End-Use Monitoring of Defense Articles and Defense Services
Commercial Exports FY 2007

This report describes actions taken by the Department of State during the past fiscal year 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, as Amended (AECA), monitors the end-use of commercially exported defense articles, defense services, and related technical data subject to licensing or other authorizations under section 38 of the AECA. The Directorate of Defense Trade Controls, in the Bureau of Political-Military Affairs (PM/DDTC), Department of State, is responsible for administering the International Traffic in Arms Regulations (ITAR) that implement section 38 of the AECA. DDTC's functions include registration of manufacturers, brokers, and exporters; licensing of commercial defense trade; overseeing compliance with the ITAR: supporting the Department of Justice and other U.S. law enforcement agencies in criminal investigations and prosecutions of AECA and ITAR violations; as well as the end-use monitoring of PM/DDTC licensed or authorized transactions. The Blue Lantern program is managed within PM/DDTC by the Office of Defense Trade Controls Compliance's (DTCC) Research and Analysis Division (RAD). Blue Lantern end-use monitoring entails pre-license, post license or post-shipment checks undertaken to verify the legitimacy of a transaction and to provide "reasonable assurance that –

i) the recipient is complying with the requirements imposed by the United States 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 6 military officers, about 40 contract personnel, a DHS/Immigration and Customs Enforcement Senior Special Agent, and an FBI Supervisory Special Agent. PM/DDTC's operational budget for FY 2007, in addition to American salaries, was approximately $12.2 million.

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

Overseas End-use Monitoring: The Blue Lantern Program

Initiated in September 1990 as the USG's first systematic end-use monitoring program, the Blue Lantern program 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, 2) aiding the disruption of illicit supply networks used by international criminal organizations or governments under U.S. or international restrictions and sanctions, and 3) 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 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 companies, to ensure delivery of licensed United States Munitions List (USML) commodities to proper end-users and confirm proper end-use, and to determine compliance with DDTC licensed agreements.

Last fiscal year, PM/DDTC completed action on approximately 81,000 license applications and other export requests. Blue Lantern checks are not conducted randomly, but are rather the result of a careful selection process 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]

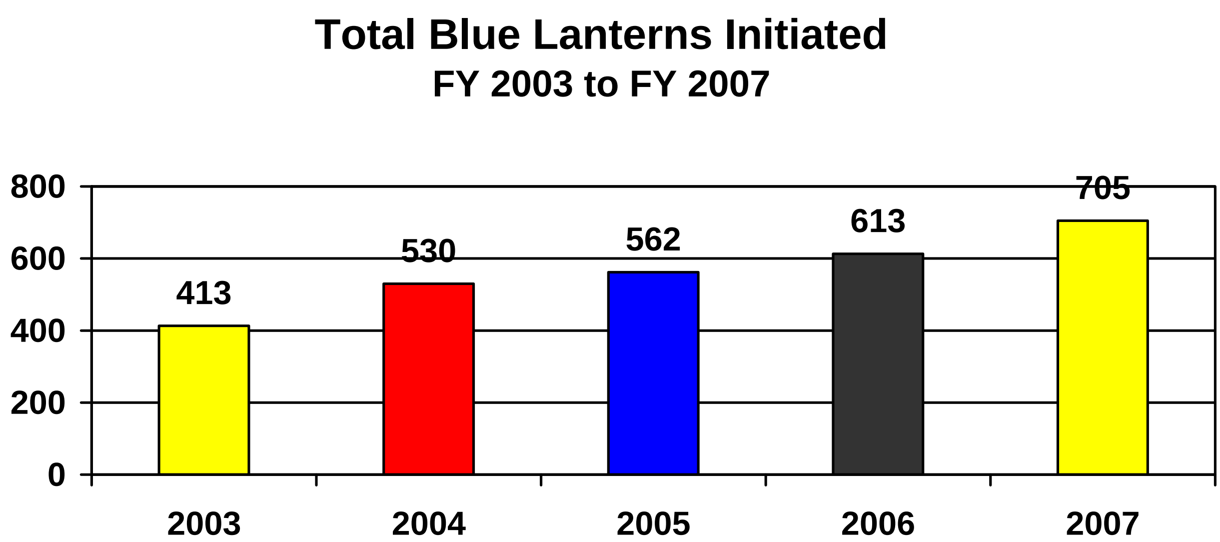
[2] Because Blue Lantern checks are selected based on potential risk and not a random sampling across all PM/DDTC licenses, data on unfavorable checks should not be regarded as statistically representative of all license applications.

Blue Lantern End-Use Checks in FY 2007

The Blue Lantern program increased its overall number of checks for the fifth year in a row (Figure 1). In FY 2007, new records were established for both the overall number of checks and unfavorable checks, as well as the recording the highest ever percentage of unfavorable checks. During FY 2007, PM/DDTC initiated 705 end-use checks: a fifteen percent increase over FY 2006's 613 checks. Of the 634 Blue Lantern cases closed in FY 2007, 143 – twenty-three percent – were determined to be "unfavorable. Unfavorable Blue Lanterns are reviewed by DTCC's Enforcement Division. Where appropriate, parties involved in unfavorable Blue Lantern cases may be subject to civil enforcement actions or referred to law enforcement for criminal investigation.

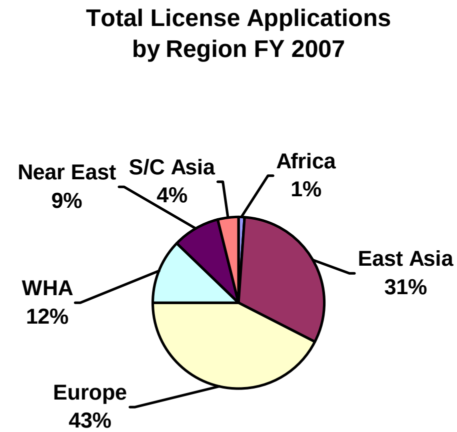
The charts on the following page illustrate the regional distribution of all export requests compared to all Blue Lantern checks and to all unfavorable Blue Lantern checks.

Figure 1:

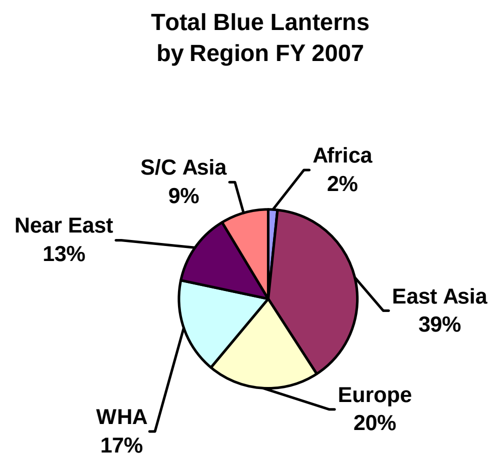


Figures 2, 3, and 4:

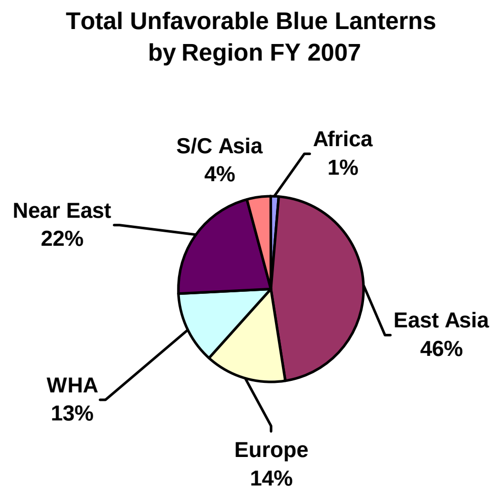
Figure 2 illustrates the global distribution of USML export license applications by region.



As Figure 3 illustrates, the geographical distribution of Blue Lantern checks does not necessarily match that of licenses. As has been the pattern for several years, Europe has relatively fewer Blue Lantern checks (20%) proportionate to the number of license applications (43%). East Asia, conversely, was the site of 39% of all Blue Lantern checks despite representing only 31% of license applications, and South/Central Asia represented 9% of Blue Lanterns – more than double the 4% of license applications for the region.



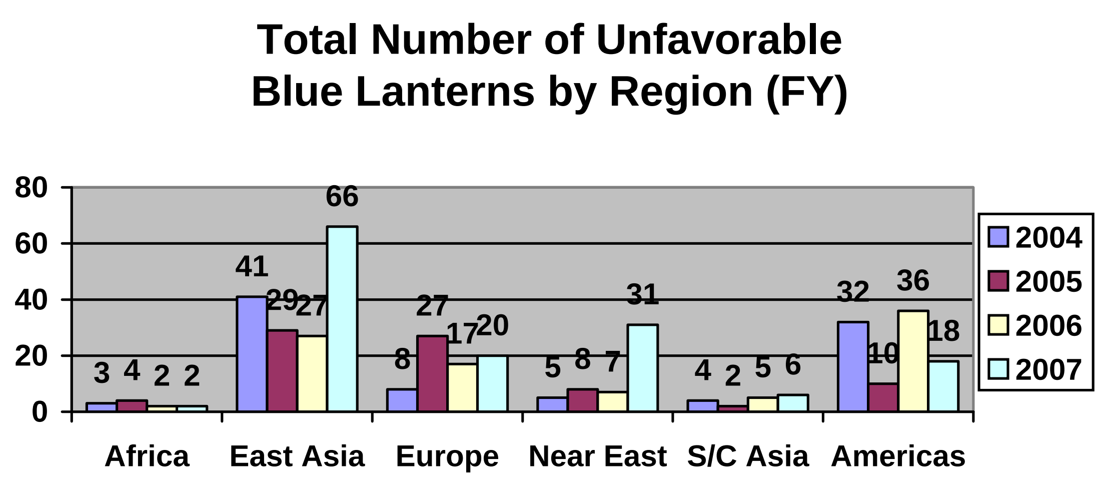
Unfavorable Blue Lantern results by region vary even further, as Figure 4 illustrates. A full 46% of unfavorable Blue Lantern cases were in East Asia and only 14% in Europe. The Near East followed East Asia with 22% of all unfavorable cases – despite representing only 9% of license applications and 13% of overall Blue cases.



Analysis of Unfavorable Checks by Region: FY 2004 - 2007

Attributing reasons for trends in unfavorable Blue Lantern determinations is complex. For several years, East Asia's unfavorable checks have remained high proportionate to the number of overall licenses while Europe's percentage of unfavorable checks has declined. Reasons may have more to do with local business culture and lack of familiarity with U.S. export statutes and regulations than deliberate attempts to divert ITAR-controlled commodities or otherwise circumvent U.S. rules. A high number of unfavorable checks in East Asia were due to findings such as a failure to identify a foreign intermediary on the license, and over-ordering components/parts in anticipation of future needs (i.e., stockpiling). In Japan, Korea, Taiwan and Singapore, government end-users regularly rely on private companies (and sometimes subcontractors) to procure and keep their armed forces supplied with ITAR-controlled spare parts. As a consequence, these companies order parts in excess of immediate needs of the government end-user; governments, when queried during Blue Lantern checks, frequently have difficulty precisely verifying these orders, resulting in unfavorable determinations. Whether ill intended or not, these practices create vulnerabilities in the export control system that can be exploited by the illicit gray arms market.

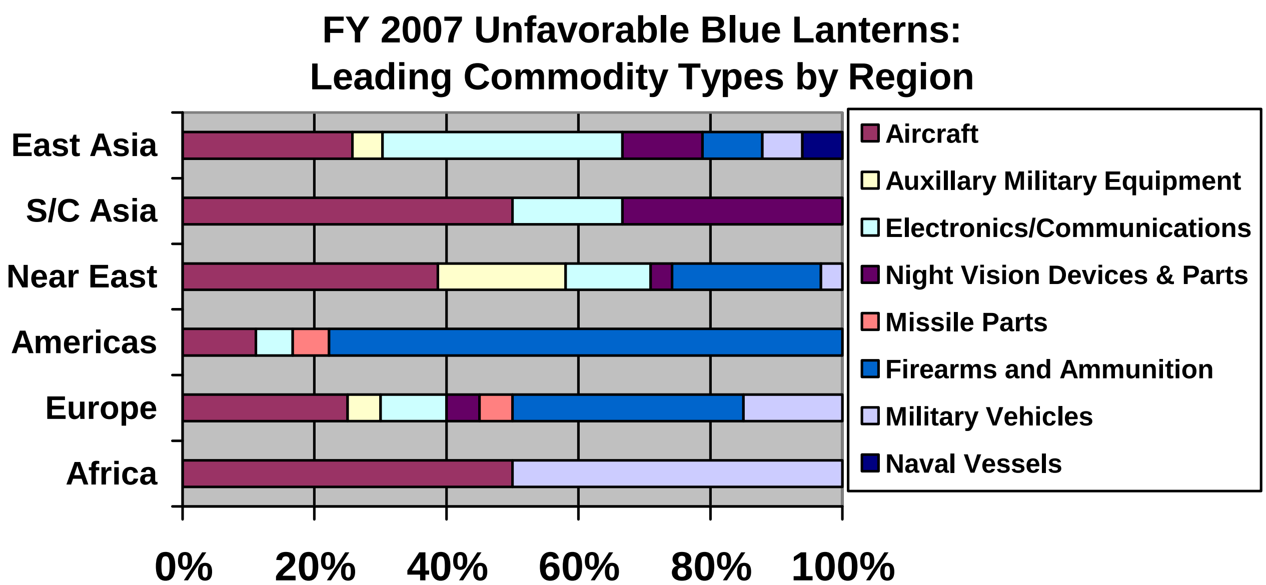
Figure 5:



Analysis of Unfavorable Checks by Commodity and Region

The chart below (Figure 6) illustrates the types of commodities most often the subject of unfavorable Blue Lanterns by region. The Western Hemisphere (especially Latin America and the Caribbean) continues to be a region with a high incidence of unfavorable cases involving firearms and ammunition. Aircraft and spares continue to generate large numbers of Blue Lanterns, especially in the East Asia/Pacific and the Near East. Given the high volume of fixed and rotary-wing aircraft-related export licenses, a robust global market in this sector, and the continuous need for parts and maintenance among civil and military air fleets worldwide, this is not surprising. Night vision equipment, formerly a category with a high incidence of unfavorable checks, posted a decline in unfavorable checks during FY 2007. This may be attributable to more scrutiny of night vision export licenses, tougher provisos attached to licenses that are approved, and overall heightened awareness of proliferation risks associated with night vision equipment in the wake of several high-profile cases, such as the penalties levied by the Department of State against ITT, a major U.S. manufacturer of night vision equipment.

Figure 6:



Reasons for Unfavorable Checks in FY 2007

Reasons for unfavorable determinations were diverse among this year's cases. The largest category (19%) was the failure of applicants to properly identify all foreign parties on the license application. While in many cases this appears a minor oversight, the requirement to identify all parties on a license is established in the AECA and section 126.13(b) of the ITAR, and 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 – as several of the following case studies illustrate. Also documented is the increasing incidence of stockpiling (10%) by foreign consignees. While maintaining an inventory of ITAR-controlled parts may make good business sense for foreign suppliers, this practice also reduces the Department's ability to effectively control defense exports and can lead to illicit diversion. A foreign company maintaining an inventory of defense articles must be the subject of an approved Warehouse and Distribution Agreement per ITAR 124.14. Finally, 10 (7%) unfavorable cases this fiscal year showed evidence of deliberate diversion or unauthorized re-export of USML, indicating that the gray arms trade is alive and well, and that vigilance in this regard is essential.

- Foreign party not listed on license application: 19% (n=27)
  - End-user not listed on license: 5% (n=7)
  - Foreign consignee not listed on license: 14% (n=20)

- Party violated terms of license or agreement: 18% (n=26)

- Unreliable Party/Derogatory Information: 13% (n=18)
  - Party deemed unreliable recipient of USML: 10% (n=14)
  - Party deemed unreliable due to criminal background: 3% (n=4)

- Stockpiling: 10% (n=15)

- End-user did not order items on license: 8% (n=12)

- Evidence of diversion or unauthorized re-export: 7% (n=10)

- Unable to confirm receipt or order by end-user: 6% (n=9)

- Refusal to cooperate: 6% (n=9)

- Unauthorized brokering: 5% (n=7)

- Different end-use from one listed on license: 3% (n=4)

- Unable to contact or locate party on license: 2% (n=3)

- Exported from U.S. without authorization: 2% (n=3)

Blue Lantern Case Studies FY 2007

Case Study #1: Unable to Confirm Order by End-User
(Post-License/Pre-Shipment Check)

Request for Permanent Export
Items: F-16 jet fighter parts
End-User: South Asian military
Foreign Consignee: European company

Reasons for Check
- No documentation from end-user
- Suspicious third-country consignee

Findings
- Consignee provides letter of intent but could not specify which parts were going to the South Asian military
- Consignee also could not provide POC at South Asian military
- Embassy unable to confirm order with South Asian military

Case Study #2: Unable to Confirm Receipt by Foreign Consignee
(Post-License Check)

License for Permanent Export
Items: C-130 aircraft parts
End-user: South Asian air force
Foreign Consignee: Southeast Asian company

Reasons for Check
- Unfamiliar foreign consignee with very limited licensing history

Findings
- Consignee claims to have numerous orders from South Asian air force but said it had not received the parts listed on this license
- Parts had been exported from U.S. more than six months earlier
- Consignee either untruthful, parts diverted to another end-user, or inadequate record-keeping

Case Study #3: Items Diverted to Embargoed Country
(Post-Shipment Check)

<u>Several Related Blue Lantern Checks</u>

Items:	Night vision imaging system (NVIS) filtered lamp assemblies
End-Users:	Government and private entities in five countries
Foreign Consignee:	Asian-Pacific company

<u>Reason for Check</u>
- Previous denied license application for export of NVIS items to China

<u>Findings</u>
- Series of Blue Lantern post-shipment checks on Asian-Pacific company's NVIS licenses: 10 of 13 indicated possible unauthorized retransfer/illicit activity
- Directed Disclosure by foreign company revealed multiple diversions of items to China and other unauthorized end-users in third countries

Case Study #4: Different End-Use and End-User
(Pre-License Check)

<u>Request for Permanent Export</u>

Item/End-Use:	Electronic components for ground radar system
End-User:	Middle Eastern military
Foreign Consignees:	Western European firm and Middle Eastern firm

<u>Reason for Check</u>
- Unusual routing to Middle East military via European and Middle Eastern firms

<u>Findings</u>
- European consignee says items will be used in vessel traffic management system for central African port
- European firm is in financial trouble, has office in Middle East

Case Study #5: Unauthorized Items Commingled with Authorized Exports
(Post-License Check)

<u>Request for Permanent Export</u>

Item/End-Use:	Aircraft spare parts
End-User:	Southeast Asian military
Foreign Consignee:	Southeast Asian state-owned company

<u>Reason for Check</u>

- Concerns about foreign consignee and its high volume of high-value licenses for large quantities of diverse items

<u>Findings</u>

- Significant military equipment (SME) and major components were exported under the license when only minor components and spare parts were authorized

Case Study #6: Consignee Not Listed on License
(Post-Shipment Check)

<u>License for Permanent Export</u>

Item:	C-130 aircraft parts
End-User:	Middle Eastern military
Foreign Consignee:	Asian-Pacific company

<u>Reason for Check</u>

- Unusual routing of items sought by embargoed countries

<u>Findings</u>

- Asian-Pacific company had transferred items to Southeast Asian consignee not listed on license without receiving authorization from either U.S. or its own country's authorities
- Middle Eastern military was expecting parts from Asian-Pacific company, but unauthorized retransfer to Southeast Asian company creates opportunity for diversion

Case Study #7: End-User with Criminal Background
(Pre-License Check)

<u>Request for Permanent Export</u>

Items:	Firearms
End-User:	Latin American firearms dealer

<u>Reason for Check</u>
- Unfamiliar end-user

<u>Findings</u>
- Company was front company for another Latin American company
- Owner admits that company exists only on paper as response to market competition and strict import limitations
- Host country authorities had temporarily suspended firearms import licenses to parent company because of its link with small arms smuggling to gangs in third country

Case Study #8: Stockpiling
(Pre-License Check)

<u>Request for Permanent Export</u>

Items:	Laser rods
End-User:	Middle Eastern military
Foreign Consignee:	Western European company

<u>Reason for Check</u>
- Application’s supporting documentation stated that foreign consignee will stock a portion of the laser rods for future orders

<u>Findings</u>
- Middle Eastern military ordered only 20 laser target designators
- Consignee’s order of excess laser rods would constitute unauthorized warehousing

Case Study #9: Items Exported without Authorization
(Pre-License Check)

Request for Permanent Export

Items:	M-113 armored vehicle parts
End-User:	Asian-Pacific military
Foreign Consignee:	Asian-Pacific company
U.S. Applicant:	High-volume exporter

Reason for Check
- Foreign consignee was the subject of a previous unfavorable Blue Lantern check
- Suspicious that a foreign consignee in the aerospace industry was dealing in armored vehicle parts

Findings
- Asian-Pacific military received the items, even though license had not been issued; US exporter failed to get authorization prior to export

Insight: Why Record Numbers of Blue Lanterns?

As noted previously, FY 2007 saw record numbers of Blue Lantern cases initiated and record numbers of cases closed unfavorably. Perhaps of greater note, FY 2007 saw the highest ever percentage of unfavorable cases (twenty-three percent of cases closed in FY 2007). During the past several years, DDTC has sought to improve targeting of cases and do more Blue Lantern checks on agreements (and not just exports of defense articles). Numbers of license applications and other requests for authorization also have increased over the past several years. However, it is disappointing that the increased awareness of ITAR requirements brought on by recent enforcement cases has not led to a reduction in the number of derogatory findings in Blue Lantern cases. Nearly 20 years ago, the Department first published a Federal Register Notice identifying basic “warning flags” that companies were urged to observe when preparing to export overseas. Among the “warning flags” were unfamiliar foreign end-users or consignees, incomplete or suspicious looking end-use documentation, unusual routing, and requests for commodities which did not appear to be in the inventory of the end-user. Since then, basic warning flags have been a staple of DDTC presentations to industry groups. Yet as this year’s findings indicate, companies both large and small continue to have their exports subject to unfavorable Blue Lantern determinations, generally as a result of their failure to do basic due diligence on the transaction and their foreign partners. Many companies do an excellent job of vetting their foreign partners and helping them to understand the ITAR. Too many, however, still do not even though the effort and cost of looking for warning flags and identifying all parties to the export is not onerous and clearly within their capabilities. Until defense exporters more uniformly and diligently exercise their responsibilities as exporters, the gray arms market will continue to have opportunities to flourish.