

End-Use Monitoring of Defense Articles and Defense Services Commercial Exports FY 2008

This report describes actions taken by the Department of State during fiscal year 2008 to implement the “Blue Lantern” end-use monitoring program. The Blue Lantern program, operated in accordance with section 40A of the Arms Export Control Act (AECA) (22 U.S.C. 2778), as amended, monitors the end-use of defense articles (including related technical data) and defense services exported through commercial channels and subject to Department of State licenses or other approvals under section 38 of the AECA.

The Department of State’s Directorate of Defense Trade Controls in the Bureau of Political-Military Affairs (PM/DDTC) is responsible for administering the International Traffic in Arms Regulations (ITAR) (22 C.F.R. Parts 120-130) that implement section 38 of the AECA. PM/DDTC’s functions include registration of manufacturers, brokers, and exporters; licensing of defense trade; insuring compliance with the ITAR and implementing civil enforcement; supporting the Department of Justice and other U.S. law enforcement agencies in investigations and prosecutions of AECA and ITAR criminal violations; as well as the end-use monitoring of transactions licensed or authorized by PM/DDTC.

The Blue Lantern program is managed within PM/DDTC by the Office of Defense Trade Controls Compliance’s (DTCC) and its Research and Analysis Division (RAD). Blue Lantern end-use monitoring entails pre-license, post-license, or post-shipment inquiries or “checks” undertaken to verify the bona fides of proposed foreign consignees and end-users, to confirm the legitimacy of proposed transaction, and to provide “reasonable assurance that –

- i) the recipient is complying with the requirements imposed by the U.S. Government with respect to use, transfers, and security of defense articles and defense services; and
- ii) such articles and services are being used for the purposes for which they are provided.”¹

PM/DDTC is currently authorized a full-time complement of 78 State Department personnel, which is supplemented by 8 military officers, approximately 60 contract personnel, a DHS/Immigration and Customs Enforcement Senior Special Agent,

¹ See section 40A(a)(2) of the AECA, 22 U.S.C. 2785(a)(2).

and an FBI Supervisory Special Agent. PM/DDTC's operational budget for FY 2008, in addition to American salaries, was approximately \$3.1 million. Five State Department personnel and two contract personnel currently work on the Blue Lantern program, in addition to other duties, within RAD.

Overseas End-use Monitoring: The Blue Lantern Program

Initiated in September 1990 as the United States Government's first systematic end-use monitoring program, Blue Lantern has strengthened the effectiveness of U.S. export controls and has proven to be a useful instrument in:

- 1) deterring diversions to unauthorized end-users and identifying possible ITAR violations,
- 2) aiding the disruption of illicit supply networks used by international criminal organizations or governments under U.S. or international restrictions and sanctions,
- 3) educating foreign governments and private companies about U.S. export controls, and
- 4) helping the Department to make informed licensing decisions and to ensure compliance with the AECA and the ITAR.

End-use checks performed under the Blue Lantern program have significantly encouraged compliance with statutory and regulatory requirements and have proven effective in combating the global "gray arms" trade. "Gray arms" refers to the use of fraudulent export documentation or deliberate misrepresentation of the facts of a transaction to acquire defense articles through legitimate channels for illicit re-transfer to unauthorized end-users.

U.S. embassy personnel, or in some instances PM/DDTC personnel, conduct Blue Lantern end-use checks overseas to verify the *bona fides* of unfamiliar foreign parties, to ensure delivery of licensed United States Munitions List (USML) articles/services to authorized end-users, to confirm proper end-use, and to determine compliance with PM/DDTC licenses and agreements and provisos imposed thereon.

In fiscal year 2008, PM/DDTC completed action on nearly 83,000 license applications and other requests. Blue Lantern inquiries are not conducted randomly, but rather are carefully selected to identify transactions that appear most at risk for diversion or misuse. License applications and other requests undergo

review by licensing officers and compliance specialists, who check case details against established criteria for determining potential risks: unfamiliar foreign parties, unusual routing, overseas destinations with a history of illicit activity or weak export/customs controls, commodities not known to be in the inventory of the host country's armed forces, and other indicators of concern. The information derived from Blue Lantern checks helps PM/DDTC licensing officers and compliance specialists assess risks associated with the export of certain defense articles and services to various countries and regions, and provides significant insight into the reliability of companies and individuals involved in defense procurement overseas.²

Blue Lantern End-Use Inquiries in FY 2008

For the sixth year in a row, the Blue Lantern program increased its overall number of inquiries initiated in FY 2008, setting a new record at 719 (Figure 1). These checks were conducted in 98 countries, also a record number. Of the 543 Blue Lantern cases closed in FY 2008, 82 (15%) were determined to be “unfavorable.” An unfavorable determination means that the Blue Lantern's findings of fact are not consistent with the information contained in the application or license. Problems identified during a pre-license check may result in denial of the license, removal of a party or parties, or the license being returned without action. Problems identified during a post-shipment check, if sufficiently serious, may result in revocation of the existing license. Entities of concern identified in pre-license or post-shipment checks are entered into DTCC's Watch List for further monitoring.

Unfavorable Blue Lantern cases are referred to DTCC's Enforcement Division for review. Where appropriate, parties involved in unfavorable Blue Lantern cases may be subject to civil enforcement actions or referred to the federal law enforcement community for criminal investigation. FY 2008 Blue Lantern checks resulted in 15 disclosures and three referrals for possible criminal investigation. The chart on the following page illustrates the number of Blue Lantern checks initiated by year. The charts on the next page thereafter illustrate the regional distribution of export requests and of Blue Lantern checks initiated, completed, and found to be unfavorable. For statistical purposes, PM/DDTC attributes a Blue Lantern check to the region of the end-user listed on the application or license.

² Because Blue Lantern checks are selected based on potential risk and not a random sampling across all PM/DDTC licenses, data on unfavorable checks should not be regarded as statistically representative of all license applications.

Blue Lantern inquiries, however, may be initiated or determined to be “unfavorable” due to foreign intermediaries in third countries.

Figure 1:

Total Blue Lanterns Initiated FY 2003 to FY 2008

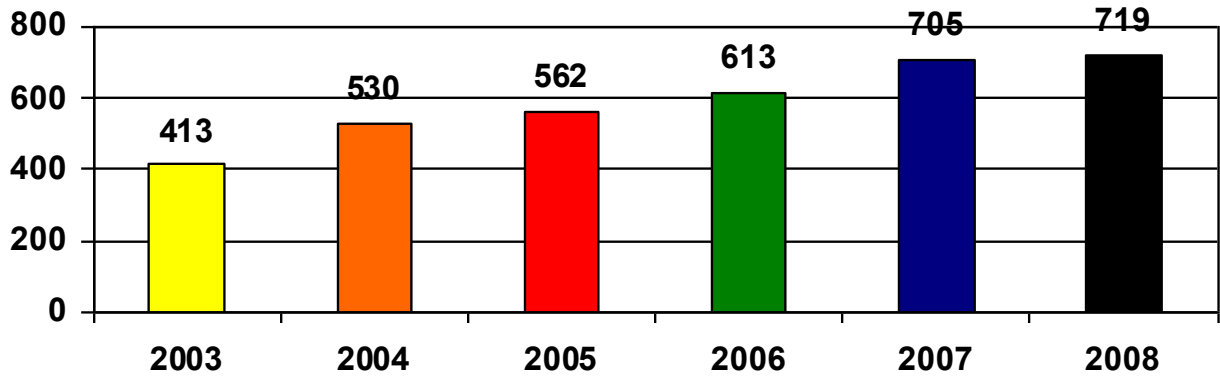


Figure 2:

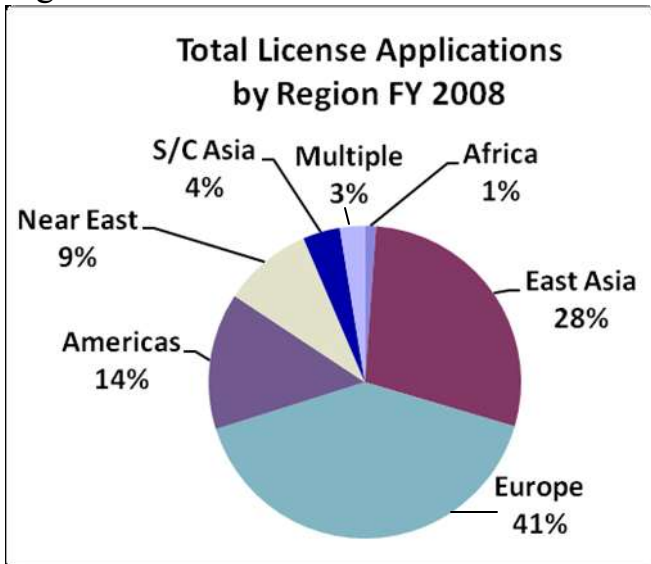


Figure 3:

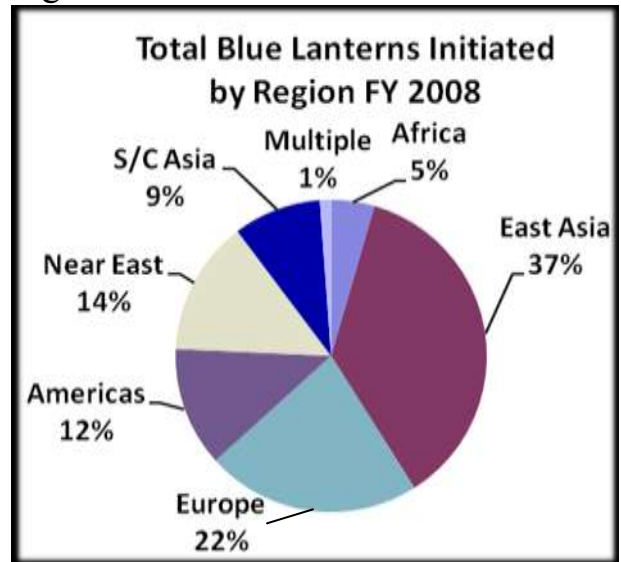


Figure 4:

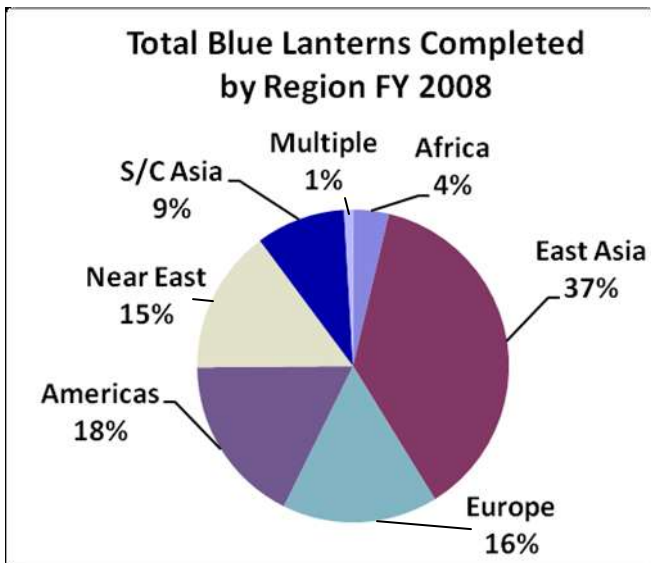


Figure 5:

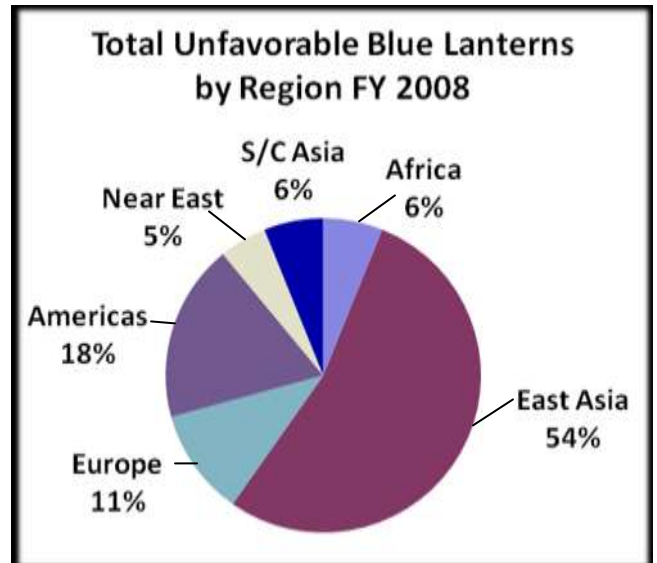


Figure 2 illustrates the regional distribution of USML export license applications.

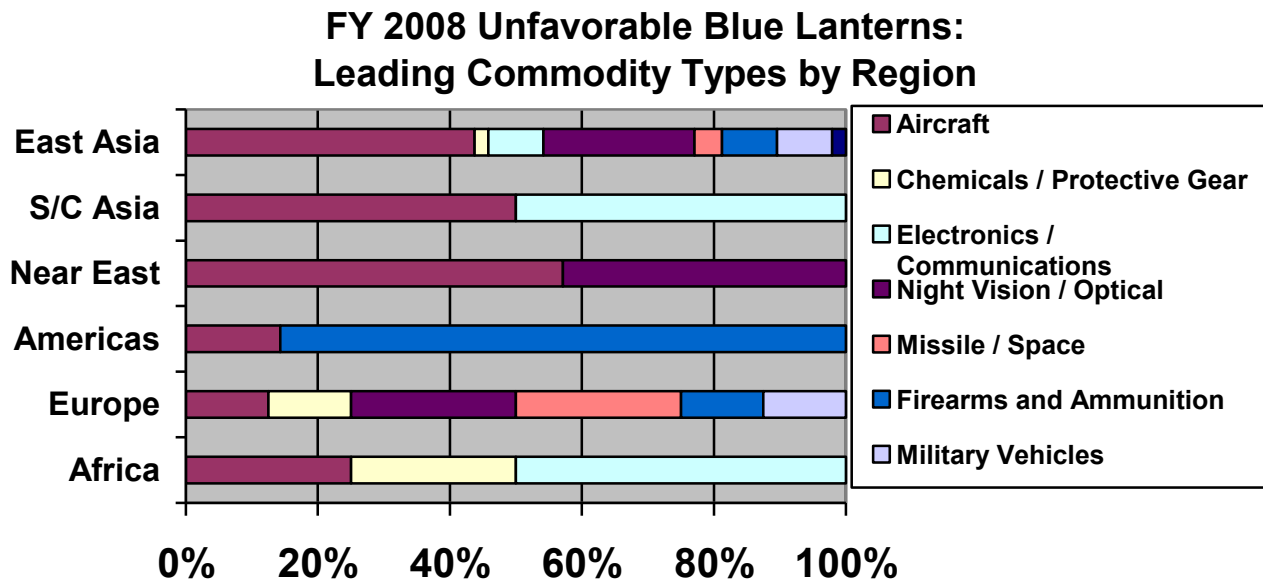
As Figure 3 illustrates, the geographical distribution of Blue Lantern inquiries initiated during FY 2008 does not necessarily match that of license applications received. As has been the pattern for several years, Europe has relatively fewer Blue Lantern checks (22%) proportionate to the number of applications (41%). East Asia, conversely, was the site of 37% of all Blue Lantern checks despite representing only 28% of applications. Likewise, the proportion of Blue Lantern checks initiated in Africa, South/Central Asia, and the Near East was significantly greater than those region's respective shares of applications.

Figure 4 illustrates the regional distribution of Blue Lanterns completed during FY 2008, which provides a useful baseline for the regional distribution of unfavorable Blue Lantern results illustrated in Figure 5. Here again, the East Asia/Pacific region is noteworthy for representing more than half (54%) of unfavorable Blue Lantern results despite comprising only a third (37%) of checks completed. Except for Africa, the respective proportions of unfavorable checks for all other regions were either less than or equal to their proportion of completed checks.

Analysis of Unfavorable Checks by Commodity and Region

Figure 6 illustrates the types of commodities most often the subject of unfavorable Blue Lanterns by region. The Western Hemisphere (especially Central America and the Caribbean) continues to be a region with a high incidence of unfavorable cases involving firearms and ammunition. Many of these cases involve pre-license checks on unfamiliar retail firearms vendors which are determined to be not responsible recipients of USML due to lack of proper security, poor record-keeping, or other insufficient business practices. Aircraft parts continue to generate large numbers of Blue Lanterns, especially in the East Asia/Pacific region and the Near East. After a decline in FY 2007, night vision and optical guidance/detection equipment returned to its previous status as a category with a high incidence of unfavorable checks, especially in the East Asia/Pacific region.

Figure 6:



Reasons for Unfavorable Checks in FY 2008

- Indications or evidence of diversion or unauthorized retransfer or re-export: 24% (n=20)
- Foreign party (end-user and/or consignee) involved in transaction but not listed on license/application: 23% (n=19)
- Unable to confirm order or receipt by end-user: 18% (n=15)
- Unauthorized brokering: 9% (n=7)
- Warehousing or stockpiling: 6% (n=5)
- Derogatory information / foreign party deemed unreliable recipient of USML: 5% (n=4)
- Unable to confirm existence of foreign party listed on license: 5% (n=4)
- Refusal to cooperate: 5% (n=4)
- End-use differs from that listed on license: 1% (n=1)

- Exported from U.S. without authorization: 1% (n=1)
- Exported items received by end-user but unaccounted for: 1% (n=1)
- Party violated terms of license or agreement: 1% (n=1)

The relative frequency of reasons for unfavorable determinations in FY 2008 shifted, in some cases significantly, compared to the previous fiscal year. The new leading category, strong indications or clear evidence of attempted or actual diversions or unauthorized retransfers of USML articles or technology, represented 24% of unfavorable results in FY 2008 but only 7% in FY 2007 (sixth place). This could be due to a number of possible factors, including better selection of applications and licenses for Blue Lantern checks, more thorough and effective checks, or increased gray arms trafficking, particularly in certain commodity groups.

Under Section 38(g)(2) of the AECA and 126.13(b) of the ITAR, U.S. applicants are required to identify all domestic and foreign parties – end-users and/or consignees – on a license request. In FY 2008, 23% of inquiries resulted in an unfavorable response due to the applicant’s failure to fulfill that statutory requirement. In FY 2007 that figure was 19%. While in some cases this appears to be a minor oversight, identification of all parties is a critical element in the ability of PM/DDTC to maintain a secure chain of custody from U.S. exporter to foreign end-user. Without transparency regarding all parties to a transaction, diversion to unauthorized end-users and end-use is far more likely to occur.

The third most common reason for unfavorable results, at 18%, was the inability to confirm receipt or order of USML items by the end-user listed on the license application. This category represents the combination of two categories from FY 2007 – “end-user did not order items on license” and “unable to confirm receipt or order by end-user” – which represented 8% and 6%, respectively, of unfavorable results last year. As in the failure to identify all foreign parties, this category contains both benign and malign cases. While some instances seem to be due to sloppy paperwork or ineffective tracking mechanisms, others appear to represent foiled attempts at diversion.

Only 5% of unfavorable checks in FY 2008 were due to the discovery of derogatory information or a party being deemed unreliable, compared to 13% in FY 2007.

FY 2008 saw an increase in the incidence of unauthorized brokering activities (9% compared to 5% in FY 2007), most often by unregistered entities. This reflects increased attention to the issue of foreign consignees acting as brokers for licensed transactions, and resulted in several new brokering registrations as well as the placement of noncompliant companies on the Watch List.

Remaining relatively unchanged compared to FY 2007 were the proportions of parties who refused to cooperate (5%) and findings of unauthorized stockpiling by foreign consignees (6%). While maintaining an inventory of ITAR-controlled parts may make good business sense for foreign suppliers, this practice reduces the Department's ability to control defense exports effectively and can lead to illicit diversion. A foreign company maintaining an inventory of defense articles must be party to an approved Warehouse and Distribution Agreement per ITAR section 124.14.

Blue Lantern Case Studies FY 2008

Case Study #1: Stockpiling and Unauthorized Retransfer/Re-export (Pre-License Check)

Request for Temporary Import

Items: Armored vehicle parts and components
End-User: Central American company
Source/Foreign Consignee: European company

Reasons for Check

- Apparent improper use by U.S. applicant of temporary import application (DSP-61) for transshipment
- Unclear how European company had acquired U.S.-origin items which were to be retransferred to Central America via U.S. applicant; no record of retransfer authorization

Findings

- European company routinely acquired U.S.-origin items from third parties without authorization, stocked them, and retransferred/re-exported them without authorization to a variety of end-users
- DTCC initiated directed disclosure proceedings and ultimately placed the European company under a policy of denial

Case Study #2: End-user Unable to Confirm Order by Foreign Consignee (Pre-License Check)

License for Permanent Export

Items: C-130 aircraft parts
End-user: West African air force
Foreign Consignees: Several European companies

Reasons for Check

- Large order of aircraft spare parts and limited licensing history of end-user

Findings

- End-user had no record of the order for aircraft spare parts
- Evidence points either to attempted diversion by intermediate consignees or poor record-keeping and procurement practices by end-user or foreign consignee

Case Study #3: Attempted Circumvention of Congressional Notification Requirements (Pre-License Check)

Multiple Requests for Permanent Export

Items: Assault rifles
End-Users: Central American military and police forces
Foreign Consignee: Central American company

Reason for Check

- High volume of weapons
- Identical commodities were ordered via multiple licenses involving same exporter and end-user

Findings

- U.S. applicant and foreign consignee appeared to have deliberately divided one large order into multiple licenses in order to avoid Congressional notification requirements (\$1,000,000 threshold for firearms licenses)
- DDTC returned applications without action; U.S. applicant resubmitted as a single license, which DDTC notified to Congress

**Case Study #4: Unable to Find Foreign Consignee
(Pre-License Check)**

Request for Permanent Export

Item/End-Use: F-16 aircraft spare parts
End-User: Southeast Asian air force
Foreign Consignees: Southeast Asian company

Reason for Check

- Sensitive commodity and unfamiliar foreign consignee

Findings

- Unable to locate or contact foreign consignee
- A bar/nightclub located at foreign consignee address stated in license application
- License denied

**Case Study #5: Items Exported Prior to License Approval
(Pre-License Check)**

Request for Permanent Export

Item/End-Use: Military electronic sensors
End-User: Asian military
Foreign Consignee: Asian subsidiary of European company

Reason for Check

- Confirm end-user's order of sensitive items

Findings

- End-user confirmed order; already in receipt of items
- Items were exported prior to license approval in violation of ITAR and AECA

Case Study #6: Suspected Diversion of Technical Data to Proscribed Destination

(Check on Proposed Amendment to Manufacturing License Agreement)

Proposed Amendment to Manufacturing License Agreement (MLA)

Item: Technical data for digital radio
End-User: Southeast Asian company in support of US DOD contract

Reason for Check

- Sensitive technology
- End-user company had subsidiaries in country subject to ITAR 126.1 (U.S. arms embargo)

Findings

- Confirmed end-user had subsidiary and manufacturing facilities in embargoed country, though no clear indication that technical data would reach proscribed destination
- Company facilities in embargoed country had sought USML technical data for unrelated project
- Referred to DTCC's Enforcement Division for further inquiry

Case Study #7: Exports Exceed Authorized Quantity

(Post-Shipment Check on Several Licenses)

Request for Permanent Export

Items: Aircraft spare parts
End-User: Southeast Asian military
Foreign Consignee: Southeast Asian company

Reason for Check

- Commodities in inventories of countries subject to U.S. arms embargoes

Findings

- Transaction legitimate, but exporter exceeded quantity of authorized commodities by over 30%
- Foreign consignee deliberately sought to stockpile items for future sales to end-user
- U.S. company also exported commodities not listed on licenses

Case Study #8: Probable Attempted Diversion to Proscribed Destination (Pre-License Check)

Request for Permanent Export

Items: Aircraft components
End-User: Middle Eastern aviation company
Foreign Consignee: Middle Eastern trading company

Reason for Check

- Unfamiliar end-user and consignee
- Items frequently sought by country subject to U.S. arms embargo

Findings

- Unable to reach principal of end-user company because he was on business travel in U.S. embargoed country
- Consignee had no actual office in country listed on application
- End-user abruptly cancelled order following Blue Lantern inquiry; high suspicion of attempt to divert USML items to embargoed destination

Case Study #9: Bogus End-Use Certificate (Post-Shipment and Pre-License Check)

One License and One Request for Permanent Export

Items: Aircraft spare parts
End-User: South Asian air force
Foreign Consignee: Middle Eastern company

Reason for Check

- Same non-transfer and use certification (Form DSP-83) submitted by two different U.S. applicants in support of two different license applications
- Foreign consignee on the Watch List and appeared to be reusing certificate to place orders with multiple U.S. suppliers

Findings

- Signer of the DSP-83 had left South Asian MOD two months before date on DSP-83
- Application returned without action; items on license already had been exported
- PM/DDTC requires that all subsequent applications involving foreign consignee include a signed DSP-83 from the end-user

Insight: Why more cases of diversion, unauthorized retransfers, and re-exports?

The ongoing globalization of defense industries and defense trade poses significant challenges to compliance with the ITAR and the AECA. As noted earlier in this report, the leading reason for unfavorable Blue Lantern determinations for FY 2008 was indications of diversion or retransfer or re-export to end-users or for end-uses not authorized on the license. Less than half of the unfavorable end-use checks in this category, however, involved apparently deliberate attempts to divert USML articles or technology to an unauthorized end-user. More commonly, authorized end-users employed licensed exports for unauthorized end-uses or retransferred or re-exported items to unauthorized foreign intermediate consignees for integration into finished products in what were otherwise legitimate transactions.

In one case, a combination of misunderstanding and miscommunication resulted in a license application failing to state that the African consignee was to integrate USML communications equipment into a larger system which would be transferred to a previously unidentified African manufacturer. The manufacturer in turn intended to integrate the system into an unmanned aerial vehicle for export to the armed forces of a Middle Eastern country.

In another case, a Southeast Asian consignee explained that it regularly re-exported military-grade zinc selenide to its facilities in China for manufacturing, along with non-USML raw materials. Company employees admitted they were unfamiliar with restrictions on USML items and did not realize the re-exports constituted ITAR violations.

The increasing complexity of global supply chains, combined with laxity about U.S. export controls compliance among certain foreign parties – and sometimes among U.S. defense exporters as well – appears to have contributed to the rise in cases of unauthorized retransfers and re-exports during FY 2008. To be sure, the numbers of these cases are few relative to the vast majority of defense trade transactions which are legitimate and fully compliant with U.S. export controls. The increase in unauthorized re-exports and retransfers, however, does serve as a cautionary flag that U.S. and foreign companies need to place as much emphasis on compliance as they do on obtaining an export license. Any transaction which evades requirements under the ITAR and the AECA and undermines the chain of custody on which our export control system is built heightens the risk of technology transfer to adversaries of the United States and weakens our national security. In the coming year, PM/DDTC will continue to use the licensing review

process and Blue Lantern program to identify violations of this sort and, where appropriate, refer for civil or criminal enforcement action.