



UNITED STATES DEPARTMENT OF COMMERCE
Under Secretary for Industry and Security
Washington, D.C. 20230

February 15, 2008

The Honorable Edward J. Markey
U.S. House of Representatives
Washington, DC 20515

Dear Representative Markey:

Secretary of Commerce Gutierrez asked me to respond to your January 29, 2008 letter regarding the Validated End User (VEU) Program in China. I appreciate your comments and questions on the VEU Program, and I am grateful for the opportunity to provide you with a comprehensive description of our China policy and of the Program.

Consistent with our broader foreign policy toward China, the Bureau of Industry and Security (BIS) administers a rigorous set of export controls designed to prevent U.S. technology from making a direct and significant contribution to China's military modernization. As part of that strategic policy, the United States seeks to encourage and facilitate commercial technology exports to legitimate civilian end-users in China.

In June 2007, BIS published specific revisions to the Export Administration Regulations that updated and clarified this policy. The revisions (i) added controls on an additional group of items to ensure they would not contribute to the China's military, (ii) ensured that end-use checks could be conducted, when needed, on all licensed exports, and (iii) allowed denial of license applications involving any item if it would make a direct and significant contribution to the China's military capability.

In addition, the updated China policy established the VEU program to facilitate secure trade to pre-screened end-users in China. Selection into the VEU program is not automatic or easy, but limited to those companies who have a demonstrable history of using controlled U.S. technology responsibly, who pass a comprehensive interagency national security review by the Departments of Defense, State, Energy, and Commerce (with support from the intelligence community), and who agree to comply with the strict follow-on requirements of the program. By facilitating exports to pre-screened customers who meet the rigorous standards of the VEU program, VEU provides a market-based incentive for compliance with our export regulations. Moreover, the VEU program itself provides a real national security benefit because it enables BIS to focus fewer resources on transactions and end-users we know a great deal about and more resources on transactions and resources we know relatively less about.

Enclosed is a document that provides additional detail on the VEU Program and responds to your questions. We would also be pleased to provide you and your staff a briefing on the VEU Program.



Thank you for your interest in our work and I welcome the opportunity to discuss this Program further with you at your earliest convenience.

Sincerely

A handwritten signature in black ink, appearing to read 'Mario Mancuso', written in a cursive style with a long horizontal flourish at the end.

Mario Mancuso

Enclosure

I. Introduction: United States Policy on Dual-Use Exports to the People's Republic of China

As the People's Republic of China (PRC) has liberalized its economy and sought the benefits of globalization, bilateral trade between the U.S. and PRC has grown exponentially. While the U.S. maintains a predominantly open market for Chinese goods, the U.S. government has sought heightened reciprocal market access for U.S. goods in the Chinese market. In the area of trade in dual-use items, the United States government seeks to facilitate exports of commercial technology items by U.S. companies to legitimate civilian end-users in the PRC. At the same time, BIS continues to implement the longstanding U.S. policy of not permitting exports of such items that would contribute to the PRC's military capability.

After a year of comment from the public, industry, and government, on June 19, 2007, BIS published a new set of export control rules for the PRC to further refine our export controls in light of well-established U.S. policy for the PRC. These revisions were intended to reflect the Administration's China policy of seeking to facilitate secure trade in dual-use items to bona fide civilian end-users while hedging against China's opaque and rapid military modernization. The revised rules have two important facets:

Additional Measures to Prevent U.S. Dual-Use Items from Contributing to the PRC's Military Capability: The revisions instituted three additional measures to further ensure that U.S. exports to the PRC would not contribute to the PRC's military capability. First, the revisions imposed controls on an additional group of item categories that could make a material contribution to China's military capabilities. Second, the revisions also expanded the universe of exports that could be subject to an end-use check to all items exported to the PRC under a Commerce license. Third, the revisions provide for greater flexibility in denying exports that would make a direct and significant contribution to the PRC's military capability.

Validated End-User (VEU): The revisions also created a new authorization, the Validated End-User (VEU) program, to facilitate trade to companies in the PRC with a track record of responsible use of licensed goods and technology. The VEU program allows U.S. companies to export specific items to prescreened customers under a general authorization that have previously and repeatedly received approvals for low-risk transactions through individual export licenses.

A. Validated End-User (VEU) Program and Procedures

1. Overview of the VEU Program

The VEU program provides customers who act responsibly with controlled items to have better access to such items than their domestic competitors, and simultaneously allows U.S. exporters to sell more efficiently to such responsible civilian customers. VEU provides market-based incentives for firms to use U.S. dual-use items responsibly. The VEU program also allows U.S. government resources to be more focused on foreign parties and items about which less is known and therefore represent a greater security risk.

BIS begins the VEU review process by closely evaluating demonstrable licensing history, export volumes, intelligence reports, enforcement information, and other independent sources of information to ensure that prospective VEUs will be responsible end-users of controlled U.S. goods, software, and technology under a general authorization rather than under individual licenses. In order for an end-user to participate in the program, applicants must submit an extensive application containing information on the VEU candidate's structure, ownership, and business activities, as well as the items proposed for VEU authorization. VEU applications must also include information regarding the candidate's exclusive engagement in civilian end-uses, compliance with U.S. export controls, agreement to allow on-site reviews prior to or following VEU approval, the capability of complying with VEU authorization requirements, and relationships with other U.S. and foreign companies.

Following internal evaluation and verification of the VEU application by BIS, the End-User Review Committee (ERC) further evaluates the VEU application. The ERC is an interagency committee that includes representatives from the Departments of Commerce, State, Defense, and Energy, and receives input from the intelligence community and other agencies as relevant. If a VEU candidate is approved by the ERC, it is offered VEU status.

2. Internal BIS and End-User Review Committee (ERC) Review

All VEU applications undergo a rigorous review both internally at BIS and with other agencies of the U.S. government through the ERC's interagency process. A detailed standard-operating-procedure is followed for all aspects of the VEU application review and approval process. Prior to the VEU application's review by the ERC, BIS takes the following actions:

- **Compliance review:** The BIS Export Management and Compliance Division uses standardized criteria to verify information contained in the VEU application. The review includes: verifying that the VEU application addresses all of the regulatory requirements specified in the EAR; conducting a review of business databases such as Hoovers and Dunn & Bradstreet to verify the applicant's ownership and organizational structure; reviewing the candidate's licensing history; and reviewing the proposed VEU compliance plan.

- **Enforcement review:** BIS's Export Enforcement arm verifies, through a standardized set of criteria, that the information reported in the VEU application is consistent with the candidate's enforcement history.
- **Export Control Classification Number (ECCN)/End-Use review:** Engineers in BIS's Offices of Nonproliferation and Treaty Compliance (NPTC) and National Security and Technology Transfer Controls (NSTTC), through a standardized set of criteria, conduct an analysis of the item categories (ECCNs) requested by the VEU applicants and the appropriateness of these items for the stated end-use. NPTC and NSTTC also conduct analyses of the proposed use and assess foreign availability for items to be received under VEU.
- **Intelligence review:** The VEU applications are referred to the intelligence community for a thorough vetting of the VEU candidate.

The results of the internal BIS review process are provided to the chair of the ERC for use in developing recommendations to the members of the interagency ERC. The ERC reviews candidates following specific procedures enumerated in Supplement No. 9 to part 748 of the EAR. The ERC considers a range of factors based on the unique circumstances of each application in determining the candidate's suitability as a VEU. All meetings of the ERC are announced with an official agenda, and minutes of each meeting are provided to all member agencies. Once the ERC makes a final determination on a given VEU application, the chairman of the ERC documents the decision in an ERC decision memorandum that is provided to all the agencies. The ERC then issues its decision outlining the conditions of approval, if any, for the VEU candidate.

II. Responses to Questions Posed in the January 29, 2008, Letter

A. Question 1.a

In answering this question, it is important to note the importance of the PRC as a market for semiconductors. In 2005, the PRC became the largest semiconductor market in the world, accounting for nearly 25 percent of the worldwide share. In 2006, Chinese demand for semiconductors fuelled 90 percent of total worldwide market growth due to the shift of electronic systems production to the PRC.

U.S. semiconductor manufacturing equipment industry groups estimate that the U.S. share of China's \$2.3 billion semiconductor manufacturing equipment (SME) market was approximately 50 percent in 2006. Between 70-80 percent of sales of U.S. SME are attributable to exports and the PRC is one of the largest growing markets. The licensing treatment of U.S. SME exports to the PRC will thus be a critical factor in the ability of U.S. industry to increase or even maintain its current market share as the Chinese market grows to over \$4 billion by 2010. Prior to the conclusion of the Coordinating Committee for Multilateral Export Controls (COCOM), the Cold War export control regime, in 1994, the U.S. share of the world SME market stood at approximately 80 percent. Today, U.S. world market share of SME hovers at 50-60 percent.

Shanghai Hua Hong NEC Electronics Company, Ltd. (HHNEC) is one of the largest semiconductor manufacturers in the PRC. HHNEC is 61.42% owned by Hua Hong International (a wholly-owned subsidiary of Hua Hong Group which, in turn, is a wholly-owned subsidiary of China Electronic Corporation (CEC)), 17.36% by NEC (a Japanese consumer electronics company), 11.22% by Hylintek (a wholly-owned subsidiary of Shanghai Belling), and 10% by Jazz (a U.S. wafer foundry). CEC's ownership interest in HHNEC was part of the information available to the agencies when HHNEC was considered for VEU status. Having evaluated the available unclassified and classified information on HHNEC, all the reviewing agencies concluded HHNEC qualified for VEU status. Certain specific information relevant to the ERC's review is classified. Other relevant information is subject to the confidentiality provisions of Section 12(c) of the Export Administration Act of 1979 (EAA). *See* 50 U.S.C. app. § 2411(c). Section 12(c)(2) of the EAA authorizes BIS to release such information "to any committee or subcommittee of Congress of appropriate jurisdiction upon request of the chairman or ranking minority member of such committee or subcommittee." In addition, many of the items authorized for export to HHNEC under VEU are available from a number of Chinese and other foreign suppliers.

B. Question 1.b

In answering this question, it is important to note the importance of the PRC as a market for civil aviation. The PRC is the largest market for commercial airplanes outside the United States. As commercial air travel in China is forecasted to quintuple by 2026, industry estimates that commercial airlines operating in China will require 3,380 new airplanes over the next 20 years. The estimated value of such future sales is \$350 billion.

Boeing and Airbus are large players in the Chinese commercial aircraft market. Airbus continues to increase its participation in the Chinese market through increased procurement from Chinese suppliers. Airbus is also building an assembly plant for its A320 aircraft in Tianjin. Airbus has goals of achieving a 50 percent market share in China by 2013. Boeing has been an important part of the Chinese civil aviation market for over 35 years. In 2002, Boeing held roughly a 73 percent share of the commercial aircraft market in China. Currently, the company holds roughly a 60 percent market share. In its stated objectives to hold a 60 percent or higher share of the commercial airline market, Boeing thus faces vigorous competition from Airbus to meet this goal.

BHA Aerocomposite Parts Co. Ltd. (BHA) is an equity-share joint venture, with American-owned Boeing and Hexcel Corporation each holding just over 40% of the company and China Aviation Industry Corporation I (AVIC I) holding just under 20%. BHA is located in Tianjin, China, and manufactures composite structures, as well as interior applications for commercial aircraft. Information regarding AVIC I's ownership interests in BHA was available to the agencies when they reviewed BHA was considered for VEU status. Having evaluated the available unclassified and classified information on BHA, all the reviewing agencies concluded BHA qualified for VEU status. Certain specific relevant information to the ERC's review is classified. Other relevant information is subject to the confidentiality provisions of Section 12(c)

of the Export Administration Act of 1979 (EAA). *See* 50 U.S.C. app. § 2411(c). Section 12(c) of the EAA, authorizes BIS to release such information “to any committee or subcommittee of Congress of appropriate jurisdiction upon request of the chairman or ranking minority member of such committee or subcommittee.” In addition, many of the items authorized for export to BHA under VEU are available from a number of Chinese and other foreign suppliers.

C. Question 1.c

1. Shanghai Hua Hong NEC Electronics Company, Ltd. (HHNEC)

HHNEC’s structure, ownership, including its parent, subsidiaries, or sibling entities, and business practices were reviewed for its VEU authorization in order to evaluate whether HHNEC or its affiliates were associated with the military or engaging in military or other unauthorized end-uses such as enabling Weapons of Mass Destruction (WMD) programs. Further, HHNEC has been authorized under other individual validated licenses under the existing interagency individual licensing process. The items authorized are used by HHNEC in its commercial manufacturing operations. Based on the information considered, which is subject to Section 12(c) of the EAA, the ERC determined that export of these items under the streamlined VEU process does not pose additional risks to national security, since these end users have already been recipients of controlled U.S. goods. Overall, HHNEC’s licensing history combined with the thorough vetting of its application by BIS and the ERC provided no evidence that HHNEC should not be a validated end-user.

2. BHA Aerocomposite Parts Co. Ltd. (BHA)

Just as in the case of HHNEC, BIS and the ERC reviewed BHA’s structure, ownership, and business practices for its VEU authorization in order to evaluate whether BHA or its affiliates were associated with the military or engaging in military or other unauthorized end-uses such as enabling Weapons of Mass Destruction (WMD) programs. Based on the information considered, which is subject to Section 12(c) of the EAA, the ERC determined that BHA had similarly been authorized under other individual validated licenses under the existing interagency individual licensing process. As BHA has previously received controlled U.S. goods, the export of items under the VEU does not add additional risks to national security.

BHA’s record, combined with the rigorous vetting of its VEU application by BIS and the ERC, provided no evidence that BHA should not be a validated end-user.

D. Question 2

BIS conducted an extensive selection process for the five VEU companies operating in China. From January 2007 through the early summer of 2007, in preparation for the prospective

authorization of the regulations authorizing VEU, BIS identified Chinese companies that could be eligible for VEU status based on the following:

- Established licensing history - high volume and/or dollar value of licensed exports from the U.S.; and
- Potential ECCNs for inclusion in VEU authorization were those that were previously identified on approved export licenses.

BIS then obtained the concurrence of its enforcement arm and the Departments of Defense, Energy, and State to assess the interest of the five companies in the VEU program. With that concurrence, BIS contacted the five companies to apprise them of the VEU program. Each of these companies then began to be formally considered for VEU status in June and July 2007. The ERC subsequently reviewed each VEU application pursuant to the relevant regulatory criteria during the course of its weekly meetings. This rigorous review culminated in the approval -- by unanimous consent -- of all five VEU candidates by all the reviewing agencies. Five companies operating in China were thus published in the Federal Register as the first set of VEU companies on October 19, 2007. The five companies were:

- Applied Materials China, Ltd.
- BHA Aerocomposite Parts Co., Ltd. (BHA)
- National Semiconductor Corporation
- Semiconductor Manufacturing International Corporation
- Shanghai Hua Hong NEC Electronics Company, Ltd. (HHNEC)

E. Question 3

As noted above, the ERC began formally considering each of the five ultimately approved VEU companies in June and July 2007. The ERC had the information it needed to consider these candidacies, including information on the company's structure, ownership, and business activities, as well as the products for which VEU authorization was requested. The ERC also obtained information, required by the EAR, on exclusive engagement in civilian end-use activities, compliance with U.S. export controls, agreement to allow on-site reviews prior to or post VEU approval, the capability of complying with VEU authorization requirements, and relationships with other U.S. and foreign companies.

Each candidate was then reviewed thoroughly by BIS through the compliance review, enforcement review, ECCN/end-use review, and intelligence review, described above. Through this review process, information related to each of these companies was considered carefully and independently verified by BIS. After this thorough vetting, these five VEU applications were referred to the interagency ERC.

It is also important to note that BIS and the ERC will review authorized VEUs on a semi-annual basis. This review will include evaluation of intelligence and enforcement information, exports, and required reports from the VEUs.

F. Question 4

As described in the response to Question 3, BIS rigorously reviewed the five VEU applications prior to referring the applications to the ERC for further consideration. The ERC, the interagency committee comprised of experts from the Departments of State, Defense, Energy, and Commerce, met on a weekly basis to consider a range of factors based on the unique circumstances of each application in determining each company's suitability for the VEU program. However, the meeting minutes of the ERC and any correspondence among ERC members are subject to the confidentiality provisions of Section 12(c) of the EAA. BIS is prepared to provide this information consistent with the requirements of Section 12(c).

G. Question 5

The identity of corporations that have applied for, been nominated for, or are currently under review for VEU status are subject to the confidentiality provisions of Section 12(c) of the EAA, described above. BIS is prepared to provide this information consistent with the requirements of Section 12(c). No applications for VEU have been denied.

H. Question 6

On January 2, 2008, BIS ceased requiring exporters who make use of a VEU authorization to submit to BIS annual reports containing the contact information of each VEU to whom eligible items were exported, the eligible destination to which the items were exported, and the quantity, value, and ECCN of the items. BIS determined that it did not have to request the information from exporters because that information is available through the Automated Export System (AES). Exporters are required to file export data in AES to actually ship items from the United States. The VEU regulation still requires, however, that re-exporters provide to BIS reports on VEU re-exports.