement 3.

#### *Clarification of red flags*

Four of the examples of red flags cited in Supplement 3, paragraph (c) would benefit from clarification. Red flag number 14 refers to a situation where, “[w]hen questioned, the buyer is evasive or unclear ...” *See* Proposal, 69 Fed Reg. at 60834. Since there is no requirement that the exporter question or investigate the buyer, we respectfully suggest it would be more appropriate to begin the red flag conditionally, i.e., “if questioned ...”

Red flag number 17 reads: “The customer’s order is for parts known to be inappropriate or for which the customer appears to have no legitimate need (*e.g., there is no indication of prior authorized shipment of system for which the parts are sought*)” (emphasis added) (*see id.*). The parenthetical phrase is added in the Proposal. The term “prior authorized shipment” implies that if the exporter had not shipped the item requiring parts, then perhaps an investigation should be undertaken to avoid a potential violation of General Prohibition 10. The exporter should not be required to assume a violation has occurred solely based on a lack of positive knowledge of a violation. Therefore, we respectfully suggest it would be more appropriate to delete the parenthetical phrase, and clarify that the exporter is entitled, absent a red flag, to assume the prior export was lawfully shipped.

Red flag number 18, which applies to a situation where “the customer is known to have or is suspected of having dealings with embargoed countries” (*see id.*), should be deleted. This red flag is overbroad and, would by its terms, encompass many customer companies outside the U.S., including nearly all large, customer companies headquartered in Canada and Europe. As is widely known, such companies frequently have legitimate dealings (*i.e.,* transactions not contrary to, or even subject to the jurisdiction of, U.S. law) with embargoed countries. Inclusion of this red flag would not

only lead to greater burdens of inquiry on the U.S. exporting community, but also would necessarily lead to the filing with BIS of a much increased number of license applications for exports to our largest trading partners, a consequence we believe BIS has not adequately considered or prepared for in terms of staffing. At minimum, if the provision is not deleted, it should be limited by deleting the reference to what is “suspected,” maintaining the current “high probability” standard for “known,” and inserting the phrase “in violation of U.S. law” at the end of the sentence.

Red flag number 19 refers to “a transaction involv[ing] a party on the Unverified List published by BIS” (*see id.*). It is unclear whether this is meant to suggest that a transaction which involves a party on the Unverified List is now regarded as a violation of the EAR. In 2002, BIS explained that the Unverified List identifies certain parties to a transaction where neither a pre-license check nor a post-shipment verification could be conducted by representatives of the U.S. government for reasons outside the government’s control. *See List of Unverified Persons in Foreign Countries, Guidance to Exporters as to “Red Flags,” 67 Fed. Reg. 40910, 40910 (June 14, 2002).* In those cases, BIS requires the exporter to exercise heightened scrutiny of the party identified on the Unverified List to “satisfy” itself that the proposed transaction does not involve proliferation activities prohibited in EAR Part 744, or violate others parts of the EAR. If the exporter inquires about the *bona fides* of its customer and concludes that the transaction does not involve a proliferation activity prohibited in Part 744, the exporter can proceed with the transaction. *See id.* at 40911. We respectfully suggest that BIS confirm that no change is intended to its interpretation of the Unverified List stated in 2002.

#### Safe Harbor

##### *Eligibility for safe harbor*

The proposed safe harbor provisions state that a party is eligible for a safe harbor from enforcement arising from only the red flag(s) that it has addressed, and the safe harbor is not available if a party has “actual knowledge or actual awareness that the fact or circumstance at issue is more likely than not.” *See Proposal, 69 Fed. Reg. at 60835.* This description of when the safe harbor is not available is confusing and apparently equates a defined term, “knowledge,” with two undefined terms (“actual” and “awareness”). “Actual knowledge” could be interpreted to mean that the party has “positive” knowledge and therefore would be required to obtain an export license. We agree that, clearly, this would not be an appropriate use of safe harbor procedures. However, making the safe harbor unavailable when red flags are not addressed or in the case of knowledge that a fact or circumstance is “more likely than not” (if that is the Proposal’s intent) overly narrows the scope of the safe harbor and calls into question whether parties will avail themselves of the safe harbor procedure.

We respectfully suggest that BIS formulate the safe harbor provisions to reflect the existing partnership between private industry and the U.S. government. *See id.* at 60833 (“BIS will continue to work in partnership with the private sector to make this front line of defense effective”). A meaningful reflection of this partnership would be to

make the safe harbor available when a party has not identified a red flag, but has reason to believe that a particular fact or circumstance at issue which indicates a proscribed end-use or end-user is “more likely than not.” This would encourage more parties to use the safe harbor procedure and therefore to more effectively utilize the considerable intelligence capabilities of the U.S. government to prevent diversion to prohibited end users or end uses.

*Concurrent consideration of license applications*

In general, sophisticated exporters with robust export compliance programs and the resources to vet their potential customers before going forward with a transaction should not be expected to make extensive use of the safe harbor process. However, for the small exporter without export control staff to undertake rigorous due diligence review of its prospective customers, use of the safe harbor process would preclude the submission of a license application until such time as Office of Export Enforcement (“OEE”) has confirmed in writing or communicated with the reporting party that its resolution of any red flags was successful. As a practical matter, however, it seems likely that an exporter, rather than accept up to 45 days of “dead time” in moving its export, will choose to apply for a license, disclosing in its application the facts constituting a red flag, and cause BIS either to issue a license or return the application without action on the grounds that no license is required (“RWA, NLR”). The result will be “overlicensing” of exports, because exporters will seek either a license or an RWA, NLR to assure themselves that the Department has no concerns with the transaction. Overlicensing will result in delays in processing all licenses, and increased licensing burdens on the current staff of BIS and the reviewing agencies. The Proposal does not indicate that the expected additional licensing workload has been evaluated or prepared for.

Unfortunately, for a small exporter not familiar with the dual-use export licensing process and the routine licensing delays experienced in the interagency dual-use licensing system, submission of a report to OEE to obtain safe harbor under the Proposal may cause the exporter to lose its opportunity to engage in the transaction because insufficient time was factored into the transaction to allow for both the reporting safe harbor review and the subsequent export licensing process set out in Executive Order 12981, 60 Fed. Reg. 62981, Dec. 8, 1995. Therefore, at minimum, we respectfully recommend that the proposal be rewritten to allow concurrent consideration of license applications while the safe harbor process is pending.

*Processing deadline*

As the Proposal is written, OEE states that it “expects” to respond to safe harbor requests from exports within 45 days. The Proposal does not specify whether this period is measured in calendar or business days, and fails to explain why BIS needs such a long period—far longer than is required to resolve a red flag in commercial practice—to evaluate what the putative exporter has done. At minimum, this period should be reduced to 30 days and clarified to be measured in calendar days.



More fundamentally, the lack of a firm deadline in the Proposal leaves the exporter unable to proceed with the transaction indefinitely, while it awaits the response from OEE. Thus, once the safe harbor review process is triggered, the exporter has no way to predict when the process will conclude. Therefore, we respectfully suggest that the safe harbor would operate more effectively if the party requesting the safe harbor is permitted, absent a response from OEE within a 30 calendar day period, to proceed with the transaction with the understanding that BIS concurs in the party's resolution of any red flags and the party qualifies for the safe harbor. This would be consistent with the current practice with regard to mass market encryption software and de minimis, one-time reports. *See* EAR Part 334, Supp. 2, para. (b) and § 742.15(b)(2)(iii).

Separately, while the Proposal states that OEE may consult with other government agencies, the Proposal does not impose any requirement that OEE complete its review of the reporting party's assessment within any stated time. This is troubling because several government agencies which may be involved appear currently not to have sufficient staff to review the current volume of dual-use licenses. Were these agencies to become involved in the interagency review of red flag reports as well as licenses, both procedures would undoubtedly experience delays.

A government response on a dual-use license application is expected within ninety days (*see* E.O. 12981). Reviewing government agencies have a deadline for review of a dual-use export license application, and a dispute resolution procedure is in place to handle those export license applications which become controversial in the interagency process. Moreover, based on government practice prior to the implementation of expedited license procedures under E.O. 12981, as amended, it is likely that without deadlines for a response to the exporter, the safe harbor request could languish in the interagency process indefinitely. Accordingly, the Proposal thwarts the objective of expedited license processing under E.O. 12981, as amended, which requires a licensing decision within 90 days from submission to the Department.

#### *Procedural changes*

We respectfully suggest that the safe harbor procedures would benefit from clarification of the following points:

- If BIS issues an “is informed” notice in response to the safe harbor application, BIS also should immediately publish the name of the customer in the appropriate prohibited list to avoid placing the applicant at a competitive disadvantage with other parties subject to the EAR.
- If BIS orally informs an applicant that BIS will not respond to the safe harbor applicant report, BIS should confirm the oral statement within two days with a written response, as described in new EAR § 764.7(c)(2)(i).
- To recognize the entirely “optional” nature of the safe harbor process, the regulations should explicitly state that declining to apply for the safe harbor does not in itself suggest “knowledge” of a violation and will not

be considered indicative of conduct other than what a “reasonable person” would have done under the circumstances.

*Involvement of OEA in interagency licensing process*

The Proposal suggests the question of whether the safe harbor review will become a means by which the Office of Enforcement Analysis (“OEA”) will have the potential exporter involved in intelligence gathering activities. OEA is mandated to enforce the EAR, and it seeks out violations through such activities as pre-license checks and on-site post-shipment verifications. We understand that historically personnel responsible for the enforcement function have been prohibited from becoming involved in the interagency licensing process, and we believe that continued exclusion of OEA enforcement personnel from the interagency licensing review process encourages the sharing of necessary information with the licensing officers during the interagency process.

Our understanding is that export license applications reviewed under the EPCI provisions have historically led to interagency assessments of whether there is a significant nexus between the item sought to be exported, the prospective ultimate consignee/end-use, and the intelligence reports about proliferation activities of concern identified in Part 744 of the EAR, *et seq.* Because proliferation activities of concern under EAR Part 744 typically are classified or secretive programs, and since the Proposal does not change the substance of Part 744, the interagency reviewers are likely (irrespective of the exporter’s resolution of any red flags previously identified in the transaction) to continue to focus on classified reports coming from the intelligence community that, one would hope, will make the necessary connection between the proposed export and the contribution the proposed export could make to suspected proliferation activities of the prospective consignee.

Conclusion

We thank BIS and the Department for the opportunity to provide these comments, which we hope will be helpful. Should you have any questions regarding these comments, please feel free to contact me, or J. Scott Maberry, Chair of our Export Controls and Economic Sanctions Committee, at (202) 662-4693, or by e-mail at [smaberry@fulbright.com](mailto:smaberry@fulbright.com).

Sincerely,



Kenneth B. Reisenfeld  
Chair



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December 15, 2004

**VIA E-MAIL: RPD2@BIS.DOC.GOV**

Ms. Hillary Hess, Director  
Regulatory Policy Division, Office of Exporter Services  
Room 2705  
U.S. Department of Commerce  
Washington, DC 20230

RE: Regulation Identification Number 0694-AC94; Proposed Rule Regarding Revised "Knowledge" Definition, Revision of "Red Flags" Guidance and Safe Harbor

Dear Ms. Hess:

The National Council on International Trade Development (NCITD) is pleased to respond to the Bureau of Industry and Security's (BIS) request for comments on a proposed rule that would revise the knowledge definition in the Export Administration Regulations (EAR), update the "red flags" guidance and provide a "safe harbor" from liability arising from knowledge under that definition.<sup>1</sup>

#### Background

Founded in 1967, NCITD is a nonprofit trade association of large and small U.S. exporters and importers who are advocates of EAR policies that are consistent with national security, foreign policy and a flexible export transaction process that promotes export trade. Our membership includes large, mid-size, and small firms, exporters and importers, freight forwarders and brokers, banks, attorneys, trade groups, and consulting firms. Our members understand the importance of their role in preventing exports and reexports that might be contrary to the national security and foreign policy interests of the United States.

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<sup>1</sup> 69 Fed. Reg. 60829 (Oct. 13, 2004).

NCITD members fully support the continuing efforts of the U.S. Government to secure our nation from threats posed by weapons of mass destruction and specifically to those that may be related to illegal or diverted exports. We, however, have serious concerns that the proposed rule will impose undue burdens on manufacturers and exporters, without any evidence that the proposed regulatory changes will have a positive impact on national security or will prevent diversions to proscribed or inappropriate end-users.

Our specific comments and concerns on the proposed rule are outlined below:

Revised Definition of "Knowledge"

BIS proposes to amend the definition of "knowledge" in section 772.1 of the EAR in four ways:

1. Incorporating a "reasonable person" standard;
2. Replacing the phrase "high probability" with "more likely than not";
3. Adding the phrase "*inter alia*" to the description of facts that could make a person aware of the existence or future occurrence of a fact; and
4. Eliminating the phrase "known to the person" from the sentence in the knowledge definition that knowledge may be inferred from the "conscious disregard of facts known to the person."

The proposed rule notes that these changes are a clarification of the current standard and are consistent with existing BIS and industry practice. We disagree. The combination of these changes to the knowledge standard will result in a decreased and vague standard of evidence to establish "knowledge" on the part of exporters.

While a "reasonable person" standard is not uncommon or in itself objectionable, adding such a standard and removing the "known to the person" language will result in the overall standard becoming unreasonably vague. Under the new standard, a person has knowledge of facts and circumstances if a "reasonable person" would, upon consideration of the facts and circumstances (not necessarily known to them), conclude that the facts and circumstances are more likely than not. This circuitous reasoning can only serve one purpose - to facilitate the enforcement of alleged violations based on after-the-fact determinations of what an exporter could have or should have "known."

The suggestion that "more likely than not" is not a change from "high probability" is not entirely accurate. The "more likely than not" standard is not only patently lower than "high probability," it requires a mathematical balancing of the facts to come up with the 51 percent likelihood that the standard, by definition, requires.

The phrase "*inter alia*" is on its face vague and gives no additional guidance or clarification to the definition of knowledge. This phrase simply provides unspecified grounds on which to find a violation.

Contrary to the impact statements set forth on page 60,829 of the proposed rule, we believe that this change will impose greater burdens on small and large entities who will struggle to understand and to comply with the new knowledge standard. This change will not reduce uncertainty among exporters and may actually increase the need for exporters to consult with legal counsel prior to making decisions on whether to proceed with a transaction. Therefore, contrary to BIS's assessment of the impact of this rule on exporters, NCITD believes that this proposal, if enacted, will increase the training and compliance burden of our members and other U.S. exporters.

#### Additional Red Flags

NCITD's members appreciate BIS's efforts to provide guidance to exporters to prevent the diversion of items subject to the EAR to proliferation related purposes and other potential EAR violations. However, by nearly doubling the number of red flags BIS has placed a substantial new burden on exporters. The following proposed red flags are of particular concern to NCITD's members:

Red Flag # 15: The customer uses an address that is inconsistent with standard business practices in the area (e.g., a P.O. Box address where street addresses are commonly used).

Comment: This proposed red flag requires an exporter to know the usual manner of addressing shipments in every country. Exporters may not be familiar with standard business practices in their customers' countries. Furthermore, P.O. Boxes are the predominant mail delivery method in numerous Middle Eastern countries, due to less developed street numbering systems, placing additional burdens on companies doing business in such countries.

Red Flag #18: The customer is known to have or is suspected of having dealings with embargoed countries.

Comment: Many foreign customers, including affiliates of U.S. exporters, have lawful dealings with countries embargoed by the United States. The fact that a legitimate foreign customer also trades legally with an embargoed country, such as Cuba, should not be considered to be a red flag unless the exporter believes there is a cognizable risk of illegal diversion to an embargoed destination.

Red Flag # 20: The product into which the exported item is to be incorporated bears unique designs or marks that indicate an embargoed destination or one other than the customer has claimed.

Comment: This proposed red flag requires that the exporter have knowledge of what kind of "designs or marks" could indicate an embargoed country is the intended destination. BIS does not specify what those designs or marks might be and is unreasonably vague.

NCITD urges BIS to modify the list of red flags as noted above. In addition, we submit that BIS should reconsider whether these additional red flags will actually provide any greater benefits than the red flags that currently exist and have been successfully used by exporters for many years.

### Safe Harbor

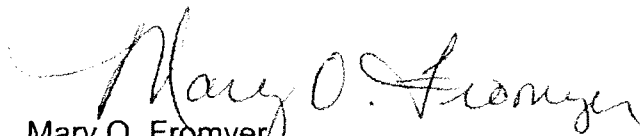
The proposed "Safe Harbor" provision is so unwieldy that it is unlikely to be of much use to exporters. As a result, we respectfully request BIS to exclude this proposal from the final rule.

Under the proposed safe harbor, exporters that take the three steps identified in new section 764.7(b) of the EAR will not have knowledge imputed to them by application of the definition of knowledge in section 772.1 of the EAR if, prior to shipment, they submit a report to BIS identifying all red flags associated with a transaction and what steps were taken to resolve them. Under the proposal, exporters cannot conclude that the red flags have been successfully resolved until they receive an affirmative reply from BIS, which is supposed to be provided within 45 days (although not defined, we believe that this refers to calendar, not business days).

NCITD believes that the costs of implementing and utilizing such a safe harbor program will outweigh the benefits of such a program. Contrary to the regulatory impact statement, this proposed safe harbor will have a negative economic impact on small and large U.S. exporters. Current business conditions require that "go" or "no go" decisions be made within a matter of hours or days. U.S. exporters cannot tolerate delays and uncertainties of up to 45 days to receive a response from BIS before proceeding with a shipment. As a result, this proposal will likely result in lost sales to U.S. companies, even if the end-users or end-uses may be legitimate. Moreover, the transaction costs of complying with all of the steps outlined in the safe harbor proposal and preparing and submitting a report to BIS may result in many companies deciding to proceed with the shipment anyway, rather than risking a negative outcome from BIS. We believe that the vast majority of U.S. exporters are equipped to evaluate whether to proceed with a shipment or not, without having to obtain the advance approval of the U.S. Government. The small percentage of companies that ignore or flout U.S. export controls will continue to do so regardless of whether a safe harbor exists or not.

If BIS intends to proceed with the safe harbor process, NCITD suggests a number of changes to the current proposal. NCITD proposes that the safe harbor review process be modeled as a notification process, similar to License Exception AGR, whereby exporters submit an advance notification to BIS and the agency is required to inform the exporters within 12 business days whether any objections have been raised by reviewing agencies. Alternatively, BIS could provide exporters with an initial first response to a safe harbor request within 5 business days or less that informs the applicant whether the scenario is acceptable, unacceptable or is complicated enough to warrant further review. In the latter case, BIS should be prepared to notify the exporter whether it is permissible to proceed or not within 30 calendar days. NCITD also suggests that BIS accept safe harbor requests via email in addition to regular mail. Finally, if BIS chooses to proceed with a safe harbor program, we request that BIS ensure that adequate staff members are employed to ensure a timely turnaround of safe harbor requests and that the reviewing agencies are required to notify BIS of their decisions in a timely manner. Thank you very much for your consideration of our comments.

Respectfully submitted,



Mary O. Fromyer  
Executive Director  
NCITD

Comments Regarding Proposed Rule Entitled  
“Revised ‘Knowledge’ Definition, Revision of ‘Red Flags’ Guidance and Safe Harbor”  
March 8, 2005

This document summarizes comments regarding a proposed rule entitled “Revised ‘Knowledge’ Definition, Revision of ‘Red Flags’ Guidance and Safe Harbor” (69 F. Reg. 60829, October 13, 2004). The comments summarized by this document were made at a meeting of the Regulations and Procedures Technical Advisory Committee that took place on March 8, 2005 in Room H3884 of Herbert C. Hoover Building on 14<sup>th</sup> Street between Pennsylvania and Constitution Avenues, Washington D.C. The comments were made by members of that committee and by members of the public who attended the meeting. This document also summarizes the responses to those comments given by representatives of the Department of Commerce at the meeting.

William H. Arvin, of the Department of Commerce, Bureau of Industry and Security, Office of Exporter Services, Regulatory Policy Division presented a brief oral summary of some of the ideas expressed in the written comments that the Department of Commerce received concerning this proposed rule.

William A. Root, a committee member and export control consultant stated that red flags relate primarily to part 744 and asked the BIS representatives if they could think of an incident in which in which they would apply to a Commerce Control List (CCL) license requirement.

Mr Arvin replied noting that a red flag in a transaction with a CCL license requirement might indicate a possible end use that would trigger a part 744 license requirement.

Mr. Root said that he understood, but as to the CCL license requirements themselves, red flags should have no relevance.

This line of discussion was not pursued further.

Terrence Murphy, a committee member and managing director and general counsel of MK Technology, LLC stated that recently an e-mail had been circulating indicating that the genesis of the knowledge rule was at a high level in the NSC and that it related to the activities of A.Q. Khan. He asked if the Department of Commerce representatives could comment on that statement.

Mr. Arvin replied that within the preceding 24 hours, he had received such an e-mail and that the person who forwarded it to him was probably at least three or four levels removed from its source. Mr. Arvin stated that prior to reading that e-mail, he had not heard any statement that the NSC had initiated this rule or that it was in response to the activities of Dr. Khan.

Catherine Thornberry, a committee member and export consultant with Export Procedures Company, Inc. stated that it would be helpful to have a statement of purpose for the rule. She



indicated that the preamble to the rule did not really state why the changes are needed or what BIS intends to accomplish

Roger Pincus, of the Department of Commerce, Office of General Counsel, Office of Chief Counsel for Industry and Security asked whether Ms. Thornberry was referring only to the proposed clarifications of knowledge definition, not other provisions of the rule.

Ms. Thornberry replied in the affirmative.

Mr. Pincus replied that BIS had stated in the proposed rule that the purpose was to clarify, to facilitate public understanding. He stated that the agency believed its proposed revisions would accomplish this, but recognized that many commenters did not see it that way. He noted that the agency is continuing to consider those comments.

Ms. Thornberry stated that when dealing with sales people one has to be able to give them information that is relatively short and that will make sense to them. The current red flags are understandable. The proposed list would be more complicated and difficult to understand and, therefore, more difficult to remember.

Ms Thornberry asked whether other parts of Commerce such as ITA review the rule before it become final?

Mr. Arvin described the clearance process. He indicated that ITA would not normally be in the clearance process for an amendment to the Export Administration Regulations. He described the U.S. Government clearance process for the proposed rule and predicted that the clearance process for the final rule would be similar. He stated that the proposed rule was reviewed by the Departments of State, Defense, Justice and by the Small Business Administration (SBA). He noted that the OMB also designated this rule as a significant rule for purposes of Executive Order 12866. Ultimately OMB will decide what the government clearance process will be.

Benjamin H. Flowe, Jr., a committee member and a partner in Berliner, Corcoran & Rowe, LLP asked whether the SBA saw the rule before it was published.

Mr. Arvin replied that the SBA saw the rule before it was published and submitted a public comment after it was published

Mr. Murphy referred to Ms. Thornberry's remarks about the need to make the rule understandable. He suggested that the rule is written in too complex a fashion and stated that rule should use plain English so exporters can use basic commercial common sense in applying it. He noted that all lawyers have a tendency to write in complex terms and that multiple reviews tend to make prose even more complex. He suggested that if the government wants the red flags to be effective, it would be helpful for the drafters and reviewers to picture themselves in the role

of a typical sales person and ask if they would be able to understand and remember this list of red flags.

Mr. Flowe observed that regulations are difficult and the “catch all” regulations are the most difficult. The government should recognize that the best that can really be done is to “catch most.”

Mr. Murphy recalled Congressional testimony by former Under Secretary of Commerce for International Trade Lionel Olmer that occurred in the Cold War during the period when the Soviet Union was to build gas pipeline to Europe. In that testimony, Mr. Olmer explained that the object of export controls at that time was not to prevent the Soviet Union from acquiring anything. Rather it was to make their acquisition efforts more complex and expensive. In the modern era we need to recognize that we still cannot catch everything. It is necessary to strike a balance between our nonproliferation goals and the costs of screening every transaction.

Maarten Sengers of Black Sengers and Associates observed that we already have a “safe harbor.” It’s called “get a license” The proposed rule sort of sets up a middle level between confidence that one has resolved red flags and a conclusion that one has not. However, the process probably will not be useful. The safe harbor offers no real advantages to the exporter compared to a license application.

Sam Gilston of the *Export Practitioner* noted Mr. Arvin’s earlier response to Mr. Murphy’s question about a claimed role of NSC in instituting this rule and asked how great were the prospects that the final rule would be changed from the proposed rule.

Mr. Arvin stated that he did not know and explained that he did not know because any final rule would have to go through the interagency clearance process and, because this is a significant rule for purposes of EO 12866, OMB could play a significant role in shaping the final rule. Mr. Arvin stated that he was unable to predict what the actions of those organizations would be.

The chairman thanked Mr. Arvin and Mr. Pincus and announced the next topic of discussion.