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United States Department of State
Office of Inspector General

Report of Audit

DEPARTMENT OF STATE
DEFENSE TRADE CONTROLS

2-CI-016

MARCH 1992

UNCLASSIFIED

United States Department of State

The Inspector General

Washington, D.C. 20520

PREFACE

This report was prepared by the Office of Inspector General in fulfillment of our responsibilities mandated by the Inspector General Act of 1978 and by Section 209 of the Foreign Service Act of 1980. It is one of a series of audit, inspection, security oversight, investigative, and special reports issued by my office as part of our continuing efforts to promote positive change in the Department of State and to identify and prevent waste, fraud, abuse, and mismanagement.

The report is the result of a careful effort to assess both the strengths and weaknesses of the post, office, or function under review. It draws heavily on interviews with employees of the Department of State and other interested agencies and institutions, and reflects extensive study of relevant documents and questionnaires.

The recommendations included in the report have been developed on the basis of the best knowledge available to the Office of Inspector General and have been discussed in draft with the offices responsible for implementing them. It is our hope that these recommendations will result in a more effective and efficient Department of State.

I wish to express my appreciation to all of the employees and other persons who cooperated in the review documented by this report.

Sherman M. Funk

DEPARTMENT OF STATE
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ABBREVIATIONS

ACDA	U.S. Arms Control and Disarmament Agency
ADP	Automated Data Processing
AECA	Arms Export Control Act
DETAS	Defense Trade Applications System
DOC	Department of Commerce
DOD	Department of Defense
DOE	Department of Energy
DTC	Defense Trade Controls
FAA	Foreign Assistance Act
FMFIA	Federal Managers' Financial Integrity Act
GAO	General Accounting Office
GSA	General Service Administration
INR	Bureau of Intelligence and Research
ITAR	International Traffic in Arms Regulations
L	Office of the Legal Advisor
MTCR	Missile Technology Control Regime
NASA	National Aeronautics and Space Administration
OES	Bureau of Oceans and International Environmental and Scientific Affairs
PM	Bureau of Politico-Military Affairs
PM/PRO	Office of Weapons Proliferation Policy

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I. EXECUTIVE SUMMARY

U.S. defense trade exports are a multi-billion dollar a year business. Exports of defense articles and services also involve foreign policy and national security issues. The Arms Export Control Act (AECA) authorizes the President to control the export of items included on the U.S. Munitions List. The President, in Executive Order 11958, dated January 1977, delegated the responsibility for administering export functions of the Act to the Secretary of State. Within the State Department that function was delegated to the Bureau of Politico-Military Affairs (PM), Office of Defense Trade Controls (DTC). Under current practice, the U.S. Customs Service is primarily responsible for conducting law enforcement activities. We have not reviewed the adequacy or modalities of State Department and U.S. Customs law enforcement roles and responsibilities. In future work, we plan to look into State's enforcement responsibilities under the AECA and International Traffic in Arms Regulations (ITAR).

DTC is responsible for administering the ITAR which contain the U.S. Munitions List and regulations governing the export of items on the list. DTC is also involved in issues relating to other laws and regulations that govern the export of Munitions List items including the Trading with the Enemy Act, the Foreign Corrupt Practices Act, the Internal Security Act of 1950, the Atomic Energy Act of 1954, the Export Administration Act, the Comprehensive Anti-Apartheid Act of 1986, and the Missile Technology Control Regime (MTCR). DTC carries out its responsibilities by registering persons and companies involved in defense trade, reviewing export license applications, and ensuring compliance with the AECA and other applicable laws and regulations.

U.S. industry has a strong interest in a fast and predictable export licensing process. According to DTC officials, in the late 1980s DTC could not keep pace with a dramatic increase in the volume of munitions export license applications because staffing was inadequate and licensing was handled manually. Congressional and industry concerns prompted a review of DTC by the General Accounting Office (GAO). GAO found that DTC had significant problems with both its licensing and compliance functions. Further, the State Department's Federal Managers' Financial Integrity Act (FMFIA) report of 1987 cited munitions control as an area of material weakness.

Although DTC added staff and resources during 1988 and 1989, an Office of Inspector General (OIG) inspection of PM in mid-1989

found that many of the same problems remained at DTC. In November 1990 OIG began an audit to examine the effectiveness of the licensing and compliance functions and to assess how DTC had resolved the problems identified by GAO and the OIG inspectors. OIG also reviewed the upgrade of the DTC automated data processing system and the results of the review are found in the report, Bureau of Politico-Military Affairs Automated Data Processing Upgrade Project, 02-CI-006, November 1991.

VIOLATIONS OF ARMS TRANSFER RESTRICTIONS

The AECA requires the State Department to control the export of Munitions List items and to develop standards for identifying high-risk exports for regular end use verification to ensure that the items are not transferred to other countries, entities, or individuals without prior U.S. authorization. Further, Section 3 of the Act requires that a report be provided to the Congress if any information is received that an unauthorized transfer of certain items has or may have occurred. According to the Office of the Legal Advisor (L), a Section 3 report is required if it is determined that a substantial violation of government to government agreements on retransfers or use of defense articles or services sold by the Defense Department "may have occurred." A Section 3 report is also required if reliable information is received that defense articles have been transferred without prior U.S. consent under specific circumstances.

According to L, the Section 3 reporting requirement does not generally apply to non-U.S. Government commercial sales. If, however, the original acquisition cost was more than $14 million for major defense equipment or more than $50 million for any defense article or service the Section 3 reporting requirement is mandatory. L stated that Section 3 reports are not mandatory if the cost of the items retransferred do not meet the monetary thresholds, unless the unauthorized transfer violates specific government-to-government assurances. Additionally, the ITAR requires that all foreign recipients of any significant military equipment or major defense equipment, commercial or government-to government, certify that the items will not be retransferred without prior written approval of the United States.

We found that PM had received many reports of significant alleged violations of the AECA and ITAR retransfer restrictions by a major recipient of U.S. weapons and technology. The reports describe a systematic and growing pattern of unauthorized transfers of sensitive U.S. items and technology by the recipient dating back to about 1983. The alleged violations include sales of sensitive U.S. items and technology to countries prohibited by U.S. law from receiving such items. Despite receiving this information over the past few years, PM did not initiate steps to report the violations to Congress and did not inform senior Department officials of the reported violations. Only recently,

and only after OIG involvement, has PM taken action to curtail the reported unauthorized transfers. Additional details on the violations are included in the classified annex to this report.

In June 1991, the Inspector General informed the Secretary of State of the reported violations and recommended that the Department inform appropriate congressional Members and Committees of the reported violations in accordance with the AECA. The Secretary instructed the Deputy Secretary to 1) review the information provided by the OIG; 2) if verified, have the necessary report prepared; and 3) establish formal procedures for ensuring that future AECA violations would be reported. The Department issued formal reporting procedures in August 1991. On September 18, 1991 the Deputy Secretary provided an oral report regarding the alleged violations to the appropriate congressional Members and Committees. A written Section 3 report was transmitted to the appropriate Members and Committees on March 6, 1992.

Recoupment of Funds

Some of the items reportedly retransferred may have been provided to the recipient under Section 506 of the Foreign Assistance Act (FAA) of 1961, as amended, with Section 505 assurances which require that the U.S. be paid the net proceeds from the sale of any item furnished under the act. Because the seller has allegedly attempted to conceal the reported transfers, it will be difficult to quantify amounts which might be due the United States.

The report contains recommendations aimed at ensuring that the violations are halted and steps are taken to recoup any funds properly due the United States. Furthermore, based on the findings of our review, we plan to recommend separately that the Director General of the Foreign Service and Director of Personnel take appropriate disciplinary action against the responsible PM official for past failure to (1) properly control and verify the end use of munitions list exports, (2) initiate reports of violations to the Congress, and (3) take timely steps to stop unauthorized transfers.

IMPROVEMENTS AT DTC

During 1990 DTC initiated a number of significant management initiatives aimed at making its licensing and compliance functions more efficient and effective. DTC wanted to decrease a serious backlog of license applications and substantially reduce the time needed to process export license applications, ensure that licenses are not approved for improper transactions and, at the same time, control the ultimate destination and end-use of defense exports.

The management initiatives have been largely successful in improving licensing operations and, as a result, DTC has eliminated the backlog and is now processing licenses in a reasonable length of time. The average processing time was reduced in 1990 to four days for 71 percent of license applications. DTC accomplished these improvements primarily by increasing staff and installing a new computer system during 1990.

DTC also initiated measures that have resulted in improved screening of applicants and increased compliance and enforcement capabilities. This includes a coordinated effort by DTC and the U.S. Customs Service to ensure that all registrants and all parties to a proposed export are screened. Applicants are screened through several databases and, if any derogatory information is found, DTC "flags" the registrant in its computer database. If a flagged registrant applies to DTC for an export license, DTC may refer the application to another agency for review, subject it to end-use monitoring, or deny the application.

BLUE LANTERN END-USE CHECKS

In September 1990 DTC initiated a systematic end-use verification procedure known as "Blue Lantern." It includes prelicense and postshipment checks of export applications by DTC. The checks are conducted by designated officials at U.S. embassies. Since its inception, the Blue Lantern process has been useful in identifying a number of AECA and regulatory violations. However, improvements are needed in program management and implementation, especially in the processes for conducting the end-use checks. The report includes several recommendations to DTC which, if implemented, will improve the effectiveness of the Blue Lantern process.

ACCEPTANCE OF GOVERNMENT-TO-GOVERNMENT ASSURANCES

The United States has a strong interest in controlling the development of nuclear, biological, and chemical weapons and their delivery capabilities. Additionally, the United States wants to control the spread of advanced and sensitive weapons technologies. The United States often obtains assurances from the recipient governments that they will not retransfer sensitive items and technologies and will limit the use of these items and technologies. However, we found that government-to-government assurances are not an effective mechanism for providing end-use verification. We identified instances where U.S. items and technology were retransferred or were used in violation of the assurances.

Blue Lantern end-use checks of items exported under such government-to-government assurances raise problems involving the

conduct of foreign relations. Foreign governments may view such checks as an infringement of their sovereign rights. The report contains a recommendation that appropriate U.S. officials notify foreign governments of the enhanced U.S. arms control mechanism being implemented.

MANAGEMENT'S RESPONSE

The Deputy Secretary, PM, and L provided comments on a draft of this report. The Deputy Secretary commented that steps have already been taken to halt the AECA violations, new procedures are in place and are working, and further actions are planned. Additionally, the Deputy Secretary stated that he would ask the Under Secretary for International Security Affairs to explore the most appropriate and effective way for ensuring that foreign governments understand the requirements of U.S. law and licensing procedures, follow-up requirements, and the steps that will be taken in cases of non-compliance.

The Deputy Secretary stated he does not agree with the OIG recommendation that recoupment should be sought of funds obtained from the unauthorized sale of retransferred items. According to the Deputy Secretary, L can find no legal basis for this action in the AECA and it would be virtually impossible to determine a value for the alleged transfers in question. In response to the Deputy Secretary's comments, OIG modified the report section and recommendation dealing with recoupment of funds. OIG acknowledged the difficulty in determining the amount of funds which might be recouped and now specifically states that recoupment should be sought only where there exists a sound legal basis.

The Deputy Secretary also stated that he does not believe that disciplinary action against responsible PM officials is warranted at this time. The Inspector General is fully convinced that the circumstances evidenced in the audit report require that disciplinary action be recommended against the responsible official. Not to recommend disciplinary action would be inconsistent with previous OIG disciplinary action recommendations, OIG responsibilities in the areas of waste, fraud, and abuse, and the Secretary's mandate to the IG to promote accountability within the Department.

Additionally, the Deputy Secretary noted that the draft report does not give sufficient prominence to significant progress and improvements made by PM/DTC and that L has identified several statements in the report that are not technically, legally correct. The report has been modified to more clearly describe progress and improvements made by PM/DTC and to address L's comments.

The comments provided by the Deputy Secretary and PM, which include comments from L, are reprinted as Appendices B and C to this report, respectively, together with OIG analyses and responses. A classified annex to this report, which details specific cases and countries that we reviewed, is being issued as a separate addendum to this report. It also includes PM comments on the information contained in the annex and the OIG analysis and response to the comments. The annex will be provided to appropriately authorized officials.

II. PURPOSE AND SCOPE

The objective of this audit was to review PM procedures for licensing the export of Munitions List items and technology and ensuring that such exports are in compliance with provisions of the AECA, other legislation governing arms transfers, and the ITAR. This report addresses the licensing and compliance processes, including an examination of how PM resolved weaknesses in the licensing process identified by the 1989 OIG Inspection and by GAO in its report Licensing Reviews for Exporting Military Items Can Be Improved, GAO/NSIAD-87-211, September 1987, and the effectiveness of procedures implemented by PM to ensure that Munitions List items are exported only to proper recipients for approved purposes. A separate audit report, Bureau of Politico-Military Affairs Automated Data Processing Upgrade Project, 02-CI-006, November 1991, deals with the upgrade of the automated date processing (ADP) system used to process and track arms export licenses.

Our review involved the following Department of State offices: Office of the Deputy Secretary, Executive Secretariat, Under Secretary for International Security Affairs, Office of Legal Adviser, PM, Bureau of Near Eastern and South Asian Affairs, Bureau of Oceans and International Environmental and Scientific Affairs (OES), and Bureau of Intelligence and Research (INR). We also obtained information from other agencies including the Department of Defense (DOD), U.S. Arms Control and Disarmament Agency (ACDA), Defense Intelligence Agency, Central Intelligence Agency, Department of Energy (DOE), Department of Commerce (DOC), and the U.S. Customs Service. We discussed arms trade and arms control issues with officials in these offices and agencies to identify matters of concern and to ascertain their views on the effectiveness of the arms export compliance process. Our audit findings on arms trade and control issues are contained in section IV of this report.

To determine the effectiveness of end-use monitoring procedures, we visited posts in Brazil, Korea, Singapore, Israel, Italy, France, and the American Institute in Taiwan. At the posts, we examined methods developed by the particular posts to conduct end-use checks and participated in a number of actual checks. The items we checked ranged from equipment, such as small arms and ammunition, to sensitive missile testing and production technology.

During this audit, the State Department drafted procedures intended to ensure that the Congress is notified promptly when information is obtained concerning unauthorized transfers or misuse of Munitions List items. Department officials also indicated that end-use monitoring of exports to countries or companies reportedly engaging in such transfers or misuse would be improved.

This review was conducted in accordance with generally accepted government auditing standards and included such tests and auditing procedures as were considered necessary under the circumstances. Audit work for this review was conducted from September 1990 to December 1992.

III. BACKGROUND

The AECA authorizes the President to control the commercial export of items included on the U.S. Munitions List. Exports of such items can be approved only when they are consistent with the foreign policy and national security interests of the United States. The President, in Executive Order 11958, dated January 1977, delegated responsibility for administering the export functions of the Act to the Secretary of State and at the same time, by power of delegation authority by the Secretary of State, regulations pursuant to this Act are administered by PM/DTC, formerly the Office of Munitions Control. Under current practice, the U.S. Customs Service is primarily involved in law enforcement activities. We have not reviewed the adequacy or modalities of State Department and U.S. Customs law enforcement roles and responsibilities.

DTC administers the ITAR which governs the export of Munitions List items. DTC is responsible for registering exporters, issuing export licenses, screening license applicants to identify persons and companies not eligible for export licenses, identifying high-risk exports for end-use verification, and administering AECA and other applicable laws and regulations.

DTC is also involved in issues related to other laws and regulations which govern the export of Munitions List items, such as the Trading With the Enemy Act, the Foreign Corrupt Practices Act, the Internal Security Act of 1950, the Atomic Energy Act of 1954, the Export Administration Act, the Comprehensive Anti-Apartheid Act of 1986, and the MTCR. These laws and regulations generally restrict the export of certain types of equipment and technology or prohibit trade with certain countries. For example, the Comprehensive Anti-Apartheid Act codified the United Nations resolution calling for sanctions against South Africa. The Act made transfers of certain items to South Africa a violation of U.S. law.

The MTCR is another measure restricting U.S. exports. The MTCR is an arrangement signed by a group of 15 countries, including the U.S., restricting the proliferation of missiles and related technology capable of delivering nuclear warheads. The MTCR consists of export guidelines and a list of the equipment and technologies controlled under the regime. According to DTC, about 80 to 90 percent of the MTCR related exports are Munitions List items controlled by DTC.

DEFENSE TRADE REORGANIZATION

The State Departments' defense trade function was significantly reorganized in January 1990 in order to provide improved export licensing services and defense trade policy guidelines to the U.S. defense industry. The Office of Munitions

Control, was renamed the Center for Defense Trade and divided into two offices: the Office of Defense Trade Policy, which establishes policy guidelines for defense trade, and DTC, which is responsible for registering exporters, approving or denying export licenses, and ensuring compliance with applicable laws and regulations.

Increase in DTC Staff

In 1987 DTC's predecessor had a staff of about 30 personnel comprised of a management staff of four people, a licensing division of about 16, and a staff of three who did compliance work. DTC now has a staff of about 65 personnel. The Office of the Director has six persons, including one DOD detailee. The computer support staff consists of three full-time personnel and a contract consultant. The administrative support staff has six full-time personnel,four contractors, and a varying number of part-time State employees. The Arms Licensing Division has 33 staff members, including 22 licensing officers of which there are five DOD personnel and two contractors. The licensing officers are responsible for reviewing specific types of license applications and specific U.S. Munitions List categories. The Compliance Analysis Division has 11 full-time personnel, including six paralegal specialists and two U.S. Customs personnel detailed to coordinate law enforcement activities.

PM has requested additional staff for DTC and in May 1990 determined that adding 27 new licensing positions was justified. Although PM requested the 27 positions in FY 1990, it was only able to fill an additional 17 positions. DOD has detailed six personnel to work as licensing officers, however, PM is concerned that, when the two year assignment at DTC is completed, DOD will not reassign staff to DTC. In FY 1991 PM requested an additional 15 positions, but none were approved by the Department.

REGISTRATION AND LICENSING PROCEDURES

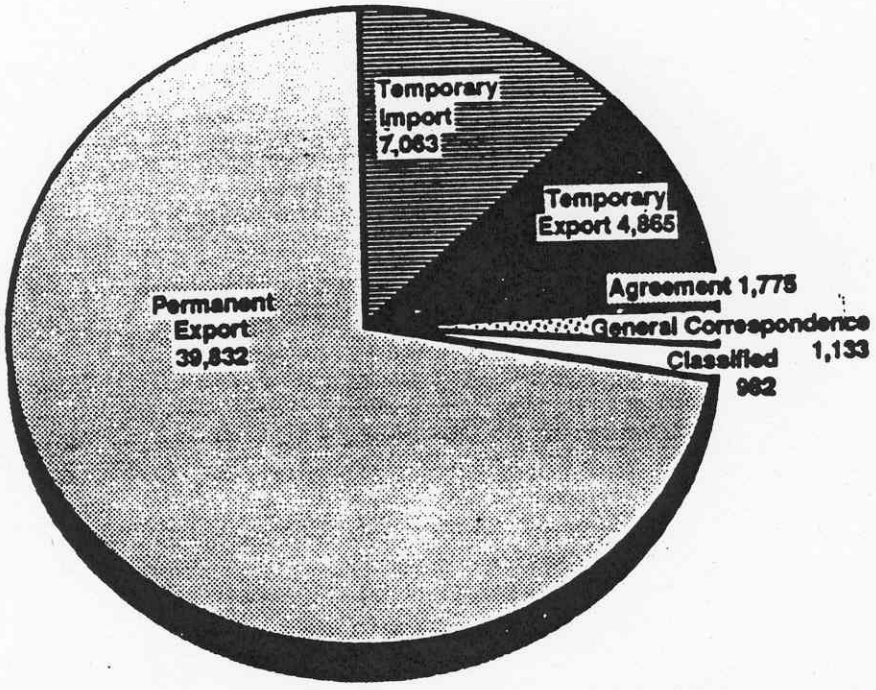
The regulations governing Munitions List exports require all manufacturers and exporters of defense articles to register with DTC. As of July 1991, there were 4,141 active registrations of manufacturers/exporters. Registration is required for all entities prior to applying for an export license, except for officers and employees of the U.S. Government acting in an official capacity, producers of only unclassified technical data, manufacturing and exporting activities that are licensed under the Atomic Energy Act, and fabricators of experimental or scientific articles only.

DTC's most easily quantifiable workload is currently in the licensing process. Over the past three years, DTC has received an average of 55,000 export application requests each year. These requests are comprised of applications to export end items

and spare parts, agreements on manufacturing items and components, agreements on technical assistance, and general correspondence. Figure III.1. illustrates the types and numbers of license applications DTC received in 1990.

Figure III.1. - 1990 License Applications

1990 LICENSE APPLICATIONS



Permanent Export -- shipping unclassified defense items and related technical data on a permanent basis.

Temporary Import -- receiving an item for repair, modification, or other purpose and returning it directly to the country from which it was sent.

Temporary Export -- taking an item overseas, e.g., to display at a trade show, with the plan to return the item to the United States.

Agreements -- involving a license agreement to grant rights for manufacturing a U.S. defense item; or a technical assistance agreement for the performance of defense services or disclosure of technical data.

General Correspondence -- for a licensed item to be reexported, retransferred, or disposed of outside the country of ultimate destination.

Classified Export -- permanently or temporarily shipping classified defense items and related technical data.

Interagency Coordination

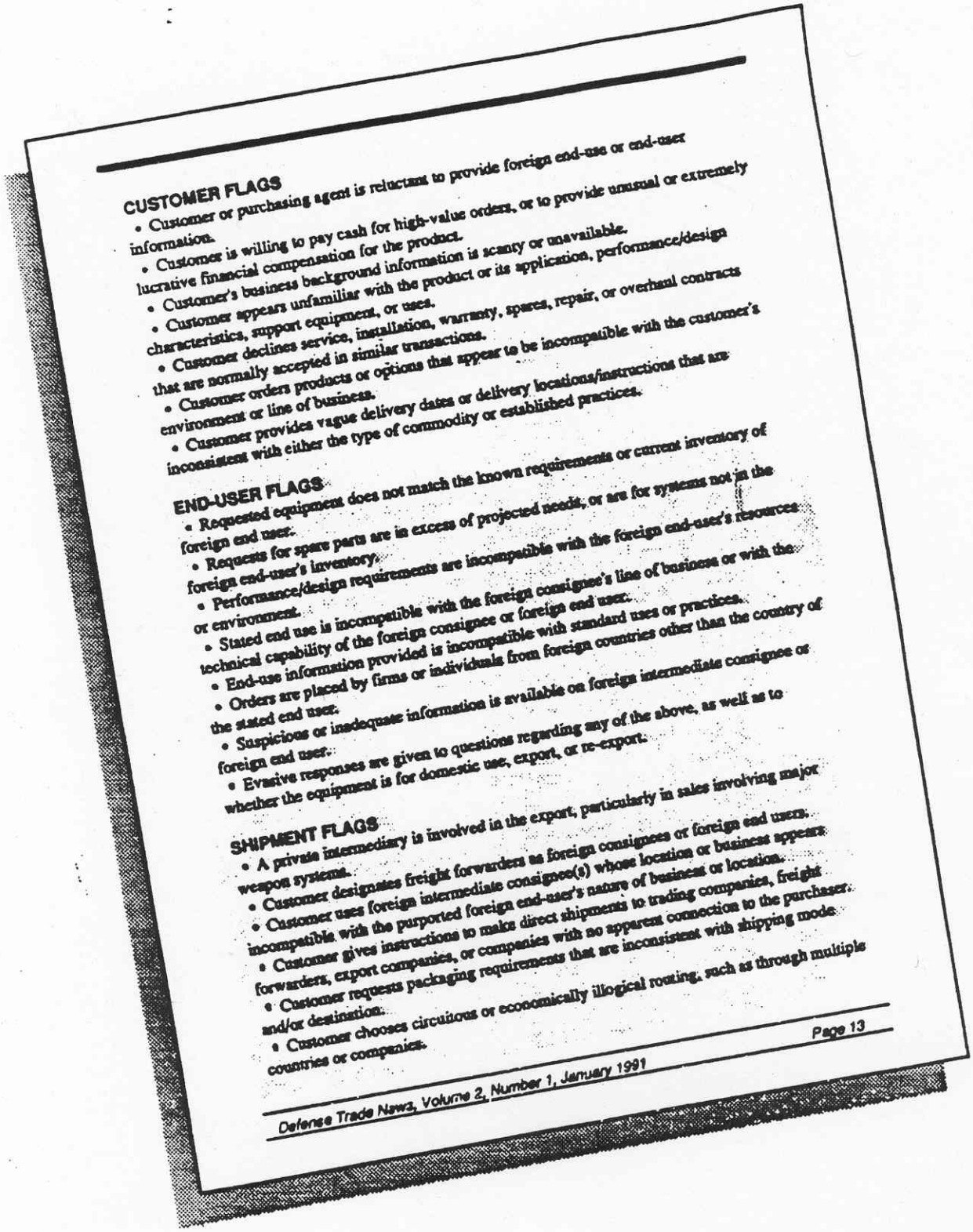
Approximately 25 percent of license applications are referred to other agencies for review. When DTC has concerns about technical or policy issues related to an application, it will refer the application to DOD, ACDA, DOE, National Aeronautics and Space Administration (NASA), or to other bureaus within the State Department requesting recommendations for approval or disapproval of the license request. The reviewing office or agency can recommend that DTC issue, deny, or return the license application to the applicant without action. The reviewing agency can also recommend not issuing a license unless the applicant agrees to restrictions on an item's end-use.

DTC has established special procedures for handling applications to export MTCR-related items. Applications are sent for review to DOD, ACDA, the relevant geographic bureau, and, in some instances, NASA and OES. MTCR cases are also sent for review to either the Missile Tech Analysis Group or the Missile Tech Export Control Group. Both are interagency groups chaired by the State Department's Bureau of Politico-Military Affairs, Office of Weapons Proliferation Policy (PM/PRO).

COMPLIANCE PROCEDURES

The AECA requires that no defense article or service shall be sold or leased by the U.S. Government to any country unless that country agrees not to transfer the article to another country or use it for purposes other than those for which furnished, without prior approval of the U.S. Government. Additionally, the ITAR requires that all foreign recipients of significant military equipment or major defense equipment certify that the items will not be retransferred without prior written approval. The AECA also requires DTC to develop and publish standards for identifying high-risk exports for regular end-use checks. Accordingly, DTC developed a list of indicators, or "flags" as referred to below, of potential illegal defense exports. (See figure III.2.)

Figure III.2. - Flags



CUSTOMER FLAGS

- Customer or purchasing agent is reluctant to provide foreign end-use or end-user information.
- Customer is willing to pay cash for high-value orders, or to provide unusual or extremely lucrative financial compensation for the product.
- Customer's business background information is scanty or unavailable.
- Customer appears unfamiliar with the product or its application, performance/design characteristics, support equipment, or uses.
- Customer declines service, installation, warranty, spares, repair, or overhaul contracts that are normally accepted in similar transactions.
- Customer orders products or options that appear to be incompatible with the customer's environment or line of business.
- Customer provides vague delivery dates or delivery locations/instructions that are inconsistent with either the type of commodity or established practices.

END-USER FLAGS

- Requested equipment does not match the known requirements or current inventory of foreign end user.
- Requests for spare parts are in excess of projected needs, or are for systems not in the foreign end-user's inventory.
- Performance/design requirements are incompatible with the foreign end-user's resources or environment.
- Stated end use is incompatible with the foreign consignee's line of business or with the technical capability of the foreign consignee or foreign end user.
- End-use information provided is incompatible with standard uses or practices.
- Orders are placed by firms or individuals from foreign countries other than the country of the stated end user.
- Suspicious or inadequate information is available on foreign intermediate consignee or foreign end user.
- Evasive responses are given to questions regarding any of the above, as well as to whether the equipment is for domestic use, export, or re-export.

SHIPMENT FLAGS

- A private intermediary is involved in the export, particularly in sales involving major weapon systems.
- Customer designates freight forwarders as foreign consignees or foreign end users.
- Customer uses foreign intermediate consignee(s) whose location or business appears incompatible with the purported foreign end-user's nature of business or location.
- Customer gives instructions to make direct shipments to trading companies, freight forwarders, export companies, or companies with no apparent connection to the purchaser.
- Customer requests packaging requirements that are inconsistent with shipping mode and/or destination.
- Customer chooses circuitous or economically illogical routing, such as through multiple countries or companies.

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Additionally, the AECA, as amended by the National Defense Authorization Act of 1990, provides for imposing trade sanctions under specific circumstances against certain U.S. and foreign persons that knowingly export or transfer missile related items and technology to non-MTCR countries.

In order to identify high-risk or suspicious cases, DTC installed a flagging system in its computer database. The system is based on inputs from U.S. Customs, the Department of Justice, DOC, and the General Services Administration (GSA). This allows DTC to identify suspicious exports before a license is approved. U.S. Customs generates a list for this purpose by searching its database for ongoing investigations of criminal activities, indictments, or convictions under the 11 statutes referred to in Section 38 of the AECA. The list includes the names of companies and individuals. According to DTC, it will soon be able to access the U.S Customs' database directly and is also working toward developing a computer link with the U.S. Attorney's Office. The flagging system also uses convictions data obtained from the Executive Office of the U.S. Attorney and from the Administration Office of the U.S. Courts. GSA provides DTC with a list of parties who are ineligible to contract with the U.S. Government. In addition, DTC checks its database of flagged companies against DOC's Table of Denial Orders.

DTC Blue Lantern Initiative

In September 1990, DTC initiated end-use verification procedures known as "Blue Lantern." The procedures are intended to provide a mechanism for verifying that information stated on export license applications is valid and that the use of the commodity or service exported is consistent with the terms of the license. The Blue Lantern process includes prelicense and postshipment checks, which are to be conducted by designated Blue Lantern officials at U.S. embassies.

A prelicense check is conducted to determine if the stated recipient is eligible to receive Munitions List items, has ordered the items, and intends to use them as indicated on the license application. A postshipment check is conducted to verify that items have been received and are being used in accordance with the license terms and provisions. Blue Lantern checks are initiated by DTC based on (1) the selection criteria developed to "flag" potential illegal exporters, (2) input from licensing officers, (3) tips from U.S. Customs, and (4) concerns raised by ACDA, PM/PRO, INR, and other intelligence sources. Checks can be initiated when exports raise political or security concerns or derogatory information becomes known about the parties involved.

PROBLEMS PREVIOUSLY IDENTIFIED IN DTC OPERATIONS

DTC's export licensing operation has been strongly criticized by U.S. exporters, Members of Congress, and others interested in improving U.S. trade. In response to a congressional request, GAO reviewed DTC's timeliness, procedures, and compliance efforts. In a September 1987 report, GAO stated that DTC did not routinely check export license application data for accuracy or veracity, had insufficient facilities and ADP capabilities, and had inadequate procedures to ensure compliance with administrative and reporting requirements.

DTC officials told GAO that an increased workload and unchanged resources restricted their ability to comply with operational requirements. According to DTC officials, its workload had increased dramatically since 1977. The number of license applications received increased from 26,000 in 1977 to 56,000 in 1990 and, as the volume of license applications grew, so did their dollar value and complexity. Despite the growth in volume and complexity, DTC's staffing levels did not change and licensing operations continued to be handled manually. As a result, the length of time required to process a license increased and exporters, concerned that they might be losing sales, complained to the State Department and Congress.

The State Department's FMFIA report of 1987 cited munitions control as an area of material weakness. The report stated that although the volume of license applications more than doubled in the period from 1977 to 1987, staffing levels remained nearly the same. According to the report, the system enhancements necessary to keep pace with the growing volume of workload had not been made. Delays in the issuance of licenses adversely impact U.S. business, while shortcuts designed to speed issuance can result in munitions sales which are either detrimental to national security or are politically embarrassing. The FMFIA report said that the September 1987 GAO report highlighted a number of weaknesses in the Munitions Control area, particularly on the compliance side.

Although DTC added staff and resources during 1988 and 1989, an OIG inspection of PM conducted in mid-1989 found that many problems remained. DTC still had insufficient resources and did little more than issue licenses. Compliance activities continued to be inadequate. The Inspection Report also noted serious problems in the development of a new automated licensing system.

We have completed a review of the ADP upgrade project and concluded in our report, Bureau of Politico-Military Affairs Automated Data Processing Upgrade Project, 02-CI-006, November 1991, that the effort to procure a sophisticated system from Wang failed because of improper management and a failure by Wang to successfully develop an essential software component. As a

result, PM expended $947,215 for a system that did not work. The IG recommended disciplinary action against the manager of the upgrade project. PM subsequently developed a system in-house which, at the time of our review, was performing effectively.

This report discusses the significant improvements made by DTC in its licensing operations and its initiatives aimed at meeting the compliance requirements of the AECA and other relevant statutes and regulations. The report includes recommendations which, if implemented, will further improve DTC compliance activities.

IV. FINDINGS

A. VIOLATIONS OF ARMS TRANSFER RESTRICTIONS

The AECA requires the State Department to control the export of Munitions List items and to develop standards for identifying high-risk exports for regular end use verification to ensure that the items are not transferred to other countries, entities, or individuals without prior U.S. authorization. Further, Section 3 of the Act requires that a report be provided to the Congress if any information is received that an unauthorized transfer of certain items has or may have occurred. According to the Office of the Legal Advisor (L), a Section 3 report is required if it is determined that a substantial violation of government to government agreements on retransfers or use of defense articles or services sold by the Defense Department "may have occurred." A Section 3 report is also required if reliable information is received that defense articles have been transferred without prior U.S. consent under specific circumstances.

According to L, the Section 3 reporting requirement does not generally apply to non-U.S. Government commercial sales. If, however, the original acquisition cost was more than $14 million for major defense equipment or more than $50 million for any defense article or service the Section 3 reporting requirement is mandatory. L stated that Section 3 reports are not mandatory if the cost of the items retransferred do not meet the monetary thresholds, unless the unauthorized transfer violates specific government-to-government assurances. Additionally, the ITAR requires that all foreign recipients of any significant military equipment or major defense equipment, commercial or government-to government, certify that the items will not be retransferred without prior written approval of the United States.

We found that reports of significant alleged violations of the AECA and ITAR retransfer restrictions by a major recipient of U.S. weapons and technology had not been properly acted upon by PM, which is responsible for initiating the reports of violations and ensuring compliance with U.S. laws and regulations governing arms exports. The violations include sales of sensitive U.S. items and technology to countries prohibited by U.S. law from receiving such items. The violations cited and supported by reliable intelligence information show a systematic and growing pattern of unauthorized transfers by the recipient dating back to about 1983. Despite receiving recurring evidence of violations over the past few years, and only after OIG involvement, PM has recently taken action to curtail the unauthorized transfers.

Additionally, we found that PM had not initiated a report of violations to Congress or informed senior Department officials of the reported violations. Because of the substantial evidence

that unauthorized large-scale transfers may have occurred over several years and PM's failure to act, the Inspector General informed the Secretary of State in June 1991 of the reported violations. The Inspector General recommended that the Secretary inform appropriate congressional Members and Committees of the reported violations in accordance with the applicable provisions of the AECA.

The Secretary instructed the Deputy Secretary to 1) review the information provided by the OIG; 2) if verified, have the necessary report prepared; and 3) establish formal procedures for ensuring that future AECA violations would be reported. The Department issued formal reporting procedures on August 24, 1991 (See appendix A) and on September 18, 1991, the Deputy Secretary provided an oral report to the Speaker of the House and the Chairman of the Senate Foreign Relations Committee. He also subsequently informed the Majority and Minority Leaders of the Senate and House of Representatives and the Chairman, Senate Permanent Select Committee on Intelligence. A written Section 3 report was transmitted to appropriate congressional Members and Committees on March 6, 1992. The classified annex to this report provides further details on this matter.

DTC has recently taken steps to curtail further unauthorized transfers by the recipient. License applications to export U.S. components for a number of weapons systems have not been approved. DTC has informed the recipient that the licenses will not be approved until questions pertaining to the sale of the systems to other parties are resolved. According to DTC, the recipient has not responded to the questions and, as a result, the licenses have not been approved.

Recoupment of Funds

Some of the items reportedly retransferred may have been provided to the recipient under Section 506 of the Foreign Assistance Act (FAA) of 1961, as amended, with Section 505 assurances which require that the U.S. be paid the net proceeds from the sale of any item furnished under the act. Because the seller has attempted to conceal the reported transfers, it will be difficult to quantify amounts which might be due the United States.

Blue Lantern End-use Checks

Since its inception the Blue Lantern process has been useful in identifying a number of AECA and regulatory violations. However, under PM's management of the program, the Blue Lantern activities for this major recipient were not effective. We found that, despite the reports of substantial unauthorized transfers by this recipient of U.S. weapons and technology, PM:

- o initiated Blue Lantern end-use checks only for small arms and ammunition destined for private firms,

- o initiated checks of the types of items mentioned in the reports of unauthorized transfers only after the audit team asked they be included,

- o instructed the post Blue Lantern official not to conduct actual end-use checks, and

- o instructed the official to accept oral and written government assurances as sufficient end-use verification.

For other recipients, the Blue Lantern checks included requests by DTC that posts conduct inspections of sensitive missile components and other high-technology items to verify actual end-use. Because of PM's instructions, no end-use verifications for this recipient were performed by the post.

Recommendation 1. We recommend that the Deputy Secretary take steps to ensure that the AECA and ITAR violations by a major recipient of U.S. military equipment and technology are halted. Future license approvals should be contingent on being able to conduct comprehensive end-use checks.

Recommendation 2. We recommend that the Deputy Secretary instruct the Under Secretary for International Security Affairs to determine, to the extent possible, the value of those unauthorized transfers involving U.S. items and technology and, where a legal basis for recoupment exists, obtain payment either directly or through future offsets for the appropriate amounts.

B. EFFECTIVENESS OF LICENSING PROCESS

DTC has significantly reduced processing time and is now processing license applications in a reasonable length of time. According to a 1990 DTC analysis, the average processing time for 71 percent of the applications was four days and the weighted average of all applications' processing time was 13 days. This is a significant reduction in the number of processing days reported by GAO in its 1987 report.

DTC accomplished this by increasing staff and installing a new computer system during 1990. DTC added 18 additional licensing officers to its staff in 1990, bringing the total number of licensing officers to 22. In addition DTC began using a new computer system, the Defense Trade Applications System (DETAS), in August 1990. The new system provides quicker access to more extensive license case information and reduces the time-consuming, manual file searches officers undertake daily to review precedent cases.

DTC also uses DETAS to monitor both quantitative and qualitative elements of the licensing process. During our review of DTC, we found no significant deficiencies in licensing operations. However, during the review of DTC's ADP system, problems were noted. These are discussed in detail in the our audit report titled Automated Data Processing Upgrade Project, 2-CI-006, November 1991.

Screening of Registration and License Applications

DTC has initiated a number of steps aimed at ensuring exporter and end-user compliance with the restrictive provisions of the AECA and other relevant laws and regulations. These measures have resulted in improved screening of applicants and increased compliance and enforcement capabilities. The screening of registration and license applicants has been significantly improved by the detail of U.S. Customs agents to DTC. Additionally, DTC has improved its coordination with the intelligence community, DOD, GSA, and DOC to identify possible irregularities in arms transactions.

DTC and the U.S. Customs Service began a coordinated effort in early 1990 to ensure that all registrants are screened. Customs now routinely screens registration applications through several databases for any derogatory information which might exist. The databases contain the names of companies and individuals being investigated or who have been indicted or convicted of U.S. criminal statute violations and the names of those ineligible to contract with the U.S. Government.

When derogatory information about an applicant is found, DTC flags the persons (individuals or corporate entities) in its computer system. All parties listed on registration statements and export license applications submitted are subjected to automated scrutiny. As a result of this enhanced review, license applications containing the names of flagged entities are more likely to be referred to other agencies for review, be subject to a Blue Lantern prelicense or postshipment check, or be denied.

OIG considers the procedures DTC has established to examine the backgrounds of registration and export license applicants to be effective in screening for inappropriate or ineligible exporters. Accordingly, we make no recommendations regarding this part of DTC's compliance activities.

C. MANAGEMENT OF THE BLUE LANTERN PROCESS

PM leadership should be commended for initiating the Blue Lantern process; it is a significant enhancement of U.S. defense trade control efforts by the Department of State to conduct overseas verification of export license applications and monitor the actual use of items by foreign recipients. However, we found

that major improvements are needed in program management and implementation, especially in the methods for selecting the Blue Lantern officials and conducting the end-use checks.

Selection of Blue Lantern Officials

When the Blue Lantern program began, DTC cabled all posts and requested that a Blue Lantern official be designated. In its cable, DTC did not describe the type of activities required or define the responsibilities of these personnel. The cable did not explain the intended scope of the program, how posts were to deal with foreign country concerns, what end-use check mechanisms were to be established, and other relevant information. As a result, the most appropriate personnel were, in many cases, not assigned as Blue Lantern officials and end-use check activities at posts vary widely.

For example, a Science Officer had been designated as the Blue Lantern official at one post we visited because the first request for an end-use check involved a high technology item. While appropriate for checking on some high technology items, the official does not have the appropriate background for conducting end-use checks of small arms and other weapons such as tanks and artillery. For those items the Foreign Commercial Service Officer, Defense Attache, or a Military Group Officer may be the most appropriate person to conduct the end-use check.

At two other posts we visited, Economic Officers had been designated as Blue Lantern officials. At both posts these officials did not conduct the end-use checks, but asked U.S. Customs officials at the posts to conduct the checks. According to the U.S. Customs officials, the Blue Lantern initiative is very useful to their law enforcement duties. However, they said that some cases are not appropriate for referral to them. They are generally not able to track items that have been retransferred or diverted with the consent of the foreign government. Furthermore, identifying instances of misuse or violations of restrictive technical provisos can often be beyond U.S. Customs areas of expertise.

An effective Blue Lantern working group had been established by one post we visited to respond to Blue Lantern end-use checks. The group is chaired by the Deputy Chief of Mission, headed operationally by the Foreign Commercial Counselor, and includes officials from the Office of Defense Attache, the Military Group, intelligence officials, and the Economic, Political, Science, and Commercial Sections. When the post receives a Blue Lantern request, the group meets to determine how to best conduct the check. For example, the group designated the Science Officer to check the use of a shipment of gyroscopes sent to a research institute. The Science Officer conducted the check during a routine visit to the institute. In another example, a check on a

shipment of handguns was conducted by the Foreign Commercial Service Office.

According to DTC officials, the designation of Blue Lantern officials was left to the posts because the posts can best decide how to use resources. At the posts we visited, however, we found that officials had little understanding of what steps were involved and what is intended to be accomplished by the Blue Lantern process. Although the officials generally attempted to provide sufficient responses to the end-use requests, their background and expertise are often not appropriate for performing end-use checks.

Guidance Provided Blue Lantern Officials

DTC has not provided adequate information to the posts concerning the scope, required procedures, and intended results of the Blue Lantern process. Post officials generally did not know what steps should be included in conducting the checks because DTC provided no overall guidance. In contrast, the Department of Commerce developed a manual, "Conducting Export Enforcement PreLicense Checks and PostShipment Verifications", which contains overall guidance for officials conducting end-use checks of Commerce controlled items.

Further, many DTC requests for end-use checks did not contain enough information. For example, DTC did not routinely state the purpose of the request. DTC should inform the post when the purpose is only to confirm that the stated recipient is, in fact, the actual recipient. However, when DTC wants to verify that the recipient is abiding by restrictions placed on the item's use or has not retransferred it, the checks will need to be more extensive.

Many license applications are approved subject to certain restrictions, referred to as provisos. For example, an export of a guidance system may be approved provided it is used in aircraft and not in missile applications. We found that DTC did not inform posts of provisos when requesting the end-use checks. As a result, the officials performing the checks were unaware of any restrictions on the use of an item.

The end-use requests should also provide information on the status of the transaction. For example, one post was asked to examine the use of an item by the recipient. The post found that the item had not yet been shipped and, therefore, its use could not be determined. According to DTC, it does not have an effective way of determining if an item has been shipped until export documentation is returned from Customs. However, DTC said it is developing a capability with U.S. Customs to determine when items are shipped.

DTC has not provided relevant regulations to posts. Blue Lantern officials have not received the ITAR, which contains information on the purpose of the licensing process, explains commonly used terms, and describes licensing forms. Another source of useful information is the Defense Trade News, which is published quarterly by DTC. It contains information on DTC activities, policies related to exports of Munitions List items, and identifies important contact points within DTC. Post officials also suggested that training be provided for Blue Lantern officials. Their suggestions included providing a segment on arms controls as part of the A-100 course for new Foreign Service Officers and at Strategic Trade Officers Conferences.

End-use Check Results

Initiation of the Blue Lantern process produced useful results almost immediately. At the posts we visited, Blue Lantern checks had identified the following possible irregularities:

- A postshipment check on a sale of small arms valued at $20,325 was initiated because the exporter was under investigation by U.S. Customs. The check showed that the address of the consignee was a boarded-up building and the consignee could not be located. The case has been referred to U.S. Customs and to the foreign government for further investigation.

- A postshipment check was requested because of concerns about the sale of propellants which can be used in missiles. The check showed that the end user had canceled its order and was, therefore, no longer a valid end user and DTC canceled the license.

- A prelicense check was requested on the proposed sale of an unusually large quantity of explosive ammunition. When interviewed by the post Blue Lantern official, the end user identified in the license application stated that his company had asked only for a bid for the items and was no longer interested in a purchase. Because the applicant did not have a firm purchase commitment before applying for a license, as is required under the ITAR, DTC did not approve the license.

- A postshipment check on the end-use of two automatic data measurement and transmission systems was initiated because of concerns that the items might be used in a missile development program. The license included a proviso barring retransfer and requiring that the items only be used in connection with manned aircraft. The end-use check showed that not all of the systems were at

the location stated on the license and that the items we examined were being used in connection with an unmanned aircraft program. According to DTC, it is attempting to resolve the irregularity.

- A prelicense check requested on the proposed sale of communications equipment, because of apparently circuitous routing of the equipment through three countries, showed that the shipment was also to be routed through a fourth country. The fourth country is prohibited from receiving equipment intended for military use. Although the items were to be installed in military vessels which were to then be resold, DTC approved the license.

The Blue Lantern process can be an effective tool for U.S. law enforcement. However, violators of U.S. export laws or licensing conditions frequently are not present in U.S. Territory and, thus, efforts of law enforcement officials are hampered unless there are relevant extradition treaties. The State Department is responsible for resolving such matters and ensuring that violations cease. however, DTC has not developed guidelines for resolving reported irregularities.

Recommendation 3. We recommend that DTC instruct posts that all appropriate post resources should be used in conducting Blue Lantern prelicense and postshipment checks. Blue Lantern officials should be of sufficient rank to task other officials to conduct the actual checks. When available, members of the U.S. Armed Services, the intelligence community, the U.S. Customs Service, and other law enforcement organizations should be called upon to assist in conducting Blue Lantern checks.

Recommendation 4. We recommend that DTC provide posts with a general overview of the Blue Lantern program and instructions for conducting prelicense and postshipment checks. The overview should include a description of the goals and anticipated accomplishments of the program. The instructions should define the steps involved in conducting the checks, discuss different approaches to be used in dealing with commercial and governmental end users, and describe how post reports of any discrepancies will be handled.

Recommendation 5. We recommend that DTC include all pertinent information in its request for Blue Lantern checks. The requests should include information on provisos, identify individuals who are involved in the transaction, state if and when the item was shipped, and describe the reason for the request. In some cases, it may be helpful to furnish manufacturer's brochures describing the item and the serial numbers of the actual items.

Recommendation 6. We recommend that DTC ensure that all Blue Lantern officials have copies of the ITAR, are kept informed of current issues in arms controls and arms trade, and are sent the Defense Trade News.

Recommendation 7. We recommend that the Assistant Secretary, PM, develop and implement written procedures and guidelines identifying sanctions which will or may be taken in the event end users or exporters are found to be violating any applicable U.S. laws or regulations regarding the use or transfer of U.S. weapons or technologies.

D. ACCEPTANCE OF GOVERNMENT-TO-GOVERNMENT ASSURANCES

The United States often obtains assurances from the recipient governments that they will limit the use of exported items and technology and will not retransfer items or technology without prior U.S. consent. Blue Lantern end-use checks of items exported under such government-to-government assurances raise problems involving the conduct of foreign relations. According to many of the officials we talked with, foreign governments may view such checks as an infringement of their sovereignty. In any case, we found that government-to-government assurances are not an effective mechanism for providing end-use verifications.

The United States has a strong interest in controlling the development of nuclear, biological, and chemical weapons and their delivery capabilities. The United States has obvious interests in controlling the illegal or unauthorized transfer of advanced and sensitive weapons technologies. However, U.S. trading partners may not always share our interests and may be driven by national incentives to use U.S. weapons and technology exports for their own purposes. For example, countries may be trying to increase their arms exports to generate revenues and achieve economies of scale for their arms industries. They may be developing nuclear or chemical weapons capabilities against the wishes of the United States.

We identified a number of instances where U.S. items and technology were used in violation of restrictive provisos. For example, in one instance we found that an automatic data measurement system was being used in an unmanned aircraft program despite assurances by the end user that it would only be used in connection with manned aircraft. In another instance, a major recipient of U.S. items and technology has reportedly sold and transferred significant quantities of these items while continuing to provide assurances that it would not.

Blue Lantern end-use checks can be an effective mechanism for identifying and deterring the unauthorized use or retransfer of Munitions List exports. However, these checks will require the cooperation of foreign recipients. Post officials told us

that to help gain foreign government cooperation, the governments should be informed by senior U.S. officials that periodic end-use checks are now required as a condition of exports. The officials said that the United States should explain that the Blue Lantern process is a routine practice which is being applied worldwide. Generally, they said that if governments believe they are not being specifically targeted and that end-use checks are a part of the export process, they will more readily accept and cooperate in the process.

Recommendation 8. We recommend that the Deputy Secretary direct appropriate U.S. officials to notify foreign governments of the enhanced arms control mechanism being implemented by DTC through the Blue Lantern process and request their cooperation in the conduct of both prelicense and postshipment end-use checks. DTC should be informed of each government's response and consider that response in export licensing decisions.

Recommendation 9. We recommend that DTC instruct posts that receipt of government-to-government assurances does not satisfy the requirements of Blue Lantern requests for prelicense or postshipment end-use checks.

V. CONSOLIDATED LIST OF RECOMMENDATIONS

Recommendation 1. We recommend that the Deputy Secretary take steps to ensure that the AECA and ITAR violations by a major recipient of U.S. military equipment and technology are halted. Future license approvals should be contingent on being able to conduct comprehensive end-use checks.

Recommendation 2. We recommend that the Deputy Secretary instruct the Under Secretary for International Security Affairs to determine, to the extent possible, the value of those unauthorized transfers involving U.S. items and technology and, where a legal basis for recoupment exists, obtain payment either directly or through future offsets for the appropriate amounts.

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Recommendation 7. We recommend that the Assistant Secretary, PM, develop and implement written procedures and guidelines identifying sanctions which will or may be taken in the event end users or exporters are found to be violating any applicable U.S.

laws or regulations regarding the use or transfer of U.S. weapons or technologies.

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Recommendation 9. We recommend that DTC instruct posts that receipt of government-to-government assurances does not satisfy the requirements of Blue Lantern requests for prelicense or postshipment end-use checks.

APPENDIX A

DEPARTMENT OF STATE
WASHINGTON

(date issued: August 24, 1991)

MEMORANDUM FOR: UNDER SECRETARY BARTHOLOMEW
ASSISTANT SECRETARY MULLINS
ASSISTANT SECRETARY COHEN
ASSISTANT SECRETARY MULHOLLAND
ASSISTANT SECRETARY ARONSON
ASSISTANT SECRETARY KELLY
ASSISTANT SECRETARY SOLOMON
ASSISTANT SECRETARY CLARKE
LEGAL ADVISER WILLIAMSON
ACTING ASSISTANT SECRETARY DOBBINS

SUBJECT: Reporting under the Arms Export Control Act (AECA) on Illegal Arms Use or Transfers

I have concluded that our procedure for making decisions on reports to Congress regarding unlawful use or transfer of U.S. origin defense goods, services, and technologies should be formalized. Accordingly, I hereby direct that the following procedure be implemented effective immediately:

1. INR shall inform L, PM and the relevant regional bureau or bureaus at the DAS or Assistant Secretary level by memorandum whenever it has acquired evidence that a potentially illegal diversion or use has occurred or that a significant transfer may have occurred that requires the imposition of any sanctions (including missile proliferation sanctions under the AECA). If INR, L or PM believe that the evidence may be sufficient to require congressional notification, they may propose a draft action memo to the Under Secretary for International Security Affairs (T), following the procedures outlined in paragraph 3 below.

2. In addition, whenever any bureau believes that there is reliable information that an illegal diversion has occurred or that a significant transfer may have occurred, that bureau shall initiate a memorandum to the Under Secretary for International Security Affairs. Such a memorandum shall also be sent if any arms related use or transaction <u>may</u> be in violation of applicable agreements with foreign governments or entities, or <u>may</u> require the imposition of any sanctions. In all cases, PM, INR and L shall be co-senders of such memorandum. It is important that such a memorandum reach the Under Secretary in a timely fashion; consensus recommendations therefore, although desirable, are not necessary.

3. Such memoranda shall be coordinated by PM with INR, L and the relevant regional bureaus and shall include (a) an evaluation of the intelligence involved (if any), (b) a recommendation as to whether a report to Congress is legally required or otherwise should be made, (c) a strategy for consulting with the countries involved, and (d) recommendations on any other steps necessary to stop the diversion, transfer, or violation and prevent a recurrence (including the possible imposition of sanctions).

4. INR will ensure appropriate coordination with the Intelligence Community. PM will insure appropriate coordination with DOD and ACDA.

5. The Under Secretary (T) shall make the determination as to whether (a) there has been an unlawful diversion or a significant transfer or (b) there may have been a violation of an applicable agreement, which requires a report to the Congress.

6. When a positive determination is made, the Under Secretary shall immediately notify, in writing, the Secretary and Deputy Secretary of such determination and the steps being taken to deal with it.

7. When a positive determination is made, H shall develop, in coordination with relevant bureaus, a strategy for congressional consultation and notification.

8. Questions about whether specific transfers have been authorized and questions on matters related to coordination with U.S. Customs enforcement should be referred to PM's Office of Defense Trade Controls (PM/DTC). Questions about applicable legal requirements should be referred to the Office of the Legal Adviser (L/PM).

In implementing these new procedures, PM, INR, and L shall conduct a comprehensive review to determine whether a report is required at this time. The review shall identify any countries or transactions that may require a report, and shall be completed within forty-five days. It shall be provided to T in the form of an action memorandum, and it shall include a report to Congress, if applicable.

- signed -

Lawrence S. Eagleburger
Acting Secretary

cc: ACDA - Director Lehman

APPENDIX B

DEPARTMENT OF STATE
WASHINGTON

February 18, 1992

TO: OIG - Sherman M. Funk

SUBJECT: Response to Recommendations Contained in Your Draft Audit Report on the Bureau of Politico-Military Affairs Defense Trade Controls Program

The draft audit report cited above contains three recommendations of actions to be taken by the Deputy Secretary of State. I will respond first to those specific recommendations and then provide some general comments on the report.

Recommendation 1. We recommend that the Deputy Secretary take steps to ensure that the AECA and ITAR violations by a major recipient of U.S. military equipment and technology are halted. Future license approvals should be contingent on being able to conduct comprehensive end-use checks.

Response. A number of steps have already been taken to deal with this problem. Your report cites my memorandum of August 1991, which spelled out new procedures to be followed in processing information related to reported violations of agreements entered into under the AECA. These new procedures are in place and they are working.

Several other steps are also being taken.

(classified information deleted)

PM will be sending a technical team to (deleted) a major recipient of U.S. equipment and technology, next month to meet with both government officials and industry representatives. The team will give briefings on the licensing process, transfer restrictions and sanctions that can be imposed for violations of agreements entered into under the AECA.

PM is currently holding up licenses on a number of requests, pending answers to several questions that have arisen over the past several months, questions that were also raised in your draft report. Licenses will continue to be held up until we have satisfactory answers to the questions posed.

With regard to the major recipient discussed in your draft report, a strong message has been delivered to an appropriate official of that government, indicating that the alleged activity must stop. Our basic objective will be to ensure that any transfers without U.S. consent do, in fact, cease. We will continue to monitor the situation and take whatever subsequent steps are deemed appropriate.

> Recommendation 2. We recommend that the Deputy Secretary instruct the Under Secretary for International Security Affairs to determine, to the extent possible, the value of those unauthorized transfers involving U.S. Government-funded equipment and technology and obtain payment, either directly or through future offsets, for the appropriate amounts.

Response. I do not agree with this recommendation for several reasons. The recommendation is based on a statement in the draft report that the proceeds of sales from FMF cases must generally be provided to the USG. First, L can find no legal basis within the AECA for such a requirement. There is a legal requirement that the proceeds of sales of U.S. provided military equipment granted to countries under the MAP program (which is covered by the Foreign Assistance Act, not the AECA) be reimbursed to the United States. There is no comparable AECA provision.

Notwithstanding the legal problems involved in the recommendation, it would be virtually impossible to determine a value of the alleged transfers in question. And if we cannot determine a value, we certainly cannot collect it.

(classified information deleted)

Finally, our basic objective should be to ensure that all transfers without U.S. consent cease. All of our energy should be devoted to this effort; our attention should not be diverted to an effort that, I believe, is virtually impossible to achieve.

Recommendation 8. We recommend that the Deputy Secretary direct appropriate U.S. officials to notify foreign governments of the enhanced arms control mechanism being implemented by DTC through the Blue Lantern process and request their cooperation in the conduct of both prelicense and postshipment end-use checks. DTC should be informed of each government's response and consider that response in export licensing decisions.

Response. I will ask Under Secretary Bartholomew to explore the most appropriate and most effective way of achieving the basic objective of this recommendation, i.e., to ensure that foreign governments understand the requirements of U.S. law and licensing procedures, follow up requirements and the steps that will be taken in cases of non-compliance.

General Comments. L has identified several statements in the draft report which are not technically correct from a legal standpoint. L has also provided its analysis to PM and PM will include recommendations on how those technical errors can be corrected when it sends its comments to you.

I also think it is appropriate to stress that significant progress has been made in the licensing and compliance processes managed by PM/DTC over the past two years. Your report does cite some of those improvements, but does not give them the prominence that they deserve. Like many other operations in the State Department, there is always room for improvement, and improvement is something that we must continually pursue. This is one operation, however, where significant progress has been made and that progress deserves recognition.

Finally, your draft report suggests that a separate recommendation will be made to the Director General of the Foreign Service and Director of Personnel that certain disciplinary action be taken against "responsible PM officials." For the past several months, I have been deeply involved with the issue of possible violations of agreements entered into under the AECA. I can assure you that steps necessary to improve our internal procedures for handling such issues have been taken and we will continue our efforts to ensure that the major recipient discussed in the classified annex to your draft is handled properly. I do not believe that disciplinary actions are warranted at this time.

- signed -
Lawrence S. Eagleburger

OIG ANALYSIS AND RESPONSE TO THE DEPUTY SECRETARY'S COMMENTS

The comments initially provided by the Deputy Secretary have been modified by the Deputy Secretary's staff to remove classified portions. The entire classified comments are reprinted in the classified annex to the report. The deletion of classified information has not substantially changed the comments.

In his comments the Deputy Secretary states that a number of steps have already been taken to halt the AECA violations, new procedures are in place and are working, and further actions are planned. Additionally, the Deputy Secretary stated that he would ask the Under Secretary for International Security Affairs to explore the most appropriate and effective way for ensuring that foreign governments understand the requirements of U.S. law and licensing procedures, follow up requirements and the steps that will be taken in cases of non-compliance.

The comments also state that the Deputy Secretary does not agree with Recommendation 2 concerning the recoupment of funds. The report has been changed in response to the Deputy Secretary's concerns about the legal basis for recoupment of funds and has been clarified to more clearly state OIG's views regarding the legal issues and, because of the secret nature of the reported transfers, the difficulties involved in clearly determining any amounts due the U.S. The report has also been modified in response to L's comments and greater prominence given to DTC progress and improvements as suggested by the Deputy Secretary.

The Deputy Secretary stated in his comments that, in view of the corrective actions which have been put in place during the past few months, the OIG recommendation regarding disciplinary action against responsible PM officials is not warranted at this time. The Inspector General is convinced, however, that the circumstances evidenced in the audit report require that he recommend disciplinary action against the responsible official. Not to recommend such action would be inconsistent with previous OIG disciplinary action recommendations, OIG responsibilities in the areas of waste, fraud, and abuse, and the Secretary's mandate to the IG to promote accountability within the Department.

APPENDIX C

February 11, 1992

TO: OIG - Sherman Funk

FROM: PM - Richard A. Clarke

SUBJECT: Draft OIG report on the Bureau of Politico-Military Affairs Defense Trade Controls

I have personally reviewed the attached draft report (Draft OIG Report 2-CI-XXX of January 1992) and am profoundly disturbed by its thrust. I ask that you to stop, reflect on my comments (including the classified annex comments), and discuss them with me before you issue the report.

What troubles me is two-fold.

o Recognition of Efforts: First, the report ignores the fact that this Administration inherited a situation of gross non-feasance. There was NO compliance program for defense trade licenses. Immediately upon taking office, I demanded a meeting of principals (D, M, T, and P) to inform them and seek resources to rectify the situation. While some resources were given to rectify licensing, I was informed by the Department that no resources would be made available for compliance until or unless we were subject to greater scrutiny and criticism.

Despite that, we reprogrammed resources and talked other agencies into non-reimbursable details to enhance the compliance function. I instituted the Blue Lantern system--not after being told to by an inspection report. We asked for intelligence officers to be assigned by INR and CIA so that there could be a system of informing us of violations and evaluating the reports. We continued, actively and through many different efforts, to seek M approval of additional compliance resources.

The bottom line is that, I recognized the problem early on and tried hard to fix it. I think we did an outstanding job, given the fact that we were denied resources to do so.

If after that unusual sort of effort to tackle a nasty problem on our own initiative, we are then subject to an OIG report that taints our reputations, you will send a message to

executives in this department not to accept jobs where there is a mess to clean up because they will be subject to damaging inspections if they are not entirely successful in cleaning up the mess in a relatively short period of time.

o Exercise of Judgement: There is an allegation in the report that basically says that we knew about violations by one country, did nothing about it until prompted, and hid the ball from principals. This is simply wrong.

First, there was no system to inform us of reliable intelligence of violations. Deputy Secretary Eagleburger acknowledged this in his directive of August 1991 that such a system be created. Second, there is a history that goes back at least ten years of reports of such violations by that country. Many of them were specious on their face. Many others were investigated by intelligence agencies for years, without any smoking guns ever being shown to us.

Third, I discussed these reports both with principals in this department and with senior officials of the government in question well before OIG ever became involved. Many of these reports were available to my last two predecessors. On one occasion (involving marketing of aerial tankers) I forced the government in question to reprimand one of its entities and enter into an agreement with us about future activity--before the OIG became involved. It was, however, a judgement that the reporting available to us did not warrant Congressional reporting. When information is not clear-cut, we are paid to make judgements. Having made those judgements, however, we were not inactive.

We stopped licenses, negotiated agreements (such as the bilateral MTCR agreement), and arranged an out-reach program to the exporters of the country in question. To suggest that we did all of this ONLY because the OIG was examining this question ignores the overall pattern of effort placed into making the Center for Defense Trade function work.

I have attached three documents to address issues raised by the draft, and have also attached at Tab D comments on the draft report provided by the Office of the Legal Adviser at the request of the Deputy Secretary's staff. My comments on the classified annex will be provided later, given the sensitivity of the information and the high level review needed for a response.

Attachments:
Tab A - Observations for Insertion into the Audit Report
Tab B - Line-by-Line Comment on Audit Report Text
Tab C - PM Responses to Specific OIG Recommendations
Tab D - Comments on Classified Annex

APPENDIX C

OIG ANALYSIS AND RESPONSE TO PM COMMENTS

The PM comments include a cover memorandum and Tabs A through D. Additionally, PM provided the L comments to OIG as an attachment to its' comments. Tab D contains PM comments on the classified annex to this report and are included, together with the OIG response and analysis, in the annex. The OIG response to PM's memorandum are stated below. PM Tabs A through C follow and are annotated with the OIG analysis and response.

In the cover memorandum, PM states that the audit report does not provide adequate recognition for PM efforts to resolve inherited problems nor properly reflect the need to exercise policy judgement. The report has been modified to more clearly describe the problems facing PM management in the late 1980's and the significant efforts and progress made since in resolving the problems. The report is not intended to discourage Department employees from undertaking difficult assignments and, in fact, describes many positive results of management initiatives, including the difficult undertaking of the Blue Lantern process.

The primary problem identified by the report is the manner in which PM responded to reports of AECA and ITAR violations by a major recipient of U.S. Munitions List items. The report states that, regarding the recipient in question, responsible PM officials failed to (1) properly monitor and verify the end use of military exports, (2) inform senior Department officials of the reported violations, (3) initiate reports of violations to the Congress, and (4) take steps to stop unauthorized transfers. In its response to the draft audit report on this matter PM states that there was no system to inform PM of reliable intelligence of violations, there was no evidence of a "smoking gun", and that reports of violations were discussed by PM with Department principals and senior officials of the major recipient in question. PM states that it made a judgement that reports to Congress were not warranted. PM also states that it stopped licenses, negotiated agreements, and arranged an out reach program to exporters of the recipient in question.

OIG Analysis and Response

The OIG audit found that relevant intelligence information is systematically provided, on a daily basis, to the most senior PM officials. However, we also found that the Assistant Secretary, PM, was the only PM official cleared to receive some categories of information. Accordingly, we do not agree with PM's comment that there was no system for providing it relevant information. Furthermore, the new procedures referred to by PM which the Deputy Secretary initiated do not relate to furnishing PM with reliable intelligence information. Instead they are

aimed at ensuring that reports of AECA violations are sent to Congress. Such reports are required under Section 3 of the AECA when information is received that violations may have occurred. Evidence of a "smoking gun" goes far beyond this legal requirement.

Regarding the PM assertion that reports of violations were discussed with Department principals and officials of the recipient, we found that PM had not proposed notifying Congress of reported widespread violations or acted effectively to halt them. When informed by OIG of the violations, Department principals acted immediately to review the OIG findings, promptly to notify the Congress, and to initiate corrective procedures to halt the violations.

APPENDIX C

PM Line-by-Line Comments on the Text
of the OIG Draft Audit Report

Page 1

The Second (now third) sentence in first paragraph should be amended to read: "Section 38 of the Arms Export Control Act (AECA) of 1976, as amended, authorizes the President to control the commercial export and import of articles and services covered by the U.S. Munitions List." This language should also be reflected in the first sentence of the second paragraph and the first sentence of page 9.

The Fifth (now sixth) sentence in first paragraph should be amended to read: "Under current practice, the U.S. Customs Service is the primary enforcement of the defense trade."

The Second sentence of second paragraph: AECA governs defense exports; other laws may relate to such exports. Also see third paragraph of page 9.

The Third sentence of second paragraph should be amended to read: "DTC carries out its responsibilities by registering persons involved in defense trade, reviewing export license applications, and ensuring compliance..."

OIG Analysis and Response

The report was changed to reflect all of the above comments except the first. The first comment is correct; however, other sections of the Act also relate to controlling U.S. Munitions List exports.

PM Comments Continued

Page 3

PM has from time to time received unverified reports concerning unauthorized transfers. These reports have been distributed throughout the Department by INR -- and on several occasions this distribution has not included DTC. None of the reports has yet been substantiated. Until 1991, PM's judgement, made after consultation with other bureaus and agencies, was that the reports were insufficiently reliable to warrant reporting to the Congress. However, the Assistant Secretary has raised retransfer concerns in discussions with the involved government during bilateral exchanges in 1989, 1990, and 1991.

The statement, "Only recently, and only after OIG involvement, has PM taken action to curtail unauthorized

transfers" is wrong. First, we still do not have verification that an unauthorized transfer has occurred. Second, the whole intent of the Blue Lantern system (initiated before the OIG began its work) is to deter unauthorized transfers.

Throughout this page, the report states that violations have occurred. This needs to be corrected to read "alleged violations" since no confirmations have yet been obtained. This includes what the Deputy Secretary informed Congress -- allegations of violations. We note that PM, along with other Bureaus and agencies, has been continuing to investigate these reports.

OIG Analysis and Response

The OIG examined many reports of unauthorized transfers by the recipient in question and discussed the reports with knowledgeable officials. The overwhelming view, stated in the reports and by the officials we talked to, is that the reports of unauthorized transfers are reliable. Further, the documents we examined include an internal document from PM/DRSA to the Assistant Secretary, PM, prepared in June 1990, describing specific reports of violations and states that a Section 3 report of violations may be warranted. Numerous other reports from ACDA and DOD support the view that many of the reported violations warrant congressional notification. Many of the officials told us that they were concerned and could not understand why PM had not acted on the reports over a long period of time.

PM also asserts that retransfer concerns were raised with the recipient in question on a number of occasions. During the course of the review, OIG found no evidence that PM had taken any effective steps to provide the congressional notification or halt the reported retransfers until audit staff brought the matter to the attention of other Department officials. The comment also notes that DTC did not receive all reports of violations. We agree that not all reports were provided to DTC. According to INR, in PM only the Assistant Secretary was cleared to receive all the reports.

OIG agrees that the intent of the Blue Lantern process is to deter unauthorized transfers and was initiated before the OIG review. The report describes how valuable the process can be and identifies cases where it has already proven to be effective. However, we found that the process was applied inconsistently. Most of the Blue Lantern officials we talked to had, or had attempted, to conduct physical verification of end-use. For the recipient in question, however, PM instructed the Blue Lantern official not to conduct investigations unless specifically

authorized. Under most circumstances, PM instructed, receipt of assurances by the Government in question is satisfactory.

The report has been modified to make more consistent the uses of the terms "alleged", "reported", etc.

PM Comments Continued

Page 4 (now Page 3)

The first sentence of the first paragraph (now second full paragraph) should be amended to reflect actual legal provision or deleted in its entirety. There are no provisions in the AECA or Foreign Operations Appropriations Act that require net proceeds be provided to the U.S. Government or the actions noted. While the Foreign Assistance Act requires that net proceeds of sales of items furnished under the MAP program be provided to the U.S. Government, the referenced country has not been a MAP recipient. (See attached L/PM memo for legal details.)

Regarding the last sentence in the second paragraph (now third full paragraph), we do not believe that the proposed disciplinary measures against PM officials and other actions are appropriate or merited. There are no legal requirements for monitoring. Confusion and inaccuracy over the legal responsibilities imposed on the Department by the AECA permeates the report and leads to seriously flawed conclusions.

The allegations that PM did not act on reports of significant violations of the AECA by one country are also wrong. Several reports to Congress under Section 3 were made during time period discussed in the audit; these included reports about the country in question. Moreover, it would appear that major differences in some of the cases referenced in the audit report can be characterized as differences in judgment.

The conclusions reached by the audit team about the reports of violations were not shared by PM or by a later interagency intelligence review, despite the fact that basically identical intelligence was available. The later review found that most of the reports were not credible. The draft report is wrong when it states that Department officials at the most senior level were not informed of the allegations and the sensitive intelligence on which they were based. The responsible senior officials were aware of the reports and did not conclude that a report to Congress was required at that time.

In addition, the audit report should note that a Section 3 report was under consideration before the OIG inquiry, but had not been finished due to the lack of verification by the

Intelligence Community. As noted in the audit report, Departmental focus on compliance in defense trade was enhanced in 1991 and when a pattern of activity had been established, the formal reporting requirements on illegal arms use or transfers were initiated in August. Pursuant to the Deputy Secretary's directive, the monitoring effort is being approached in a factual, detailed, and analytical manner. A reporting schedule has been established, with emphasis on a process that includes direct Under Secretary oversight and that reaches out to the interagency community for the full benefits of intelligence sources and regional expertise.

OIG Analysis and Response

The report section dealing with recoupment of funds has been changed to more clearly state OIG's views regarding the legal issues and the collectability of funds.

The AECA and ITAR require that recipients of certain U.S. Munitions List items agree not to retransfer such items without prior U.S. consent. The AECA also requires the development of standards for identifying high-risk exports for regular end-use verification. PM asserts, however, that the AECA contains no legal requirement for monitoring. Nevertheless, PM has developed the standards for identifying high-risk exports and is conducting regular end-use checks through the Blue Lantern process. OIG found that PM did not conduct actual end use checks of the recipient in question and, instead, instructed the Blue Lantern official to accept the recipient's assurances. In response to the PM comment, OIG modified the report statement that the "...AECA requires the State Department to monitor the end use of Munitions List items to ensure that the items are not transferred to other countries, entities, or individuals without prior U.S. authorization" to more clearly state AECA requirements.

PM states that Section 3 reports were made concerning the recipient in question during the period of the audit and that a Section 3 report was under consideration before the OIG inquiry, but had not been finished due to the lack of verification by the intelligence community. The record shows that the Deputy Secretary's oral report to Congress in September 1991 was the first Section 3 report provided to Congress regarding the recipient in question since 1982. Further, neither PM nor L have been able to confirm that a Section 3 report was issued during the period of the audit or even recall the circumstances of the alleged report. Additionally, L informed OIG staff that a Section 3 report was not under consideration within the Department, but rather that the need for a report, based on intelligence reports, was being discussed.

With regard to PM's comment referring to an interagency review group, we found that the group reviewed a limited number of intelligence reports received subsequent to publication of a major intelligence summary in September 1990.

PM Comments Continued

Page 5 (now Page 4)

The second paragraph should be amended to read: DTC also initiated measures that have resulted in improved screening of applicants and increased compliance and enforcement capabilities. This includes a coordinated effort of DTC and the U.S. Customs Service to ensure all registrants and all parties to a proposed export are screened. Comments about the suspicious activity, allegations or known violations are available in the computer or other files maintained by DTC. A person (individual or entity) about whom adverse or derogatory information is developed or received and who might be referenced on license applications or other requests or approval related to defense trade is electronically "flagged" by DTC.

Cases involving such a name are referred immediately to the Compliance Analysis Division for review. While the case is under compliance review, the license is not subject to approval. The review may involve the input of a number of agencies, including the U.S. Customs Service, which now routinely screens registration applications through several databases.

If any derogatory information is found, the relevant party is "flagged" in the DTC computer database. DTC's own efforts focus on "matching" names on the General Services Administration, Department of Justice, the Department of Commerce Table of Denials Orders, and other available lists with persons about whom there are particular concerns or specific interest, as (1) they are seeking some form of approval from the United States; (2) they have been indicted for or convicted of U.S. criminal statutes cited in Section 38(g) of the AECA and Section 120.24 of the ITAR; and (3) they are ineligible to contract with any agency of the U.S. Government.

When a "match" exists between the above-mentioned lists and names in a given case, the Compliance Analysis Division reviews the application in question and makes a recommendation regarding final disposition to DTC's Arms Licensing Division.

The first sentence of the third paragraph should be revised to read: In 1990 DTC initiated systematic end-use verification procedures known as "Blue Lantern," which have since been substantially refined.

Delete from fifth sentence of the third paragraph "...selecting the Blue lantern officials and..." since officer assignments do not involve DTC program management. Details concerning "Blue Lantern" action officer selection are covered in the PM response to OIG recommendation 3.

OIG Analysis and Response

The report has been modified to reflect a number of the above suggested revisions. However, the comments provide a great deal more detail than OIG views as necessary to understanding the Blue Lantern screening process. Accordingly, since the information is stated above, it is not repeated in the report text.

PM Comments Continued

Page 9

Insert in the second sentence "and national security" between the words "policy" and "interests."

The reference to the Comprehensive Anti-Apartheid Act is no longer valid. See discussion included in the attached memorandum from L/PM - Cummings.

OIG Analysis and Response

The words "national security" were added as suggested. The reference to the CAA was not deleted because it was in force during the period of the review and sales of the types of items in question remain violations of U.S. law.

PM Comments Continued

Page 10 (now Pages 9-10)

The section "DTC Reorganization" should be revised to read: With the creation of the Center for Defense Trade in January 1990, the defense trade function at State was substantially reorganized, with the objective of providing improved export licensing services and defense trade policy guidelines to the U.S. defense industry. DTC, with an enhanced capability for registering persons in the business of defense trade, reviewing export license applications, and ensuring compliance with applicable laws and regulations, emerged from the old Office of Munitions Control. The Office of Defense Trade Policy, responsible for defining policy guidelines for defense trade and trade facilitation, was also created.

In 1987 DTC's predecessor had a staff of about 30 personnel comprised of a management staff of four people, a licensing division and administrative support staff of about 16, and a staff of three who did compliance work. DTC now has a staff of about 65 personnel.

The Office of the Director has six persons, including one DoD detailee. The computer support staff is made up of three full-time personnel and a contract consultant. The administrative support staff has six full-time personnel, four contractors, and a varying number of part-time State employees. The Arms Licensing Division has 33 staff members, including 22 licensing officers responsible for reviewing license applications according to type of and U.S. Munitions List commodity categories. This complement includes five DoD personnel and two contractors. The Compliance Analysis Division has 11 full-time personnel, including six paralegal specialists and two U.S. Customs personnel, detailed to coordinate enforcement activities.

PM has requested additional staff for DTC and in May 1990 the Bureau of Personnel determined that adding 27 new licensing positions was justified. Although PM requested the 27 positions in FY 1990, the Department approved an increase of only 17 positions. In FY 1991 PM requested an additional 15 positions (including those identified by PER), but none were approved. PM is concerned that DoD will not reassign staff to DTC when the assignment of its six detailees is completed.

OIG Analysis and Response

The above comments suggest changes which differ little from the OIG draft. Because they likely portray PM staffing levels at this point in time, the report was revised to accept the PM reported levels. OIG understands PM's frustration at being unable to obtain additional personnel, and commends PM for continually seeking adequate staff resources during a period of very tight budget austerity.

PM Comments Continued

Page 12 (now Page 11)

Modify first sentence to read: "DTC's most easily quantifiable workload is currently in the licensing process."

Page 16 (now Page 15)

Substitute "operational" for "administrative" in penultimate line (now second paragraph, third line).

OIG Analysis and Comments

The report was revised in accordance with the above comments.

PM Comments Continued

Pages 19-20 (now Pages 17-18)

As pointed out in the Legal Advisor's memoranda (Tab E), the AECA does not require the Department to monitor the end use of Munitions List items. The Department's responsibility is to obtain assurances from the recipient government or entity that transfers will not occur without U.S. approval. Confusion and inaccuracy over the legal responsibilities imposed on the Department by the AECA leads to seriously flawed conclusions.

The specific allegation that PM did not act on reports of significant violations of the AECA by one recipient country is not true. The report is wrong to make a blanket statement that the intelligence reports regarding the alleged diversions are "reliable." There was no system to ensure that intelligence reports of violations were either called to PM's attention or evaluated by the Intelligence community. There are at least ten years of such reports of violations by the country in question, many of which have been investigated by U.S. agencies over the years without ever being confirmed. A recent review by an interagency group found that almost all were not credible, PM has drafted a report to Congress on those that were.

This section should be revised to read:

The AECA requires the Department to obtain assurances from the recipient government or entity that items are not transferred to other countries, entities or individuals without prior U.S. authorization. Further, the Act requires that a report be provided to the Congress when credible information is received that an unauthorized transfer has or may have occurred.

Prior to September 1991 there was no system to ensure that intelligence reports of violations were either called to PM's attention or evaluated by the Intelligence community. There are numerous reports of violations by the country in question, many of which have been investigated by U.S. agencies over the years without ever being confirmed. Almost all of the allegations of violations considered in the draft report were clearly specious. However, in one case, these allegations involved a major U.S.

ally and raised questions of the highest political and diplomatic sensitivity.

Given this sensitivity, PM handled these allegations in a manner consistent with the Department's responsibilities under the AECA, but outside of normal procedures. Department officials at the most senior level were informed of the allegations and the sensitive intelligence on which they were based well before the OIG became involved. It was judged that these reports, lacking further confirmation, did not warrant Congressional notification. Senior levels of PM met repeatedly over the last 18 months with the alleged violator on a close-hold basis to raise the allegations and to seek assurances that:

(1) U.S. permission would be sought for all retransfers.

(2) That allegations of unauthorized retransfers would be fully accounted for and explained.

(3) and that the recipient government take whatever steps necessary to ensure that such unauthorized transfers did not occur.

When the alleged violator did not respond, PM reinforced its queries with a series of refusals to issue further licenses for projects or entities of concern. Discussions of these allegations continue, and PM has been able to obtain the recipient government's agreement to take the necessary steps to end unauthorized transfers, stop ongoing projects and, in a bilateral agreement, declare adherence to relevant international control regimes such as the MTCR.

We are sending a team to work with government agencies and industry in the country in question to develop greater understanding of and adherence to U.S. law. The issue is sensitive, and goes to the heart of our relationship with this ally, and the sort of blanket solution which the OIG draft report seems to call for will take time and sustained high-level effort to obtain.

OIG Analysis and Comments

PM's assertion that the AECA does not require end-use monitoring of Munitions List exports is discussed in the OIG response to PM's Page 4 comments.

The statement that PM did not act on reports of significant violations of the AECA by one recipient country is accurate and is fully supported by information in the audit report. Regarding the report's characterization of the intelligence reports

concerning the alleged diversions as "reliable", this judgement is based on a review of numerous reports, discussions with intelligence officials throughout government, and a written statement by the Director of Central Intelligence. As noted before, the Secretary and Deputy Secretary concurred in the assessment of and took immediate action to halt the reported violations and inform Congress.

PM again states that there was no system to ensure that intelligence reports of violations were called to PM's attention. The OIG audit found that relevant intelligence information is systematically provided, on a daily basis, to the most senior PM officials. However, we also found that the Assistant Secretary, PM, was the only PM official cleared to receive some categories of information. Accordingly, we do not agree with PM's comment that there was no system for providing it relevant information.

PM also states that the information was not evaluated by the intelligence community and that there are at least ten years of such reports of violations by the country in question, many of which have been investigated by U.S. agencies without ever being confirmed. OIG agrees that numerous reports of violations have been received over the past ten years. These reports include at least seven summary reports evaluating the subject's arms trade world-wide. While we are not aware that a "smoking gun" has been found, the reports clearly call for providing Section 3 reports to Congress as recommended in the audit report.

With regard to PM's comment referring to an interagency review group, we found that the group only reviewed a limited number of intelligence reports received subsequent to publication of a major intelligence summary in September 1990.

PM provided a suggested revised version to the audit report. Because OIG does not believe the PM version accurately describes the audit findings, the report has not been revised in accordance with the PM suggestions.

PM Comments Continued

Page 21 (now Pages 18-19)

The first bullet under "Blue Lantern End-Use Checks" is misleading: There was no "weeding-out" process or focus placed on certain arms exports. No arms export is considered "insignificant." Requests for end-use checks are based on discrepancies noted on the export license application, incomplete data or concerns/information raised through intelligence or other sources.

The second bullet is also misleading: When the cases in question were brought to the attention of DTC personnel handling the "Blue Lantern" program, PM initiated the end-use checks. When the regional bureau subsequently expressed concern about the extensive list of checks proposed by the OIG audit team, DTC personnel were advised by the OIG that the entire list did not have to be used.

The third and fourth bullets are incorrect: PM never instructed the post's "Blue Lantern" official not to conduct "actual" end-use checks. In reply for specific guidance about conducting end-use checks, the post in question was advised that

> "...the means and process of verifying the bona fides of a munitions license application will naturally vary widely according to local conditions. The Department certainly encourages the full range of country team resources ... Officers conducting end use checks should keep in mind that their function is to initiate inquiries into the bona fides of the transactions, and not generally to conduct an investigation unless otherwise authorized ... Physical evidence concerning the disposition and use of defense materials is always desirable but confrontation with host officials is unnecessary unless specifically directed by the Department. Under most circumstances [deleted] Government assurances, for example, will be satisfactory.

OIG Analysis and Response

The first bullet accurately describes PM's initial Blue Lantern requests regarding the recipient in question, despite the many reports of violations. The second bullet is also accurate as stated. Numerous ACDA and PM/PRO recommendations for end-use checks had not been acted upon until OIG audit staff pressed DTC staff to initiate the checks in connection with planned audit fieldwork.

With regard to PM's comments on the third and fourth bullets, the guidance stated above instructs the Blue Lantern official to generally not conduct an investigation unless otherwise authorized and that, under most circumstances, recipient assurances are satisfactory. As a result of the instructions, the Blue Lantern official did not conduct any actual end-use verifications. In contrast, Blue Lantern officials at other locations were instructed to initiate actual end-use verifications where the officials deemed it appropriate.

PM Comments Continued

Page 23 (now Page 20)

The last paragraph (now last full paragraph) should be modified to read:

> When derogatory information is found, DTC flags the persons (individuals or corporate entities) in its computer system. All parties listed on registration statements and export license applications are subjected to automated scrutiny. As a result of this enhanced review, license applications containing the names of flagged persons are more likely to be referred to other agencies for review, be subject to a Blue Lantern pre-license or post-shipment check, or be denied.

Page 24 (now Page 21)

The second sentence under "Management of the Blue Lantern Process" should be modified to read: The initiative is a significant enhancement of U.S. defense trade activities which should result in improved controls.

The "Selection of Blue Lantern Officials" needs to be substantially revised. See PM responses to OIG recommendations 3 and 4.

Page 29 (now Page 24)

The cases involving two tracking/guidance systems and communications equipment are under active DTC review. In the former case, our initial findings do not indicate any diversion, but a follow-up is being pursued. The draft should be amended to reflect this.

Pages 29-30

We have deferred comment about State enforcement responsibilities to the Office of the Legal Adviser. (Tab D)

OIG Analysis and Response

The report has been modified to more clearly describe the steps taken by DTC when derogatory information is found, to state that the Blue Lantern process is an enhancement of defense trade controls, and to provide more recent information on a Blue Lantern case. OIG provides responses to the other issues mentioned in the comments in the appropriate sections.

APPENDIX C

OIG Recommendations Re DTC

Recommendation 1. We recommend that the Deputy Secretary take steps to ensure that the AECA and ITAR violations by a major recipient of U.S. military equipment and technology are halted. Future license approvals should be contingent on being able to conduct comprehensive end-use checks.

PM response: Although this recommendation was not directed to PM, we wish to note actions that have been taken or are under way in this regard:

First, it must be noted that in the case of this country, we are talking about thousands of licenses granted every year for a broad range of technology and products and involving business contracts valued from a few dollars to the millions of dollars. Comprehensive end-use checks of all licenses are not warranted, as the allegations of violations involve only a few licenses for a few specific projects.

PM has persistently raised retransfer concerns with the major recipient of U.S. defense articles and services that was referred to in the OIG audit report. Administrative actions, such as freezes of license issuances, have been initiated by PM to increase the pressure on the recipient to respond to PM's efforts on these retransfer concerns. In March 1992, we will initiate a round of bilateral talks aimed at addressing all the relevant issues, including explicit compliance with U.S. law and regulations.

State's focus on compliance in defense trade was enhanced in August 1991 with the establishment of reporting requirements on illegal arms transfers. Pursuant to a directive from the Deputy Secretary, the monitoring effort is being approached in a detailed and analytical manner. A reporting schedule has been established, with emphasis on a process that includes direct Undersecretary oversight and that reaches out to the interagency community for the full benefits of intelligence sources and regional expertise.

The first report was submitted to the Under Secretary of State for International Security Affairs for review and further action in December 1991. Moreover, as a direct consequence of the initial information gathering process, the intelligence community was reminded of State's concerns and was requested to initiate more systematic collection and dissemination of information on illegal diversions and unauthorized transfers.

OIG Analysis and Response

PM states that comprehensive end-use checks of all licenses are not warranted. OIG agrees that it is not necessary, or even worthwhile, to conduct end use checks for all items. However, OIG believes that PM should initiate actual end use checks for items which are subjects of reports of illegal or unauthorized retransfer. PM states it also persistently raised retransfer concerns with the major recipient in question. However, the audit found no evidence that PM had taken any effective measures relating to retransfer concerns.

PM states that actions are now underway regarding the reported illegal diversions and unauthorized transfers. According to the PM comments the actions include freezes of license issuances, initiation of bilateral talks aimed at addressing compliance with U.S. law and regulations, establishment of reporting requirements on illegal arms transfers pursuant to a directive from the Deputy Secretary, and submission of a report submitted to the Under Secretary of State for International Security Affairs.

As noted in the audit report, these actions were initiated after the IG informed the Secretary and Deputy Secretary of the circumstances found during the audit. According to the Deputy Secretary's staff and INR officials, the Assistant Secretary, PM, argued that no report to Congress was warranted even after the Deputy Secretary had directed that a report be prepared and provided to appropriate Members of Congress.

PM Comments Continued

Recommendation 2. We recommend that the Deputy Secretary instruct the Under Secretary for International Security Affairs to determine, to the extent possible, the value of those unauthorized transfers involving U.S. Government-funded equipment and technology and obtain payment, either directly or through future offsets, for the appropriate amounts.

PM response: Again, although this recommendation was not directed to PM, the Bureau is involved in relevant activities. Uncertainties about indigenous development and legal limitations on U.S. authority complicate any effort to assign accurate monetary value to unauthorized export transactions. Nonetheless, recoupment of monies involved in FMF-financed transactions will be a subject of discussion in the above-mentioned March 1992 trip. We also refer to the memo from the legal advisor regarding the lack of legal authority to seek payment in cases involving commercial munitions exports.

OIG Analysis and Response

The report section dealing with recoupment of funds has been changed to more clearly describe the legal issues and the difficulties involved in clearly determining amounts due the U.S.

PM Comments Continued

Recommendation 3. We recommend that DTC instruct posts that all appropriate post resources should be used in conducting Blue Lantern pre-license and post-shipment checks. Blue Lantern officials should be of sufficient rank to task other officials to conduct the actual checks. Members of the U.S. Armed Services, the intelligence community, the U.S. Customs Service, and other law enforcement organizations should be called upon to assist in conducting Blue Lantern checks.

PM response: When the "Blue Lantern" program was established in September 1990 (see 90 State 317082; DTG 190044Z SEP 90), PM, in conjunction with relevant geographic and functional bureaus, determined that end-use checks might be handled by "a variety of officers (e.g. commercial or pol-mil officers, U.S. Customs attaches, SAOs, DATTs)" since key factors (i.e., configuration of the Country Team, U.S.-host government relations, and available expertise) would vary from post to post. In a follow-on message (91 State 196365, DTG 150248Z Jun 91), all diplomatic and consular posts were provided with the following guidelines regarding the utilization of personnel:

> "Blue Lantern" action officers are comprised of a wide variety of agency representatives. Whenever feasible, coordination with a regional Customs officer is recommended...The Department encourages use of the full range of Country Team resources regardless of the "Blue Lantern" action officer's agency affiliation.

In future "Blue Lantern" program updates, we plan to cite and further encourage the type of close coordination efforts by Country Teams as noted in the OIG report. To attempt to instruct posts regarding supervision and reporting structure is beyond PM's mandate and, we suspect, would raise undesirable problems with the Chiefs of Mission concerning their prerogatives under NSDD-38.

Recommendation 4. We recommend that DTC provide posts with a general overview of the Blue Lantern program and instructions for conducting pre-license and post-shipment checks. The overview should include a description of the goals and anticipated accomplishments of the program. The instructions should define the steps involved in conducting the checks, discuss different

approaches to be used in dealing with commercial and governmental end-users, and describe how post reports of any discrepancies will be handled.

PM response: This was accomplished via telegrams 90 State 140219 and 91 State 196365. The latter is a very detailed account of the "Blue Lantern" program, its goals, and the procedures for the posts to follow. There is a continuing effort to refine "Blue Lantern" and all posts will be kept informed of any significant changes.

Recommendation 5. We recommend that DTC include all pertinent information in its request for Blue Lantern checks. The requests should include information on provisos, identify individuals who are involved in the transaction, state if and when the item was shipped, and describe the reason for the request. In some cases, it may be helpful to furnish manufacturer's brochures describing the item and the serial numbers of the actual items.

PM response: In the early days of the program, we discovered that posts often needed more information, and have since made every effort to provide it. This is reflected in cable 91 State 196365, in which we noted that information provided in end-use requests often has all the details available but also encouraged posts "to request additional specific information that might facilitate [their] jobs."

Recommendation 6. We recommend that DTC ensure that all Blue Lantern officials have copies of the ITAR, are kept informed of current issues in arms controls and arms trade, and are sent the Defense Trade News.

PM response: When the revised ITAR is published in Spring 1992, DTC will ensure that copies are distributed widely, including to Blue Lantern action officers. Beginning in October 1990, we disseminated Defense Trade News to over 120 addressees in U.S. diplomatic/consular posts and to all domestic and overseas Customs offices. As of December 1991, every post began receiving at least one copy of the publication. Beginning with the January 1992 issue, our mailing list will include copies addressed specifically to the "Blue Lantern" action officer at each post; back issues will also be sent.

OIG Analysis and Response

OIG considers the steps noted in the PM responses the report recommendations 3,4,5, and 6 to be significant improvements in the Blue Lantern process. The process had been initiated just prior to the start of the audit work. DTC managers were, at the

start and throughout the course of the audit, identifying problem areas and attempting to resolve them. OIG audit staff briefed DTC staff on problems identified after each overseas trip to examine program operations. DTC managers acted on the issues identified and the OIG recognizes the program improvements.

PM Comments Continued

Recommendation 7. We recommend that the Assistant Secretary, PM, develop and implement written internal procedures and guidelines identifying sanctions which may be taken in the event end-users are found to be violating any applicable U.S. laws or regulations regarding the use or transfer of U.S. weapons or technologies.

PM response: U.S. policy has been to oppose the automatic sanctions implied in the written procedures and guidelines recommended above. Automatic sanctions infringe on the Secretary's flexibility to conduct diplomacy and restrict our ability to obtain a satisfactory outcome to bilateral disputes. Written procedures and guidelines, as proposed in recommendation seven, would ultimately be counterproductive and hamper the Department in carrying out its responsibilities. This recommendation runs in the face of a long-standing position of both this and earlier administrations in regard to both legislative initiatives and policy recommendations. Applicable sanctions and the guidelines for imposing them are already spelled out clearly in both law and regulation.

OIG Analysis and Response

OIG found that applicable sanctions and guidelines are not clearly stated in existing regulations. For example, the ITAR does not contain regulations applicable to the unauthorized transfer of Munitions List items by foreign recipients, Congressional reporting requirements, and sanctions proscribed under the AECA. However, OIG recognizes the concerns expressed by PM regarding the Secretary's flexibility to conduct diplomacy. Accordingly, the recommendation that written guidelines and procedures be published in the ITAR, a public document, has been deleted. The recommendation that written internal guidelines and procedures be developed has been retained.

PM Comments Continued

Recommendation 8. We recommend that the Deputy Secretary direct appropriate U.S. officials to notify foreign governments of the enhanced arms control mechanism being implemented by DTC through the Blue Lantern process and request their cooperation in the conduct of both pre-license and post-shipment end-use checks.

DTC should be informed of each government's response and consider that response in export licensing decisions.

PM response: Although this recommendation is not directed to PM, DTC is preparing an instruction cable to address its substance. The effort, as we see it, should focus on development of policies and procedures that encourage enhanced foreign government cooperation in the conduct of end-use checks. Linkage between end-use check results and licensing is intrinsic to the process, or there would be little purpose in doing the checks at all. This does not mean, however, that difficulties in a "Blue Lantern" case should necessarily affect all other licenses for that particular country.

Recommendation 9. We recommend that DTC instruct posts that receipt of government-to-government assurances does not, in themselves, satisfy the requirements of Blue Lantern requests for pre-license or post-shipment end-use checks.

PM response: We believe that the above-mentioned process should have as one of its aims the reconciliation of various types of existing government-to-government assurances with the requirements of the "Blue Lantern" program. For this reason, we plan first to catalogue the types of existent agreements, compare their provisions with our export control needs, and then make an effort to eliminate any operational constraints on the fulfillment of State's statutory mandate concerning the control of U.S. defense trade.

OIG Analysis and Response

In its' comments, PM states that measures are being taken to accomplish the intent of recommendations 8 and 9. OIG will examine the effectiveness of the planned steps during its analysis of compliance.

APPENDIX C

United States Department of State
Washington, D. C. 20520

Memorandum January 27, 1992

TO: D/P&R -- Mr. Bauerlein

FROM: L/PM -- Edward Cummings

SUBJECT: IG Audit of DTC

Attached at your request are legal comments on the draft IG audit of DTC. I have tried to provide changes and recommendations that would make the report accurate from a legal standpoint and to point out which statements or assumptions on the Arms Export Control Act regime are incorrect or need elaboration. As you will note, some of the key recommendations appear to be based on a misunderstanding of the rather complex laws involved and hopefully these comments will be helpful.

I will furnish a copy to DTC so that it can also take the comments into account.

Draft: L/PM -- ECummings
WPPPM 1684x-7838

APPENDIX C

January 24, 1992

Comments on the IG Report on PM

1. Page 1, line 9. (now line 7)

- o Change. Insert "export functions" before "the Act".
- o Reason. Accuracy. As drafted, the sentence is technically not correct. The change would make it clear that Executive Order 119856 delegated the export functions of the Act to the Secretary of State, while certain other functions (e.g., import functions) were delegated to other departments.

OIG Analysis and Response

The OIG audit was conducted primarily to examine the Department's management of export controls of Munitions List items. Accordingly, the words "export functions" were added as suggested.

L Comments Continued

2. Page 1. para. 2, second sentence.

- o Change. Delete "DTC also administers portions of other laws and regulations that govern the export of Munitions List items, including the Export Administration Act . . . .", and replace it with a clause such as "DTC is also involved in issues related to laws such as the Export Administration Act . . . ." or "assists in the implementation of other laws, such as . . . ."
- o Reason. The sentence is not legally correct as drafted in several respects. For example, DTC does not administer the laws referred to or the MTCR, and the EAA does not govern the export of USML items (it only governs items not on the USML). In addition, the relevant provisions of the Comprehensive Anti-Apartheid Act are no longer in force. The suggested change would make the sentence correct.

OIG Analysis and Response

The audit report has been modified to reflect L's statement that the DTC is not responsible for "administering" the other Acts referred to in the report section. Reference to the

Comprehensive Anti-Apartheid Act was not deleted, because unauthorized transfers of Munitions List items to South Africa when the Act was in force remain violations of U.S. law.

L Comments Continued

3. Page 2, last paragraph, first sentence. (now second para.)

- Comment. This sentence states that the AECA requires the State Department to monitor the end use of USML items to ensure that they are not transferred without U.S. consent. This does not appear to be accurate. The Arms Export Control Act does provide that items may not be sold without required assurances from foreign governments, and not exported without a license. However, there does not appear to be an express statutory requirement to monitor end use.

- There is of course an express requirement in Section 505(a)(3) of the Foreign Assistance Act of 1961 (FAA), as amended, that the U.S. obtain agreement from recipients of grant military assistance under Chapter 2 of Part II of that Act that they will (as the President may require) permit continuous observation and review of items furnished on a grant basis. This provides a basis for end use monitoring but not a requirement. However, this only applies to the MAP program generally, and not FMS and commercial cases, and the transfers about which the IG report appears to be concerned.

- Some of the countries referred to in the report (such as [deleted]) have apparently not been MAP recipients. ([deleted], for example, received Patriots and other weapons on an emergency basis under Section 506 of the FAA in October 1990, and gave the U.S. the necessary §505 assurances; however, virtually all of the other equipment it has acquired is not subject to the §505 conditions).

- It should be noted that in December 1987, the President signed into law an amendment to the AECA which required that he develop standards for identifying high-risk exports for regular end-use verification, and that the standards be published in the Federal Register (which was done in 1988). However, this is not a monitoring requirement, and verification has commonly been obtained by receiving assurances from appropriate entities (such as the foreign government concerned).

- Recommendation. It is recommended that the report identify the precise statutory requirement or that the sentence be revised to reflect the above comments.

4. Page 2, last paragraph second sentence. (now second para.)

- This sentence states that the AECA requires a report to Congress if any information is received that an unauthorized transfer has or may have occurred.

- Comment. This sentence is not legally correct.

- Section 3 of the AECA requires a report to Congress if any information is received that a transfer requiring consent under §3 has occurred without the President's consent, or if a substantial violation of an applicable agreement governing the transfer or use of items may have occurred.

- Most of the licenses granted by DTC are not subject to the §3 reporting requirement. Section 3 applies to FMS and MAP transactions, but (effective 1980) applies to commercial exports only to the extent that the original export was valued at more than $14 million in major defense equipment or $50 million or more of defense articles or services generally.

- Thus, a mere report that a transfer may have occurred does not require a report -- the Department would either have to believe that a transfer did occur of items subject to the reporting requirement and subject to the monetary threshold in commercial cases (i.e., based on reliable information) or conclude that a substantial violation of the relevant government to government agreement may have occurred.

- Recommendation. That the relevant language be changed to reflect the above comments. The easiest technical change would be to add the word "certain" before "unauthorized," which would make the sentence correct but which may not provide the Secretary with a complete context for assessing compliance.

OIG Analysis and Response

OIG staff discussed the above comments with L officials to obtain a clarification of the Department's legal interpretation of AECA requirements to control arms exports and to report unauthorized transfers to Congress. The report sections dealing

with AECA arms control and reporting requirements have been modified to reflect the Department's legal position.

L Comments Continued

5. Page 4, para. 1, second sentence. (now Page 3, second para.)

- This sentence states that funds received from the resale of items provided under U.S. funded Foreign Military Financing and Credit programs must generally be paid to the U.S. and are not to be retained by the seller.

- Comment. This sentence does not appear to be legally correct.

- FMF funding is governed primarily by relevant provisions of the AECA (e.g. §23) and the annual Foreign Operations Appropriations Acts (currently Title III of Public Law 102-513). There does not appear to be any provision in these Acts requiring that net proceeds be provided to the U.S. Government or the actions suggested in the sentence referred to.

- However, §505(f) of the Foreign Assistance Act of 1961, as amended, does require that net proceeds of sales of items furnished under the MAP program be provided to the U.S. Government. (The MAP program has now been terminated, and was in the process of being phased out during the 1980's.) However, this provision does not apply to FMF, and the country primarily referred to the audit has simply not been a MAP recipient (although the few transfers of Patriots referred to above are of course subject to §505).

- Recommendation. That the above comments be reflected in an appropriate manner or that the discussion be deleted.

OIG Analysis and Response

The L comment has been reviewed by officials of OIG's Office of Counsel. They have concluded that L's statement that the AECA does not expressly provide a mechanism for the recoupment of funds derived from the authorized transfer of Munitions List items by a foreign recipient is technically legally correct. Accordingly, the report has been changed to recommend recoupment of funds only where a legal basis to do so exists. An example of this is where items may have been retransferred which were provided under Section 506 of the FAA.

L Comments Continued

6. Page 4, second para., last sentence.(now Pg. 3, third para.)

- This sentence indicates that the IG intends to recommend disciplinary action against certain officials for failing to properly monitor and verify end use, inform senior officials of the reports of diversions, initiate reports to Congress, and take steps to stop unauthorized transfers.

- Comment. It would appear to be appropriate to reflect in the audit that there is no legal requirement for monitoring, and that this recommendation is based on the auditor's conclusion on what a proper monitoring system should be (i.e., that disciplinary action is recommended for failing to take action required neither by law, regulation, nor Department policy).

- Second, it would appear to be appropriate to state that senior officials were apparently aware of many of the allegations, since they saw the same intelligence reports in many or most cases (i.e., senior officials were aware of the reports). As in the case of the PM officials, they also may have concluded that the reports were too speculative or not sufficiently reliable to justify a Congressional report at the time.

- Third, it would also be advisable to mention in an appropriate place that a Section 3 report was under consideration within the Department when the IG inquired about this issue, but PM was apparently not prepared to concur in finalizing it because the intelligence community refused to state in writing that transfers did in fact occur and to provide sufficient evidence rather than simply their conclusions. (The DCI also did indicate in writing that transfers could not be confirmed without inspecting the items in question.) It was only after the pattern-of-reports argument was developed in the summer of 1991 that the report was pursued and then made in August of that year. (It is not clear whether the Intelligence Community is willing to state authoritatively at this time that the transfers actually occurred).

- It would appear to be appropriate to state that several §3 reports to Congress were made during the time period discussed in the audit (including reports dealing with the country of primary concern), since otherwise the

impression may be given that there were no reports to Congress.

- Finally, it would also appear to be appropriate to indicate that the responsible PM officials who are charged with implementing the law reached different judgments or conclusions on the available intelligence in the key cases referred to in the audit than did the auditors and possibly other agencies. This apparent difference in judgment appears in part to be the source of the recommendation for disciplinary action, and it would appear to be fair to reflect this in an appropriate manner.

OIG Analysis and Response

OIG staff discussed the above comments with L officials to obtain clarification of the Departments legal position on AECA arms control and reporting requirements. The OIG report has been changed to more clearly state the requirements of the AECA, i.e. that the AECA requires the State Department to control the export of Munitions List items and to develop standards for identifying high-risk exports for regular end use verification to ensure that the items are not transferred to other countries, entities, or individuals without prior U.S. authorization. While there is no express requirement in the AECA that the end use of exports be monitored, it appears clear that compliance with the above stated provisions require some degree of end use monitoring, particularly if intelligence reports identify probable violations. The recommendation for disciplinary action is based, in part, on evidence showing that PM had not taken appropriate steps to monitor the end use of sensitive military items and technology to ensure that the alleged violator complied with relevant AECA restrictions.

OIG staff also discussed with L officials the statements that a Section 3 report was under consideration within the Department and that it would be appropriate to state that several §3 reports to Congress were made during the time period discussed in the audit including reports dealing with the country of primary concern. OIG had found no evidence that a Section 3 report was under consideration or that such reports had been made concerning the country in question since 1982. L informed us that, while there was no Section 3 report being considered, the issue of whether a report might be appropriate in view of the intelligence reports was being discussed. Further, L could provide no support for its statement that Section 3 reports were made concerning the country in question during the period discussed in the audit or recall any information about such

reports. Accordingly, the report has not been modified to reflect L's comments on these issues.

L Comments Continued

7. Page 9

- Much of the discussion on this page is similar to page 1, and it is recommended that the same changes be made.

OIG Analysis and Comments

The OIG analysis and response to the L comments were previously addressed.

L Comments Continued

8. Page 9, last sentence and first sentence on page 10. (now Page 9, third paragraph, last two sentences)

- Change. Revise as follows: "For example, the Comprehensive Anti-Apartheid Act contained a provision that codified the mandatory 1977 arms embargo against South Africa. This provision is no longer in force. The arms embargo had previously been implemented by the Executive Branch under the authorities of the AECA and the EAA."

- Reason. Accuracy. Some of the statements do not appear to be accurate from a legal standpoint (e.g., the language stating that any transfers of U.S. manufactured equipment to South Africa was prohibited is not correct, and sections 317 and 318 of the CAAA itself explicitly recognized that certain items could be sent if Congress was notified in advance.)

OIG Analysis and Response

Reference to the Comprehensive Anti-Apartheid Act was not deleted, because unauthorized transfers of Munitions List items to South Africa when the Act was in force remain violations of U.S. law. However, the report has been changed to state that the CAA prohibited the transfer of "certain" items to South Africa.

L Comments Continued

9. Page 10, first full para. (now Page 9, forth paragraph)

- Change. Replace "agreement" with "arrangement."

- Reason. Accuracy. The MTCR is not a formal agreement, and is not binding under international law. It is commonly referred to as an agreement, but it would to be better to be more precise.

10. Page 15, first para. (now Page 14, first paragraph)

- This sentence states that sanctions are required whenever anyone knowingly exports or transfers missile related items and technology to non-MTCR countries.

- Change. Delete "anyone" and replace it with "certain U.S. and foreign persons" and add the following clause at the end of the sentence: ". . . under specified circumstances."

- Reason. The statement is legally incorrect. For example, sanctions are not required if the exports referred to are for non-missile purposes, and the sanctions generally do not apply if they are from MTCR countries.

OIG Analysis and Response

The report has been revised to more specifically describe the MTCR and its requirements.

L Comments Continued

11. Page 19, paras. 2 and 3. (now Page 17, paragraph 1 and 2)

- Comments Number 3 and 4 are applicable to paragraphs 2 and 3.

OIG Analysis and Response

As stated previously, the report sections dealing with AECA arms control and reporting requirements has been modified to reflect the Department's legal position.

L Comments Continued

12. Page 19, para. 1, third sentence. (now Page 17, para. 3, first sentence)

- This sentence essentially states that PM was responsible for initiating §3 reports during the period in question. While it is commonly assumed that this is the case, it should be emphasized and reflected in the report that PM was not formally responsible for initiating such reports. For example, PM was not delegated this function pursuant

to any delegation of authority nor apparently by memorandum from the Department's senior leadership. §3 reports have in past years also been initiated by other bureaus.

- Procedures on §3 reports were only formalized in August, 1991, after it was decided that the procedures needed revision, in part due to the IG's identification of the fact that draft reports were not sent to the Under Secretary unless the relevant Assistant Secretaries determined that reports were required. It thus may be inaccurate to state that PM had this responsibility.

- Finally, the report does not appear to mention in any place that consideration was being given within the Department to a §3 report while the IG audit was taking place. As indicated above, a key reason why a draft report was not sent to the Under Secretary prior to the IG's intervention was the fact that PM did not agree with the conclusions being drawn by others on the reliability of the intelligence and apparently its refusal to accept intelligence community assertions. The divergent views displayed during the deliberative process, as well as the concern expressed by the IG, demonstrated that the Department had no clear process or procedure to ensure that cases involving such doubt or dispute were referred to an Under Secretary. Thus, it appears to be misleading not to mention that senior officials disagreed on the facts and the intelligence, and that this was a key reason why a report was not submitted at that time. This demonstrates the soundness of the procedures adopted in August, 1991, to address the IG's timely concerns.

OIG Analysis and Response

In its comments, L states that it may be inaccurate to state that PM was responsible for initiating Section 3 reports, that a Section 3 report was under consideration during the audit, and that it appears to be misleading not to mention that senior officials disagreed on the facts and intelligence.

The OIG found no formal delegation of authority from T tasking PM with the responsibility to initiate Section 3 reports. However, the Bureau is responsible for administering the provisions of the AECA, including compliance with the Section 3 requirements. OIG does not regard a specific delegation for each section of an Act as generally necessary to establish management responsibility. Further, although other Bureaus are not precluded from initiating Section 3 reports, officials we discussed this matter with, including L and INR officials, stated

that practice dictates sending recommendations for Section 3 reports to PM and that attempting to by-pass PM would require acting outside "normal channels."

Regarding the statement that a Section 3 report was under consideration within the Department, L has now informed OIG staff that a Section 3 report was not under consideration within the Department, but rather the need for a report, based on intelligence reports, was being discussed. Furthermore, while senior officials may have disagreed on the facts and intelligence, OIG has found no evidence to support this comment although OIG requested that PM provide such support.

L Comments Continued

14. Page 20, first full para, second sentence. (now Page 18, para. 2)

- o This sentence states that the Deputy Secretary provided an oral report of violations to Congress on September 18, 1991.

- o Change. Delete "of violations" and replace it with either "that a substantial violation of applicable agreements may have occurred" or simply drop "of violations."

- o Reason. It is not clear that the Deputy Secretary stated that violations had occurred. Rather, because of the pattern of reports, Congress appears to have been told that substantial violations may have occurred. A key reason for this is that the intelligence community has apparently been unable or unwilling to state categorically that unauthorized transfers did occur. Making the changes suggested would obviate the need to inquire into what exactly was said by the Deputy Secretary for purposes of the audit.

OIG Analysis and Response

The report has been modified to more accurately depict the Deputy Secretary's oral report to Congress.

L Comments Continued

15. Page 22, Recommendation No. 2. (now Page 19)

- o The recommendation appears to be based on the statements made in the report that recoupment is generally required legally, which as indicated above comment under 5) appears to be incorrect.

OIG Analysis and Response

The report section dealing with recoupment of funds has been changed to more clearly state OIG's views regarding the legal issues and the difficulties involved in clearly determining amounts due the U.S.

L Comments Continued

16. Page 29, last sentence. (now Page 24, first full para., second sentence)

- Change. Replace this sentence with the following: "However, violators of U.S. export laws or licensing conditions frequently are not present in U.S. territory and thus the efforts of law enforcement officials are hampered unless the relevant countries have extradition treaties with the U.S. that cover the alleged violation of U.S. law."

- Reason. This sentence states that U.S. law enforcement officials do not have jurisdiction over violations of U.S. laws or proviso by foreign countries or importers. This is very inaccurate. The AECA and related export regulations generally apply to violations by importers or agents of foreign governments. The real problem for law enforcement officials is that the alleged offenders are frequently not within U.S. territorial jurisdiction.

OIG Analysis and Response

The report has been modified in accordance with L's comment.

L Comments Continued

17. Page 31, Recommendation 7. (now Page 25)

- This recommendation states that guidelines and procedures should be developed and published in the ITAR identifying the sanctions that will be taken in case of violations. It should be noted that the ITAR already contains specific provisions specifying the administrative, criminal, and civil sanctions to be imposed (e.a., Part 128 (Administrative Procedures), Part 127 (Violations and Penalties), Part 126, section 126.7 (basis for license denials)). Consequently, publishing new provisions in the ITAR appears to be superfluous. Requiring sanctions automatically based on a finding of a violation in a manner that exceeds the current regulatory standards

could raise due process and other concerns. However, developing internal guidelines on how to deal with potential violations would appear to be a prudent step.

OIG Analysis and Response

OIG found that applicable sanctions and guidelines are not clearly stated in existing regulations. For example, the ITAR does not contain regulations applicable to the unauthorized transfer of Munitions List items by foreign recipients, Congressional reporting requirements, and sanctions proscribed under the AECA. However, OIG recognizes the concerns expressed by L regarding the Secretary's flexibility to conduct diplomacy. Accordingly, the recommendation that written guidelines and procedures be published in the ITAR, a public document, has been deleted. The recommendation that guidelines and procedures should be developed has been retained.