

PNNL-29236

Trade Compliance Insurance Product

Revisiting the feasibility of an
insurance product to strengthen trade
compliance and reduce proliferation
risks

September 2019

T Gray
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RA Weise

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Pacific Northwest National Laboratory
Richland, Washington 99354

Summary

In October 2018, Pacific Northwest National Laboratory (PNNL) published a report¹ in collaboration with the Stimson Center² on the feasibility of an insurance product that would reduce proliferation risks associated with small and medium-sized enterprises by encouraging stronger trade compliance. This preliminary report concluded that a Trade Compliance Insurance Product (TCIP) is feasible and identified existing insurance analogs, challenges, and outstanding questions for further industry outreach. From October 2018 to September 2019, PNNL worked to validate this preliminary report through a series of interviews with representatives from the manufacturing, finance, insurance and shipping industries. This report follows up on the initial 2018 Report and summarizes the findings of the industry interviews related to the TCIP and more broadly makes recommendations for the next steps.

In total, the project team conducted seventeen interviews and attended a handful of industry events from October 2018 to September 2019. A full record of the interviews, along with a discussion of the interview protocols, can be found in a separate PNNL report.³ The specific companies and the names of individuals interviewed are not included in this report because the interviews were conducted under the Chatham House Rule. In order to address some of the outstanding questions from the 2018 Report, it was necessary to supplement the interview responses with open-source research. In other cases, it was not possible to answer the question with the available information during the research period.

Based on the industry interviews and research conducted from October 2018 to September 2019, the project team concluded that the TCIP, as proposed in the 2018 Report, is feasible but not currently marketable, meaning it would not make a good market incentive for strengthening trade control compliance in SMEs at this time. In conducting this research, PNNL identified six additional specific findings. Some of these findings support the key conclusion that the TCIP is not currently marketable; the remaining findings are not directly relevant to the TCIP but are nonetheless valuable for the work of the PNNL project team as a whole:

Finding #1: The TCIP is not currently marketable, but the TCIP concept addresses an important gap in the currently offered insurance coverage.

Finding #2: Upon further inspection, Foreign Corrupt Practices Act (FCPA) insurance may not make a good model for the TCIP because corruption-related claims are less legally and reputationally fraught than sanctions-related claims.

Finding #3: Improving trade compliance awareness with small and medium-sized businesses remains a challenge.

Finding #4: The U.S. government interpretation of technologies that are export controlled is expanding; the impacts on trade compliance are still unclear but should be monitored moving forward.

¹ Weise R.A., T.T. Gray, K. Cuddy, L. Umayam, and J. Kempfer. 2018. *Trade Compliance Insurance: The feasibility to strengthen trade compliance and reduce proliferation risks*. PNNL-28094. Richland, WA: Pacific Northwest National Laboratory.

² <https://www.stimson.org/>

³ Adams, G.A., Gray, T.T., Weise, R.A., Industry Outreach FY2019 Interview Summaries, PNNL-29282. Richland, WA: Pacific Northwest National Laboratory.

Finding #5: The increased enforcement activities by the U.S. government for trade control violations cause concern for industry. It is uncertain if this activity is sufficient to raise awareness amongst SMEs so that they improve compliance and/or seek TCIP-like products.

Finding #6: There is increased pressure from regulators on insurance companies and financiers to play a larger role in identifying trade and sanctions non-compliance, but there are limits to what insurers and banks can do.

While PNNL ultimately concluded that the TCIP is not currently a marketable incentive to strengthen trade compliance in SMEs, the industry feedback helped identify additional areas of research to inform future market incentives and trade compliance policies. The following research questions were identified for further consideration:

Could an industry standard for trade compliance be developed to help establish a minimum level of compliance?

What incentives, if any, are most likely to encourage SMEs to strengthen their trade compliance?

What can be learned from the distinctions in how different industry sectors (e.g., finance, insurance, manufacturing) manage trade compliance?

What can be learned from specialized insurance or trade associations on how they manage risks associated with trade compliance?

In order to answer these questions and further explore some of the finding of this report as well as continue industry outreach on trade compliance, PNNL will organize a workshop in FY20. The workshop will address these issues by bringing together key industry stakeholders, including manufacturers, financiers, freight forwarders, shippers, and insurers, to discuss trends and incentives in trade compliance and identify shared best practices and distinctions among the industries.

Acronyms and Abbreviations

| | |
|-------|--|
| ANPRM | Advance Notice of Proposed Rulemaking |
| BIS | Bureau of Industry and Security |
| CCL | Commerce Control List |
| CTPAT | Customs Trade Partnership Against Terrorism |
| D&O | Director's and Officer's |
| DDQ | Due Diligence Questionnaire |
| DOC | Department of Commerce |
| EAA | Export Administration Act |
| EAR | Export Administration Regulations |
| ECCN | Export Control Classification Number |
| ECRA | Export Control Reform Act |
| FCPA | Foreign Corrupt Practices Act |
| ICP | Internal Compliance Program |
| OFAC | Office of Foreign Assets Control |
| P&I | Protection and Indemnity |
| PNNL | Pacific Northwest National Laboratory |
| SDN | Specially Designated Nationals and Blocked Persons |
| SME | Small and Medium-Sized Enterprises |
| TCIP | Trade Compliance Insurance Product |
| UK | United Kingdom |

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1.0 Introduction

In October 2018, Pacific Northwest National Laboratory (PNNL) published a report¹ in collaboration with the Stimson Center² on the feasibility of an insurance product that would reduce proliferation risks associated with small and medium-sized enterprises (SME) by encouraging stronger trade compliance (hereafter known as the 2018 Report). The 2018 Report concluded that, based on preliminary research, a Trade Compliance Insurance Product (TCIP) is feasible; the Report also identified existing insurance analogs, challenges, and key considerations that required more research. As a next step, the 2018 Report provided questions for further industry outreach before the TCIP concept could be developed and brought to market.

From October 2018 to September 2019, the PNNL project team researched the questions from the 2018 Report by interviewing representatives from the manufacturing, finance, insurance and shipping industries. The project team performed open-source research to answer questions not addressed through the industry interviews. This document follows up on the conclusions and areas for additional research from the 2018 Report, summarizes the findings from the research conducted, and makes recommendations concerning the TCIP and insurance incentives more broadly.

Specifically, the following sections provide a summary of the 2018 Report, the results obtained from FY19 industry outreach, answers to each of the research questions posed in the 2018 Report and a section summarizing the key findings from the 2019 industry interviews and research. The final section concludes with recommended next steps for the TCIP and more potential incentives and research topics to further trade compliance.

¹ Weise R.A., T.T. Gray, K. Cuddy, L. Umayam, and J. Kempfer. 2018. *Trade Compliance Insurance: The feasibility to strengthen trade control compliance and reduce proliferation risks*. PNNL-28094. Richland, WA: Pacific Northwest National Laboratory.

² <https://www.stimson.org/>.

2.0 Overview of the 2018 Report

The primary objective of the 2018 Report was to assess the feasibility of creating an insurance product that could reduce proliferation risks by encouraging stronger trade compliance in SMEs. To assess that insurance product, the project team used the following three questions:

1. Is there adequate demand for a TCIP?
2. Would insurance companies be willing to supply a TCIP?
3. If the first two criteria are met, is there an appropriate model for structuring the TCIP that will reduce risk for companies, while maintaining an acceptable level of risk for insurers?

The project team answered these questions primarily through open-source research, along with interviews with private sector representatives.

Based on that research, the project team concluded that an insurance product for trade compliance was feasible - meaning that there could be adequate demand for such a product, that insurance companies could be willing to supply it, and that there are insurance analogs that could serve as a model. This conclusion was developed with limited data, however, and the project team made several assumptions related to the behavior of the insurance market and incentive structures for insurers and their clients. Through the 2019 research and interviews, some of those assumptions were validated while others were ultimately disproved, which will be discussed in the conclusions of this report.

On the demand side, the 2018 Report concluded that demand for a TCIP might exist, based on increasing enforcement activity by the U.S. government for trade control violations and the desire by companies to protect themselves from some of the damages associated with enforcement activities. On the supply side, the 2018 Report found that insurance companies could model a TCIP on Directors' and Officers' (D&O) Insurance coverage related to violations of the Foreign Corrupt Practices Act (FCPA).¹ As the 2018 Report conclusion noted, the feasibility of the TCIP was based on the assumption that insurance companies would be willing to supply such a product and able to develop the capabilities to assess it. The 2018 Report also found that insurers could provide the TCIP to companies with trade compliance programs and offer lower premiums to companies with stronger compliance programs.

Finally, the 2018 research identified areas for further research to validate the assumptions about insurance market behaviors and incentives, speak with more insurers directly about whether they would be willing to develop a TCIP, and specifically to identify how a product could be developed.

¹ For a full discussion of the FCPA and the rationale used to reach that conclusion, see Weise R.A., T.T. Gray, K. Cuddy, L. Umayam, and J. Kempfer. 2018. *Trade Compliance Insurance: The feasibility to strengthen trade compliance and reduce proliferation risks*. PNNL-28094. Richland, WA: Pacific Northwest National Laboratory.

3.0 Validating the 2018 Report

A key outcome of the 2018 Report was a list of research questions to validate the Report's findings. To answer these questions, PNNL conducted in-person and phone interviews with representatives from the manufacturing, finance, insurance, and shipping industries. In total, the project team conducted seventeen interviews from October 2018 to September 2019. A full record of the interviews, along with a discussion of the interview protocols, can be found in a separate PNNL report.¹ The specific companies and the names of individuals interviewed are not included in this report, because the interviews were conducted under the Chatham House rule.

Based on the interviews, the following responses are summarized for each of the twelve outstanding questions from the 2018 Report. In some cases, it was necessary to supplement the interview responses with open-source research to fully answer each question. In other cases, it was not possible to answer the question with the available information during the research period.

3.1 Are insurance companies willing to sell such a product?

Determining if insurance companies would be willing to sell a TCIP was one of the most important topics addressed during the interviews with insurance company representatives. One representative noted that the TCIP addresses an important gap in insurance coverage. Moreover, all of the insurance company representatives found the idea interesting; however, none would be willing to market such a product at this time. The primary reason provided for this hesitancy related to sanctions risk and public perception. Under a TCIP, it is possible that some claims could result in an insurance provider paying damages to a company or individual that may eventually be added to a sanctions list or has a relationship with a designated entity. Insurance representatives were especially concerned about having any business connections with entities on the U.S. Treasury Department's Specially Designated Nationals and Blocked Persons (SDN) List,² but did not mention that same concern with regards to entities on other trade controls-related lists, such as the U.S. Department of Commerce (DOC) lists.³ In the best case scenario for insurers, if insurers offered such coverage, the insurance company could be seen as protecting a company affiliated with illegal transactions, and even if that company was not culpable this could negatively affect the reputation of the insurer. In the worst case, the insurance company itself could face enforcement actions for supporting an entity trying to evade sanctions. As such, insurance companies noted that the TCIP, in the current enforcement regime, presents a great deal of risk without a guaranteed reward.

It is important to note that many of the insurers stated that they would be more interested in marketing the TCIP if it were clear that the U.S. Government (or the UK Government) backed the product. For example, a safe-harbor provision not to prosecute insurers who offered such insurance if they acted in good faith would reassure potential insurance providers.

¹ Adams, G.A., Gray, T.T., Weise, R.A., Industry Outreach FY2019 Interview Summaries. PNNL-29282. Richland, WA: Pacific Northwest National Laboratory.

² <https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>.

³ These lists include the Sectoral Sanctions List, the Non-SDN Iran Sanctions List, the Denied Persons List and several more. Most of these lists are included within the Consolidated Sanctions List (CSL), <https://www.export.gov/article?id=Consolidated-Screening-List>.

Beyond this core issue, some insurance companies expressed reservations around their ability to assess trade compliance risks, while others indicated that they could develop the ability to assess this risk, just like they have with cyber risks in recent years. Additionally, insurers felt that a government-supported industry standard might be an effective way for insurance providers to verify that a company is not a bad risk before providing coverage under the TCIP. This is discussed further in Section 3.3 below.

3.2 What exactly would this insurance product cover, and would such a benefit be marketable enough to create demand?

The 2018 Report clearly stated that a potential TCIP could not cover any civil or criminal penalties associated with trade control violations. The proposed TCIP, modeled on D&O Insurance for FCPA violations, was intended to only cover the legal and administrative fees of the affected company and any affected employees, along with any legal fees or civil damages associated with derivative lawsuits.

Based on interviews with D&O insurance experts, this model conforms with other existing forms of D&O insurance, but the research also indicated that FCPA Insurance may not be widely used in industry. The reasons that FCPA insurance may not be widely used are unknown and were not apparent from the project team's research. However, it is possible that FCPA insurance is only used by companies at the greatest risk for enforcement actions. The proposed TCIP could generate similar demand among companies at particular risk of sanctions or export control violations, however, marketing to unaware SMEs remains a challenge. Regardless, this may be a moot point, as the general feedback from insurance companies is that they are not interested in selling such a product, given the current enforcement regime.

3.3 How will insurance companies determine whether a potential insurance policy holder has a sufficiently robust export compliance program to qualify for the insurance?

Given the interviewees' general uncertainty about offering a TCIP, the project team did not press the insurers for great detail about how such a product might be assessed. Nonetheless, the insurance industry representatives noted that they could develop the expertise to assess trade compliance, just as they have for cybersecurity insurance and other emerging threats. However, it was clear that insurance companies are unlikely to develop that expertise without some form of government support for this type of insurance, given the reputational and financial risk that could be associated with this product.

One insurance industry representative suggested two ideas that could be used to help address trade compliance risks: 1) Due Diligence Questionnaires (DDQs)¹ and 2) internal "licenses" for certain transactions. DDQs are a tool used by some companies to assess risk by asking a client to complete a questionnaire related to the client's operations and compliance. While DDQs can be difficult to complete, especially for companies that have not given enough thought to their compliance programs, they can be a useful screening tool to assist insurers in assessing trade compliance risk. In fact, one insurer reported that requiring completion of a detailed DDQ can

¹ Many FIs use some form of DDQ to help them complete their due diligence, but the level of detail in questionnaires can vary widely across companies and as can the types of responses deemed acceptable by the FIs' compliance officers.

serve to exclude companies that could present a greater risk for trade compliance, as they may not be able to complete the DDQ. Internal “licenses” was another means suggested by an insurance company to assess trade compliance risk. By identifying certain kinds of transactions or companies that require less oversight, an insurance company can issue an “internal license” allowing those transactions (such as certain shipping activities) to be covered and thereby freeing up more time for the insurance company to assess transactions that present higher risk for enforcement actions.

As discussed in Question #1, an industry-certified standard (e.g., ISO Standard) for trade compliance could also assist insurers in assessing which companies qualify for insurance and how to complete due diligence on those companies. While one insurer noted that a company compliant with the standard would not necessarily receive lower premiums, a standard could help insurers apply a “lighter touch” in terms of due diligence for that company. One industry representative noted that standards have been useful in the UK in similar areas, such as corruption and supply chain management. Standards have been used to enforce compliance and establish requirements in a way that allows industry and the government to negotiate as equal partners in establishing the standard. However, all of the industry representatives agreed that a standard for trade compliance would be most useful if it had support from, or was recognized by, the government.

3.4 Would insurance companies be willing to offer lower premiums for companies with trade compliance programs?

Generally, it seems that insurance companies would not be willing to offer lower premiums for companies with stronger compliance programs, based on the feedback from several insurance industry representatives. Several insurance industry representatives noted that a stronger compliance program will likely result in “a lighter touch” in terms of due diligence by the insurance company. Though reduced premiums would represent a stronger incentive for companies with an internal compliance program (ICP) to purchase the TCIP, this is not the only incentive for the product, since companies would primarily buy it to reduce their own risks related to trade compliance. Lower premiums would simply be a perk.

3.5 How are insurance companies evaluating the compliance programs of companies for which they are providing FCPA Coverage for directors and officers and would those methods work for trade compliance insurance?

None of the industry representatives interviewed had any direct experience with FCPA insurance and how it is evaluated by insurance companies. Given that the insurance industry is not currently interested in offering the TCIP, the team did not spend more time researching this question in FY19. However, if the insurance industry sentiment changes in this regard, the project team could return to this question.

3.6 Could existing government certification, such as the Customs-Trade Partnership Against Terrorism (CTPAT), be used as a methodology for assessing trade compliance programs?

Generally, the industry was agnostic toward using CTPAT, or similar government programs, as a methodology for assessing trade compliance programs. While one industry representative noted that a program like CTPAT can raise awareness and create industry buy-in for compliance programs, another industry representative highlighted the fact that CTPAT is not transferrable or recognizable between countries, meaning that an insurance company from the UK would find limited utility in a U.S. program like CTPAT. Despite this lack of consensus on CTPAT, most of the industry representatives agreed that some kind of government-supported incentive or standard related to trade compliance would be valuable, as it could set a minimum standard for what the government expects for trade compliance. It should be noted that BIS has released a document elaborating the “Elements of an Effective Export Compliance Program, which can help address this issue.¹ However, the industry feedback that PNNL has collected on this document is that it is too generic for many companies and would not provide sufficient detail for assessing compliance with the TCIP, though it could serve as a starting point.

3.7 Would large companies buy this type of insurance product?

Representatives from both the manufacturing industry and the insurance industry indicated that large companies might be interested in the proposed TCIP. Since these larger companies are typically aware of trade compliance and may already have internal compliance programs, they already understand the risks associated with trade control enforcement actions and have demonstrated that they are willing to invest their resources to mitigate those risks. Furthermore, representatives from the insurance industry noted that they would be more willing to provide a trade compliance insurance product to larger companies if they already had a strong internal compliance program, as the risks would be lower. Though these findings were a positive indicator for the TCIP generally, larger companies with ICPs were never the target market for the TCIP; it was intended to encourage better trade compliance in SMEs, which are less likely to purchase the TCIP.

3.8 Would SMEs buy this type of insurance product?

Unfortunately for PNNL’s hypothesis, the industry feedback was not encouraging for the TCIP. Industry representatives from both the manufacturing and insurance industries were not optimistic about SMEs buying this type of insurance. The reason offered for why SMEs would not buy the TCIP was simple: lack of awareness of trade controls. If SMEs do not know they need an ICP, they will not know or think they need to purchase TCIP. One large manufacturer noted specifically that it often works with SMEs and when SMEs learn of the trade controls requirements associated with the manufacturer’s products, the SMEs will occasionally decline a contract because they do not have the resources to develop an internal compliance program. This data would seem to indicate that if the SMEs are unwilling to dedicate resources for a compliance program, they are also unlikely to dedicate resources to buying an insurance product. If a company had to decide between paying to establish an ICP or paying to buy

¹ *Export Compliance Guidelines: The Elements of an Effective Export Compliance Program*, U.S. Department of Commerce Bureau of Industry and Security, Washington, D.C., January 2017.

insurance, they should probably use those limited resources to establish an ICP, which may include purchasing services from third-party compliance professionals.

3.9 Are SMEs aware of (and concerned about) enforcement actions related to trade controls?

The project team was not able to solicit any feedback from SMEs on this topic from October 2018 to September 2019. This is a recurring challenge, as it is difficult to engage smaller companies because it is hard to identify who to engage. If SMEs do not realize they are making controlled items and therefore do not self-identify as needing compliance assistance, it is difficult for the project team to identify those SMEs. It should be noted, though, that the current U.S. administration seems to be making trade control enforcement a bigger priority, both for sanctions and export controls. It is difficult to know if this will raise awareness of the topic with SMEs, but further analysis of this may be warranted. For more information on expanding enforcement actions for trade controls, see Section 4.

3.10 How big is the market of SMEs that are hesitant to enter the export market because of fear of potential enforcement actions?

As noted in Section 3.9 above, the project team was not able to solicit any feedback from SMEs on this topic from October 2018 to September 2019. This is a question that deserves further enquiry, as it directly relates to the benefits and consequences of trade control enforcement actions.

3.11 Would regulatory or enforcement changes be necessary in order to get SMEs interested in these insurance products?

As noted in Section 3.9 above, the project team was not able to solicit any feedback directly from SMEs on this topic from October 2018 to September 2019. However, the 2019 research identified several regulatory or enforcement changes that are relevant to the entire market, not just SMEs. Many of the representatives from the insurance industry noted that support from the U.S. Office of Foreign Assets Control for the TCIP or a similar product would be critical for success of such an incentive. Specifically, insurers noted that they could develop the capabilities to assess trade compliance; however, stronger government backing, which includes protection from liability, and potentially an industry standard, would be needed to encourage companies to develop this capability. Finally, across the industry, the interviewees agreed that more outreach efforts to communicate how U.S. government enforcement policy will treat the TCIP will be necessary for the TCIP or a similar product to be successful.

3.12 What types of coverage should be included to encourage the shipping industry to purchase insurance?

The project team conducted outreach to the shipping industry to address this question but was met with limited responses. More contacts need to be developed in the shipping industry. PNNL is organizing a workshop in December 2019 with the Stimson Center and plans to focus one workshop session on trade compliance in the shipping industry, which should help establish better contacts for future research.

4.0 Findings

Based on the in-person and telephone interviews with industry representatives from October 2018 to September 2019, the project team concluded that the TCIP, as proposed in the 2018 Report, is a feasible product, but it is currently not a marketable incentive for strengthening trade compliance in SMEs at this time. A full elaboration of that finding is provided below in Findings #1 and #2. Additional key findings relevant to the work of the PNNL project team are provided the remaining four findings. Some of Findings #3 through #6 support the conclusion that TCIP is not marketable at this time and some have unclear impacts on the TCIP and compliance in general, which may warrant further research.

Finding #1: The TCIP is not currently marketable, but the TCIP concept addresses an important gap in insurance coverage.

At this time the general feedback on the TCIP was that insurers are not interested in marketing such a product, nor are SMEs likely to buy it. At the same time, insurers noted that the idea is a good one and that there could be a market for the TCIP at some point in the future. Specifically, the insurance companies acknowledged that the TCIP addresses an important gap – how to protect companies that have made honest mistakes from facing the full force of trade control enforcement actions. Though the lack of marketability of the TCIP was disappointing, several specific barriers for a TCIP were identified that may help to identify future trade control incentives.

First, because the TCIP would provide coverage for harm associated with trade control violations, there is a potential reputation issue. Insurers do not want to appear to be providing coverage for companies accused of sanctions and export control violations, even if those accusations are unfounded, as this could present a significant reputational risk. This is an important finding, because it undercuts the assumption from the 2018 Report that insurers would be willing to provide the TCIP if demand existed. Beyond the reputational risk potentially associated with a TCIP, insurers also noted that if they pay out damages associated with a sanctions violation, they could take on their own sanctions-related risk. OFAC's aggressive sanctions enforcement practices were cited in multiple interviews as a concern for insurers in even considering offering sanctions-related insurance, *or insurance that might be perceived as being related to sanctions*. The risk to insurers on the TCIP was therefore not justified by the potential rewards.

Secondly, the 2019 interviews raised questions regarding whether insurers could develop the expertise to assess a client's trade compliance. This finding also challenged an assumption from the 2018 Report that insurance companies would be able to develop the capabilities to assess trade compliance. Specifically, the interviews highlighted concerns regarding the methodology insurers would use to assess a company's ICP and how insurers would ensure that the quality of an ICP was maintained once coverage was provided. Insurers noted that they could develop these capabilities, as they did for cyber security insurance; however, to do so stronger government backing (and potentially an industry standard) for this type of coverage would be needed.

Despite these challenges to the TCIP, insurance companies did signal a willingness to offer this type of coverage in the future for companies that have a strong compliance program, particularly

if that program has been certified or endorsed by the government in some way. Unfortunately, this would still be unlikely to encourage the original target market, SMEs, to buy this product.

Finding #2: Upon further inspection, Foreign Corrupt Practices Act (FCPA) insurance may not make a good model for the TCIP because corruption-related claims are less legally and reputationally fraught than sanctions-related claims.

The research in 2019 found that FCPA insurance may not be as good a model for the TCIP as the project team initially envisioned. Specifically, it is unclear how many companies purchase FCPA coverage, and additional research may be needed to understand how widely this type of coverage is used. Of course, widespread use of the FCPA insurance is not necessary for it to be used as a model for a TCIP, but without this wider use, it may be difficult to collect the data necessary to develop the TCIP. Additionally, FCPA insurance may not make a good model for the TCIP because FCPA coverage does not have to consider the risk of paying a sanctions-related claim.¹

If insurance companies later express willingness to provide a TCIP, or related product, PNNL could conduct further research on the FCPA model later.

Finding #3: Improving trade compliance awareness with small and medium-sized businesses remains a challenge.

The 2019 research suggests that there could be interest in a TCIP product, but this interest is more likely from larger companies, rather than SMEs. The research findings indicated that, due to the increasing complexity of international trade, many SMEs may not be aware they have trade compliance obligations. Furthermore, even those SMEs with awareness of trade controls may not have the resources to address this issue. Interviews indicated, and the PNNL research team agreed, that if resources are limited, companies should probably invest in ICPs, not in a TCIP.

Feedback from industry indicated that the TCIP would be unlikely to raise awareness of trade controls with SMEs, nor would it encourage SMEs to dedicate more resources for trade compliance. These issues may be best addressed through government outreach on the topic of trade controls and/or the use of enforcement actions against trade control violators. Interestingly, as discussed in Finding #5, the issue of export control enforcement may begin to factor more prominently in the calculations of some SMEs soon, as the U.S. government is taking steps to expand the types of technologies that are export controlled and the use of enforcement actions against export control violators. When this happens, there might be increased demand from SMEs for a TCIP or other compliance assistance. Given the centrality of SMEs to trade compliance and the nuclear supply chain, continued exploration of ways to increase SME awareness would be valuable.

¹ See Finding #1 for more information on insurers sanctions-related risk with the TCIP.

Finding #4: The U.S. government is expanding export controls to include new technologies; the impacts on trade compliance are still unclear but should be monitored moving forward.

Since completion of the 2018 Report, an important legislative change occurred that is expected to generally affect trade compliance and more specifically affect the feasibility of the TCIP. In August 2018, the President signed into law the Export Control Reform Act (ECRA), as part of the John S. McCain National Defense Authorization Act for Fiscal Year 2019.¹ While the ECRA accomplished several important tasks, including providing permanent statutory authority for the Export Administration Regulations (EAR),² the most significant accomplishment was creation of the mandate for the U.S. government to identify and control “emerging and foundational technologies” that are essential to national security. The ECRA did not define the term “emerging and foundational technologies,” but it did establish several interagency advisory committees to define these terms. The outcomes of these committees are expected to impact trade compliance, as the committees will undoubtedly identify new technologies that require export controls.

The *emerging technologies* mandate of the ECRA was addressed on 19 November 2018 when the DOC’s Bureau of Industry and Security (BIS) published an advance notice of proposed rulemaking (ANPRM), seeking public comment on criteria for defining and identifying emerging technologies with the goal of eventually proposing new export control classification numbers (ECCN) in the Commerce Control List (CCL).³ While BIS has yet to announce the results of ANPRM, it is expected to impact a wide array of companies that work in any of the identified industries, including biotechnology, artificial intelligence and machine learning technology, position, navigation, and timing technology, microprocessor technology, advanced computing technology, data analytics technology, quantum information and sensing technology, logistics technology, additive manufacturing (e.g., 3D printing), robotics, brain-computer interfaces, hypersonics, advanced materials and advanced surveillance technologies.

Beyond the 2018 ANPRM related to emerging technology, it is important to note that the ECRA also contained a mandate to identify and define foundational technologies, for which export controls are needed. While it is expected that BIS will publish a second ANPRM to define and seek public input on export controls for foundational technologies,⁴ this has not yet happened.

While the exact technologies and industries affected by the ECRA have yet to be identified, it is likely that these changes will affect a large number of companies given the wide array of new technologies that might be added to the EAR. However, it is unclear if SMEs will be aware of the expanded scope of export controls or if it will further incentivize them to develop ICPs or buy the TCIP. The effects of the ECRA on the awareness of SMEs regarding export controls is a topic for further analysis.

¹ John S. McCain National Defense Authorization Act for Fiscal Year 2019, Pub. L. No. 115-232 (2018).

² The statutory authority of the EAR was initially provided by the Export Administration Act of 1979 (EAA). Since the EAA lapsed in 2001, the EAR has been reauthorized by the president by executive order.

³ Docket No. 180712626–8840–01, Department of Commerce, Bureau of Industry and Security, 19 November 2018, <https://www.federalregister.gov/documents/2018/11/19/2018-25221/review-of-controls-for-certain-emerging-technologies>.

⁴ <https://www.jdsupra.com/legalnews/update-on-u-s-government-review-of-93470/>.

Finding #5: The increased enforcement activities by the U.S. government for trade control violations cause concern for industry. It is uncertain if this activity is sufficient to raise awareness amongst SMEs and encourage them to improve compliance and/or seek TCIP-like products.

Beyond expanding the scope of export controls through the ECRA, the U.S. government is also strengthening the enforcement of trade controls, a trend which is causing concern in portions of industry aware of trade controls. In fact, since January 2017, the current administration has increased export control investigations by 21%,¹ and on 16 May 2019, BIS added Huawei Technologies — the largest telecommunications equipment producer in the world — and 68 affiliates to the DOC Entity List. Another 46 Huawei affiliates were subsequently added to the Entity List on 21 August, bringing the total to 114 Huawei affiliates. While BIS has issued a temporary general license for the listed companies that would allow engagement for certain transactions until 18 November 2019, further engagement with these companies is uncertain as trade tensions continue between the United States and China. In any case, this action taken against Huawei, combined with the 2018 enforcement action against ZTE,² demonstrate that the current administration intends to use export controls more forcefully than it has in the past, perhaps eventually rivalling OFAC's aggressive enforcement of sanctions.

The project team's research in 2019 confirmed that companies in a wide array of industries are aware of and concerned by the increasing enforcement actions, as many are uncertain how it will affect their business. However, as this relates to the TCIP, the project team is uncertain whether increased enforcement action will encourage better trade compliance by SMEs. In fact, these changes could have a few possible impacts on trade controls: 1) SMEs remain unaware of the increased enforcement actions and therefore the actions do not impact their behavior, 2) the enforcement actions discourage SMEs from joining the export market altogether, or 3) enforcement actions may encourage SMEs to invest in ICPs (and eventually to seek TCIP-like coverage). The effect of export control enforcement actions on trade compliance by SMEs is an interesting question that deserves further analysis.

Finding #6: There is increased pressure from regulators on insurance companies and financiers to play a larger role in identifying sanctions non-compliance, but there are limits to what insurers and banks can do.

The recent increase in trade compliance enforcement actions has increased the pressure on banks and insurers to identify sanctions violations, but it has also presented new challenges for these industries. For example, representatives from FIs noted they are not in a position to assess trades compliance programs or identify trade control violations. Both insurers and banks said they have felt vilified by regulators for not performing these tasks that are outside their scope of business. FIs argue that the responsibility for trade controls and sanctions should fall with the entity trading the commodity, which is why their contracts typically put the burden on the policy holder. The FIs interviewed further noted that there are gaps and limitations in the

¹ At the recent Annual Conference on Export Controls and Security, Secretary Ross stated, "Since the start of 2017, BIS has initiated 2,284 export control investigations, a 21 percent increase in the number of cases opened from the previous two-and-a-half years."

² In June 2018, BIS imposed a \$1.1 billion civil fine on ZTE, in combination with other fines already imposed, making it the largest BIS enforcement action in history. For more information, see: <https://www.bis.doc.gov/index.php/documents/pdfs/2401-2018-bis-annual-report/file>.

data they have available for assessing trade compliance. These data gaps are particularly important when looking at insurance in the shipping industry, because the different nodes and the paper-based nature of the network makes it very difficult for insurers in the shipping industry to gather the type of data the government appears to expect them to have. Collecting information beyond what is needed for business and identifying sanctions violations is not part of these companies' business models. If the government wants this information, they should regulate for it, but companies felt demanding "excess" information collection without legislative basis is unreasonable and ineffective.

Insurers and bankers additionally expressed anxiety (and some frustration) over the fast-evolving nature of U.S. trade policy and the differences in sanctions policies between the United States and the European Union concerning Iran and Russia. One issue that came up several times with insurance representatives was the use of OFAC "gray lists."¹ These lists pose a particular challenge for insurers, because contractually insurers cannot break cover for a company if it is on the gray list but has not actually been designated by OFAC. Additionally, since the gray lists provide little information as to why a company has been added, the insurance companies often have no recourse to break cover on the "gray listed" company² and must continue providing coverage until the company is officially listed. Banks, however, seem less bothered by gray lists. For example, a bank can simply choose to stop financing an entity on a gray list. These types of distinctions between how various sectors perceive gray lists highlight the need for different regulatory approaches for sectors and highlight how different enforcement approaches by different regulators may be leaving gaps in the nonproliferation regime. Additionally, gray lists also present general problems for due process; a listed party is denied access to financing and property without having received the necessary due process to be designated and without any formal process for appeal.

Finally, it should be noted that, despite the complaints regarding trade controls, insurers think that increased pressure from regulators could encourage them to invest more in emerging technology and increase the availability of data, especially regarding the shipping industry. There are private companies that provide shipping data and analysis, and in the future insurers may need to invest more in ship tracking and data consolidation services. The lack of standardization in shipping industry data will pose challenges for assessing the industry on its trade compliance activities. However, if insurers begin to demand this data as a condition of coverage, then the industry may adapt, just as other industries have adapted to accommodate the sanctions requirements of the banking sector. One lesson learned from the interviews though is that banks and insurance companies are unlikely to demand data that does not support their business models unless regulators require it.

¹ A *Gray List* is a list of entities (e.g., ships, companies, persons) included within OFAC advisories of entities suspected of sanction violations but which have not been legally designated. An example of a *gray list* is Annex 2 of the OFAC North Korea Sanctions Advisory, dated 21 March 2019. https://www.treasury.gov/resource-center/sanctions/Programs/Documents/dprk_vessel_advisory_03212019.pdf.

² If more information was provided, it is possible that insurers could find that other material provisions of the contract had been violated, allowing them to terminate the contract. Such termination is not possible based on inclusion on an OFAC "gray list."

5.0 Recommendations

The project team ultimately concluded that the TCIP is not a marketable incentive to strengthen trade compliance in SMEs at this time. However, the engagement with industry on the TCIP concept yielded several important findings that may ultimately contribute to other industry incentives and help inform U.S. nonproliferation policy.

5.1 Industry Outreach Next Steps and Sharing Best Practices Across Industries

Considering the findings and additional areas of research identified in this paper, the project team recommends continued industry engagement and outreach in a few targeted areas. The areas include:

- **Trade Compliance Incentives** – Though the TCIP was found to not be marketable at this time, industry noted that the TCIP highlighted an important gap in insurance and compliance. Incentives are needed to improve compliance amongst companies who are unaware of trade compliance risks and protect companies from trade control enforcement actions caused by honest mistakes.
- **Sharing Trade Compliance Practices Across Industries** – Sanctions enforcement is expanding and affecting industries, like the insurance industry, that were previously ignored. Fortunately, other industry sectors, like finance, already have experience with sanctions compliance and may be able to share some of their lessons learned.
- **Identifying Industry Distinctions** – While lessons in trade compliance can certainly be shared across industry sectors (finance, insurance, manufacturing, shipping), it is also important to acknowledge the distinctions between the sectors, as some incentives will be more effective for one sector than another. This is especially true with regards to differentiating banks from insurance companies.
- **Different Regulatory Approaches Across the Supply Chain** – Different government agencies approach their regulated entities differently, which can result in gaps or unequal nonproliferation compliance practices across the nuclear supply chain. Understanding the whole supply chain and identifying places where regulations may not be robust enough (or too robust) to effectively meet policy goals would be useful for reducing nonproliferation risks.

PNNL is organizing a workshop in FY20 to address these issues by bringing together key industry stakeholders, including manufacturers, financiers, freight forwarders, shippers, and insurers, to discuss trends and incentives in trade compliance and identify shared best practices and distinctions among the industries.

5.2 Next Steps for Further Research

The project team does not recommend further exploration of the TCIP concept at this time, but the feedback from industry did identify additional areas of research to inform future market incentives and trade compliance policies. Specifically, the following research areas were identified:

- **Standard Development:** Could an industry standard for trade compliance be developed to help establish a minimum level of compliance? If such a standard is backed by the U.S. or other governments, it could help banks and insurers better assess a company's trade compliance program and limit the legal liability of a company that meets the standard.
- **Better Understanding the SME Market:** The 2019 research indicated that SMEs think about trade compliance differently from the larger manufacturers, insurers and financiers that were interviewed for this study. As the scope and enforcement of export controls expands, understanding how SMEs think about export controls will be more important as more SMEs are directly affected. Direct outreach to SMEs may be necessary to understand their awareness of export controls and what incentives will be most effective in strengthening their export control compliance.
- **Distinctions Among Industry Sectors:** What can be learned from the distinctions in how different industry sectors think about trade compliance? The 2019 research indicated that trade control tools and incentives use by the U.S. government (e.g., gray lists) can have very different impacts in the affected industry sectors. A better understanding of those distinction may help develop better trade control incentives in the future and improve nonproliferation outcomes.
- **Lessons from Specialized Industries:** Would specialized insurance or trade associations share their feedback on how they manage risks associated with trade compliance? For example, insurers that provide coverage to companies active in the nuclear supply industry may have lessons that are valuable for the insurance industry more broadly.

6.0 References

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