How Well Do You Know Your Customer?

Commerce Department Says Third Parties Are Funneling Sensitive Goods to Russia

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As a consequence of the Russian conflict with Ukraine, the United States has sharply restricted trade with Russia, especially exports for use in Russia’s energy and defense sectors. The Commerce Department’s Bureau of Industry and Security (BIS), which regulates both commercial as well as “dual use” exports with military applications, has a “presumption of denial” on licenses to export controlled goods and technology to Russia for use in oil and gas exploration or production.

Regardless of classification, licenses are now required for many products (reviewed on a case-by-case basis) if the exporter has knowledge that the exports may be used by military end users or for military end uses in Russia. Last year, the State Department’s Directorate of Defense Trade Controls announced a policy of denial for exports or reexports of “any high technology defense articles or services” controlled under the International Traffic in Arms Regulations (ITAR).

Finally, among other controls, the Treasury Department’s Office of Foreign Assets Control (OFAC) has imposed broad restrictions on all trade with Crimea, and targeted sanctions on the Russian energy and banking sectors and numerous individuals, including major Russian business leaders and former military and political leaders in Russia.

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2 15 C.F.R. §§ 744.21, 746.5.

Ukraine. The OFAC sanctions also apply across the board, regardless of a product’s export classification.

The restrictions on trade are absolute. Violations can carry substantial civil and criminal penalties, as well as denial of export privileges and debarment as a government contractor. Absent a license, no U.S. person may engage in trade with sanctioned persons or territories – directly or indirectly. Reexports or transshipments to sanctioned end users or territories are also unlawful under the ITAR and the Export Administration Regulations (EAR) and can expose the U.S. exporter to liability, even if the exporter did not know that Russia was the ultimate intended destination of the items. For these reasons, it is essential for U.S. exporters to exercise vigorous due diligence on their customers.

Now BIS has expressed concern that Russian buyers of controlled goods, unable to trade directly with U.S. suppliers, have resorted to third country intermediaries that operate as “fronts” funneling unlicensed defense and energy exports from the U.S. to Russia. BIS recently posted guidance specifically directed at this problem: “Guidance on Due Diligence to Prevent Unauthorized Transshipment/Reexport of Controlled Items to Russia.” In doing so, BIS notes that export controls “are a shared responsibility between government and industry.” In addition to serving as a salutary warning against the risks of dealing with intermediaries, the new guidance puts an added burden on exporters to be vigilant.

The new guidance is consistent with previous “Know Your Customer” and “Red Flag” warnings published by BIS, but underscores four key points that U.S. exporters should address in export compliance and due diligence policies:

1. **Pay attention** to “any information that may indicate an unlawful diversion is planned.” There is no bright line benchmark for “adequate” due diligence: Given the increased use of intermediaries and “front companies” to evade the Russia sanctions, BIS says that exporters “should pay attention” to “any information that may indicate an unlawful diversion is planned.” [Emphasis added.] BIS urges exporters to watch for “discrepancies in the destination country and the country from which an order is placed or payment is made.” The new guidance also recommends that U.S. exporters “pay attention to the countries [that] a freight forwarder serves, as well as the industry sectors a distributor or other non-end user customer supplies.” For example, if a freight forwarder (or distributor) engages in substantial trade with Russia, BIS expects U.S. exporters to be on guard against potential transshipments. BIS further notes that “the exporter has an affirmative duty to inquire about the end use, end user, and ultimate destination of the item . . . whenever a person who is clearly not going to be using the item for its intended use (e.g., a freight forwarder) is listed as an export item’s final destination . . .” [Emphasis added.]

There is no bright line benchmark for “adequate” due diligence. For this reason, exporters must act defensively. When and if problems arise, the adequacy of due diligence will be judged after the fact. BIS advises U.S. exporters to consult a variety of resources to vet all parties to a transaction, including “business registers, company profiles, [and] websites . . .” Of course, if a U.S. exporter knows from experience that a distributor has a

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5. The “Know Your Customer” and Red Flags guidance are contained in Supplement No. 3 to Part 732 of the EAR.
substantial presence in Russia, it will be deemed “on notice” of the risk of transshipment. To document due diligence, it is important to keep a record of the vetting process. Although liability is absolute, penalties are generally reserved for gross negligence, or for firms that failed to make good faith efforts at compliance. Nevertheless, the new BIS guidance raises the bar on good faith compliance.

2. **Use of the Consolidated Screening List to check all parties to a transaction is warranted:** The guidance notes that, in all cases, U.S. exporters should screen customers against the U.S. government’s Consolidated Screening List at [http://export.gov/eg_main_023148.asp](http://export.gov/eg_main_023148.asp) (also available at [http://internationaltradeadministration.github.io/explorer/#/consolidated-screening-list-entries](http://internationaltradeadministration.github.io/explorer/#/consolidated-screening-list-entries)). The Consolidated Screening List identifies persons and entities subject to trade sanctions, including “denied parties” with a track record of export violations. (Best practices argue for screening all parties – not just the customer.)

3. **Due diligence is warranted for all export transactions, including EAR99 items:** The guidance cautions against relying solely on the export classifications of items in assessing whether a license is needed. BIS notes that exporters should not only consult the Commerce Control List, but also determine the end use and end user requirements of the EAR – even for non-sensitive items that are categorized as “EAR99.” (EAR99 items generally do not require a license – unless the end use or end user is subject to sanctions. For example, virtually all shipments to Crimea now require a license – and most such license applications are subject to a policy of denial.6)

4. **U.S. exporters are now on formal notice that third country intermediaries are illegally shipping U.S. goods to Russia.** BIS continues to focus heavily on exports of U.S. items that are turning up in Russia in violation of the EAR. Increased enforcement may follow. U.S. exporters are now on formal notice that third country intermediaries are illegally shipping U.S. goods to Russia. BIS is monitoring this area closely, and expects heightened due diligence from exporters. Exporters should therefore not count on a pass, for example, if they are failing to verify the buyer’s bona fides when exporting goods to buyers with no fixed address, or if they have authorized shipments that objectively “don’t make sense” (e.g., exports of spare parts to buyers that never purchased the original equipment).

U.S. trade sanctions against Russia have been an area of rapid and constant change in the past year. Following these due diligence steps can help determine whether a risk of diversion to Russia is present – and whether assistance from legal counsel is warranted.

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**For More Information**

Stroock’s National Security/CFIUS/Compliance Group provides advice and counsel on U.S. export controls and trade sanctions, among other national security issues. For more information on due diligence programs or a copy of the BIS guidance, please contact:

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6 For more details on restrictions on exports to Crimea and related licensing requirements, see 15 C.F.R. § 746.6.