

Compliance Challenges Raised by Russia's Evasion of New U.S. Trade Restrictions on Luxury Goods, Industrial Products and Controlled Items

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In the months following Russia's invasion of Ukraine, many Western companies withdrew their products from Russian markets.¹ In response, the Russian government has authorized a wide range of consumer, industrial, and technology products for "parallel import," permitting Russian businesses to import products that are not licensed for sale or distribution in Russia without obtaining permission from the rights holder.

Many companies may view parallel imports of their products as implicating commercial and possibly contractual concerns, but few may be aware that recent changes in U.S. export controls against Russia could raise meaningful compliance implications for both U.S. and non-U.S. companies in this context.

In this Client Update, we outline recent developments in U.S. export controls that significantly expand the scope of items captured by restrictions targeting Russia, and the increased risks presented by Russia's approach to parallel imports. We then discuss the steps that companies should consider taking to mitigate the risks and protect themselves in the aggressive sanctions and trade controls enforcement environment.

Expanded Export Restrictions on Russia²

U.S. export controls historically have applied primarily to military goods and those non-military goods, software, and technology that could have military applications or raise national security concerns. These non-military items are regulated under the Export Administration Regulations ("EAR"), which set restrictions on transferring controlled items to certain jurisdictions or end-users or for certain end-uses.

¹ See, e.g., New York Times, *Companies Are Getting Out of Russia, Sometimes at a Cost* (Oct. 14, 2022), <https://www.nytimes.com/article/russia-invasion-companies.html>.

² Nearly all of the measures discussed in this Client Update also apply to Belarus, which has been targeted for its support and assistance to Russia's military.

The recent export controls targeting Russia have extended licensing requirements to luxury goods and certain commercial and industrial items that were not previously controlled for export. They also have barred the unlicensed export to, or transfer within, Russia of all items controlled under the EAR, including items that did not previously require a license for export to Russia. As a result, many companies that historically did not face U.S. export compliance obligations are now more likely to be subject to them.

New Restrictions on Luxury Goods

Effective March 11, 2022, the U.S. Commerce Department's Bureau of Industry and Security ("BIS") amended the EAR to impose restrictions on the export, reexport, and in-country transfer of identified "luxury goods" (i) to or within Russia, or (ii) to specified Russian oligarchs and "other malign actors" targeted by U.S. sanctions, wherever located.³

Each restricted "luxury good" is identified by the good's number and description in the Census Bureau's Schedule B for filing export shipment information through an interdepartmental system maintained by U.S. Customs and Border Control.⁴ Covered goods include, among others, (i) alcohol and tobacco products; (ii) perfume, makeup, and skincare products; (iii) handbags and luggage; (iv) furs, skins, feathers, silk, silk products, carpets, and textiles; (v) high-end clothing and athletic gear, generally defined as items valued at more than \$300; (vi) jewelry, watches, and metals; and (vii) vehicles and engines.

These goods are subject to a licensing requirement (with a presumption that a license will be denied) so long as they are subject to the EAR, which means, for this purpose, that the goods are of U.S. origin (wherever located) or located in the United States (regardless of origin). For U.S.-origin items outside the United States, the restrictions apply both to U.S. persons and to non-U.S. persons dealing with these goods.

New Restrictions on Commercial and Industrial Items

Since the annexation of Crimea in 2014, BIS has maintained a prohibition on export, reexport, and in-country transfer of certain items subject to the EAR if those items were intended to be used in exploration or production of Russian energy resources.

In May and September 2022, BIS greatly expanded this restriction by establishing new licensing requirements (subject to a presumption that a license will be denied) for a wide range of items not previously subject to specific controls under the EAR. For the purposes of these restrictions, most of the items are identified by their Harmonized

³ See BIS, 87 Fed Reg 14785 (Mar. 16, 2022), 15 CFR 746.10.

⁴ See 15 CFR 746, Supplement No. 5.

Tariff Schedule codes, as supplemented by Schedule B codes from the Census Bureau. They include, among others, (i) industrial and machinery equipment; (ii) power transmission equipment; (iii) diodes and semiconductor devices and processors; (iv) chemicals; and (v) motors, engines, pumps, and generators.

Commercial and industrial items restrictions apply analogously to the luxury goods restrictions: they extend to any person dealing with goods subject to the EAR, meaning U.S.-origin goods (wherever located) and goods located in the United States (regardless of origin).

Embargo on All Items Controlled under the EAR

In addition to the above, BIS has imposed a broad embargo on the export, reexport, or in-country transfer to or in Russia of any items specifically controlled under the EAR, thereby restricting any transfers of those items to Russia.⁵ The EAR controls not only physical goods, but also software and technology, and the embargo is likely to capture a broad range of technology products, including computer hardware and software. This includes goods made outside the United States so long as they include more than a de minimis amount of controlled U.S.-origin goods or software (generally over 25% for commodities). In other words, if an item produced outside the United States incorporates controlled U.S. goods or software that constitutes more than 25% of the item's total value, that item may itself become subject to the EAR and the broad embargo against Russia.

New "foreign direct product" rules targeting Russia further extend the reach of U.S. export controls to certain items produced outside the United States if those items are the "direct product" of (i.e., produced by the use of) controlled software or technology or are the "direct product" of equipment that is itself the "direct product" of controlled U.S.-origin software or technology.⁶ Among the more important classes of products captured by these restrictions are semiconductors manufactured outside the United States in factories that use U.S.-controlled software or technology, or equipment produced from such software or technology, for fabrication, testing or other production activities.

⁵ In addition, BIS maintains a broad embargo on all items intended for Russian military end-uses or end-users. See 15 CFR 744.21(a)(2).

⁶ More stringent "foreign direct product" rules apply if a party to the proposed transaction is identified in the EAR as a Russian military end-user.

Russia's Legalization of "Parallel Imports" and Related Legal Risks

These expanded export controls have been met with countermeasures in Russia itself, as Russian authorities seek to blunt the impact of Western measures by encouraging the continued flow of goods into Russia. One such countermeasure has been to authorize a wide range of products for "parallel import," allowing unfettered import of these products into Russia without permission of the rights holders.

Although reliable reporting on the volume of products captured by the parallel import scheme is not available, media reports and anecdotal accounts indicate that a significant amount of goods subject to U.S. trade controls is making its way into Russia. In August 2022, the Deputy Prime Minister of Russia estimated that Russia will import approximately \$16 billion in goods in 2022 under the parallel imports scheme.⁷

Russia's legalization of parallel imports is likely to make it far easier and less risky for downstream resellers and distributors of U.S.-origin goods to export those goods to Russia, especially if those third parties view themselves as outside the practical reach of U.S. law enforcement.

As a general matter, U.S. or multinational companies that manufacture or lawfully distribute these goods would not violate U.S. export controls if, downstream, their products are exported or resold into Russia without their knowledge or consent.⁸ However, the EAR includes a broad backstop provision, General Prohibition 10, that prohibits all direct or indirect dealings involving any item subject to the EAR if a person knows that a violation of U.S. export controls has occurred, is about to occur, or is intended to occur in connection with the item.

For this purpose, the EAR defines "knowledge" to include "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," which may be "inferred from evidence of the conscious disregard of facts known to a person [or] a person's willful avoidance of facts."⁹ Accordingly, if a company has information indicating a high probability that a distributor or customer is circumventing U.S. export controls that

⁷ See Reuters, *Russia's 2022 parallel imports to reach 4% of 2021 overall imports* (Aug. 15, 2022), <https://www.reuters.com/markets/europe/russias-2022-parallel-imports-reach-4-2021-overall-imports-2022-08-15/>.

⁸ Some companies have decided to stop sales of their products into Russia even though they were not legally required to do so. Although legal risks may be diminished in those circumstances, such companies may still face reputational and other risks if their statements do not comport with reality due to diversion through resellers or distributors.

⁹ 15 CFR 772.1.

apply to the company's products, failure to act on that information could raise compliance implications under the EAR.

Manufacturers of luxury goods and industrial products and technology companies may therefore find themselves subject to new and broad export controls requirements at a time when their downstream distributors and resellers may have strong incentives to violate those requirements.

Risk Mitigation Considerations

There are a number of steps that companies can consider to mitigate compliance risks under U.S. export controls.

- *First*, given the significant expansion in the types of goods now subject to Russia-related restrictions, it may be worthwhile for companies that are broadly engaged in the relevant industries to take stock of their exposure to U.S. export controls. Companies should ensure that they have an up-to-date and accurate understanding of which of their products are subject to export controls, as well as policies and procedures that they currently have in place to ensure compliance.
- *Second*, companies should consider which of their lines of business or sales and distribution routes may be particularly exposed to Russia-related risks. BIS has identified several items that it views as raising heightened risks of diversion, including aircraft parts, certain communication equipment, cameras, oil field equipment, marine propulsion equipment, and vacuum pumps. But this is by no means an exhaustive list, and companies should carefully consider which of their products and sales routes present potential risks of diversion to Russia.
- *Third*, and relatedly, companies should carefully consider the geographical footprint of their distribution and sales network and identify those jurisdictions that present higher risks of diversion and evasion. BIS helpfully has identified some high-risk jurisdictions, including Armenia, China, Georgia, India, Israel, Kazakhstan, Turkey, and the United Arab Emirates. While restricted goods may be lawfully exported to these countries, their reexportation to Russia may be prohibited. Yet resellers based in these jurisdictions may view themselves as outside of U.S. jurisdiction and may be incentivized to export products to Russia, facilitated by Russia's parallel import scheme.
- *Fourth*, in the areas of heightened business line, sales channel, or jurisdictional risk, companies would be well advised to monitor their business for red flags indicating

that diversion into Russia or other violations of U.S. export controls restrictions are taking place. Such red flags may include unusual sales patterns, such as a significant year-over-year increase in sales to a distributor based in one of the above-mentioned jurisdictions that cannot be explained by local market trends. It can also include circumstances in which a distributor or a reseller, ostensibly based outside of Russia, has the same owners as a Russian company or bears other indicia of acting on behalf of Russia-based entities or individuals.

- *Finally*, in areas of heightened risk, and in particular if red flags are identified, companies should consider conducting thorough and risk-appropriate due diligence on their counterparties and the sales channel. If weaknesses in the company's compliance policies or procedures are identified, those should be remediated as quickly as possible, with compliance training provided to relevant personnel.

Getting it right will be important. The U.S. authorities already have devoted unprecedented enforcement resources to identifying and prosecuting violations of export controls and related circumvention schemes. To that end, the BIS has enlisted the U.S. anti-money laundering regulator, the U.S. Treasury Department's Financial Crimes Enforcement Network, to educate U.S. financial institutions about suspicious activities related to export violations and remind them of their mandatory reporting obligations. Accordingly, U.S. banks and other financial institutions, particularly those involved in trade finance, are expected to focus their risk-based AML compliance programs on identifying potential evasions of U.S. export controls against Russia and reporting their customers' "suspicious" activities to U.S. authorities.

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Please do not hesitate to contact us with any questions.

Washington, DC



Satish M. Kini
smkini@debevoise.com



David A. O'Neil
daoneil@debevoise.com



Robert T. Dura
rdura@debevoise.com

London/New York



Berk Guler
bguler@debevoise.com



Jane Shvets
jshvets@debevoise.com

New York



Carl Micarelli
cmicarelli@debevoise.com