

**DEPARTMENT OF THE TREASURY
EFFORTS TO PREVENT ILLICIT TRANSFERS
OF U.S. MILITARY TECHNOLOGIES**

OIG-00-072

March 23, 2000



Office of Inspector General

United States Department of the Treasury



OFFICE OF
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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MEMORANDUM FOR TIMOTHY F. GEITHNER, UNDERSECRETARY FOR
INTERNATIONAL AFFAIRS

FROM:

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SUBJECT:

Audit of the Department of the Treasury
Efforts to Prevent Illicit Transfers of U.S.
Military Technologies (OIG-00-072)

The attached report presents an assessment of efforts by Department of the Treasury bureaus and offices to prevent illicit transfers of U.S. military technologies to countries and entities of concern. The report addresses counterintelligence and export control measures, and the monitoring of foreign investments in U.S. financial institutions and businesses that might have national security implications. The report is part of a multi-agency review required by the National Defense Authorization Act for Fiscal Year 2000, and due to Congress by March 30, 2000.

The review discloses that the Department of the Treasury has only peripheral responsibilities with regard to counterintelligence program activities, but cooperates with and supports agencies involved in these efforts. The U.S. Customs Service, a Treasury Bureau, enforces export controls that could produce useful counterintelligence information, and arrangements exist for the appropriate sharing of this data.

An assessment of Treasury's export control measures was completed in June 1999 in connection with an interagency review of export licensing procedures requested by the U.S. Senate Governmental Affairs Committee. The review focused on export licensing procedures, but covered general export enforcement controls as well. Review results are contained in Office of Inspector General Report entitled *Interagency Report on Export Licensing Procedures* (OIG-99-090) dated

June 15, 1999. The report contained 4 findings and 11 recommendations aimed at improving the U.S. Customs Service's export licensing support and general export enforcement control procedures. Customs agreed to take action on all the recommendations and, as of November 16, 1999, had completed three and was in process of addressing the remainder.

Treasury's Offices of the Comptroller of the Currency and Thrift Supervision monitor significant ownership changes in banks and thrifts. The Federal Reserve Board and the Federal Deposit Insurance Corporation share similar responsibilities with regard to holding company and other acquisitions. All banking regulators have related background check procedures that provide for the referral of foreign investor information to counterintelligence agencies for review.

Treasury also chairs the Committee on Foreign Investments in the United States (CFIUS), which reviews foreign mergers and acquisitions of U.S. businesses with potential national security implications. CFIUS efforts have deterred some foreign investments involving potential national security implications, but notifications are voluntary and CFIUS was not timely notified of two significant acquisitions. Mandatory reporting requirements were recommended by the Cox Committee and included in a recent legislative proposal that was withdrawn. This is among issues being reviewed by the General Accounting Office. Absent mandatory reporting, CFIUS needs to take a more proactive role to identify non-filers. We believe this could be accomplished through electronic file comparison efforts and recommended that CFIUS identify sources of available data and develop procedures to identify non-filers.

Your response to our draft report indicated concurrence with this recommendation and that the CFIUS chairperson would initiate appropriate action to address our concern. It also included an explanation of the rationale for voluntary reporting and a discussion of adversities associated with mandatory reporting. The full text of the response is presented in Appendix 1 to this report. The

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proposed action, when completed, will satisfy the intent of our recommendation.

We appreciate the courtesies and cooperation provided to our auditors during the audit. If you wish to discuss this report, you may call me at (202) 927-5400 or a member of your staff may contact Charles Mataya, Director, Program Audits at (713) 706-4611.

Attachment

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Overview

The purpose of this review was to assess the adequacy of Department of the Treasury's (Treasury) measures to prevent illicit transfers of U.S. military technologies to certain countries and entities of concern. These measures include counterintelligence activities, export controls, and monitoring of foreign investments in U.S. businesses. The review is required by the National Defense Authorization Act for FY 2000, which also required similar efforts by the Inspectors General (IG) of the Departments of Commerce, Defense, State, and the Central Intelligence Agency. Reporting is due to Congress by March 30, 2000.

An assessment of Treasury's export control measures was completed in June 1999 in response to an interagency audit effort requested by the Senate Governmental Affairs Committee. Review efforts involved a determination of the adequacy of export licensing procedures applicable to dual-use commodities and munitions. Treasury's involvement included a review of export enforcement controls pertaining to these items, which also addressed the technologies covered in the scope of the current review and export controls in general. The related Treasury OIG report was addressed to the U.S. Customs Service (Customs) and is entitled *Interagency Report on Export Licensing Procedures* (OIG-99-090). It contained 4 findings and 11 recommendations, the majority of which pertained to strengthening controls over export license enforcement efforts. Customs is in the process of taking action to address our recommendations.

This report discloses that Treasury has no designated counterintelligence responsibilities, but coordinates with and supports agencies involved in these efforts. Also, all significant changes in financial institution ownership are monitored by Treasury and other banking regulators; and

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related background check procedures provide for the referral of information on foreign investors to counterintelligence agencies. However, improvements are needed in the monitoring of foreign investments in U.S. businesses with potential national security implications.

Objective, Scope and Methodology

The objective of this review was to assess the adequacy of Treasury's counterintelligence measures, export controls and foreign investment monitoring in U.S. commercial activities to prevent illicit transfers of U.S. military technologies to countries and entities of concern described in Appendix 2.

Review results are based upon information obtained from Treasury Departmental and bureau officials involved in intelligence, export enforcement, banking oversight and foreign investment reporting activities. Information was also obtained from banking regulatory officials outside of Treasury, and General Accounting Office (GAO) auditors. Review efforts were coordinated with Office of Inspector General (OIG) staffs from the Departments of Commerce, Defense, State and the Central Intelligence Agency, and included contacts with some officials from these agencies. Information was also obtained from various audit and congressional reports, and agency records and documentation. Audit work was performed from September 1999 through February 2000.

Audit Results

Our review disclosed Treasury has only peripheral responsibilities with regard to counterintelligence efforts involving national security. Although a member of the intelligence community, Treasury has no designated national security counterintelligence responsibilities. However, Treasury cooperates with and supports agencies involved in

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such activities. One Treasury Bureau, the U.S. Customs Service (Customs), enforces export requirements that could yield useful counterintelligence information, and arrangements exist for appropriate sharing of this information.

Treasury also participates in the review of foreign investments in certain U.S. banks and thrifts, review of foreign acquisitions in U.S. businesses having national security implications, and reporting of foreign financial investments in U.S. marketable securities. Banking regulators review significant ownership changes in financial institutions. These reviews include background checks that provide for the referral of information on foreign investors to agencies involved in counterintelligence activities. Treasury collects data concerning foreign investments in U.S. long-term securities for economic analysis, but this information is not pertinent for national security reviews.

Treasury also chairs the Committee on Foreign Investment in the United States (CFIUS)¹ which reviews foreign mergers and acquisitions of U.S. businesses with national security implications pursuant to Exon-Florio legislation. These reviews have deterred some foreign investments that posed a potential risk to national security. However, reporting to CFIUS is voluntary and CFIUS has limited information available to identify non-filers. In addition, during our review, we became aware of two significant foreign acquisitions which were not timely notified to CFIUS. One of these involved the purchase of a U.S. company that

¹ CFIUS was established by Executive Order 11858 in 1975 to review acquisitions of U.S. businesses that might threaten national security. Initial membership included the Secretaries of the Treasury; Commerce, Defense and State, plus the Attorney General, Director of the Office of Management and Budget, the U.S. Trade Representative and Chairman of the Council of Economic Advisors. In 1993, the membership was expanded by Executive Order 12860 to include the Director of the Office of Science and Technology policy, and the Assistants to the President for National Security Affairs and Economic Policy.

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manufactured ball bearings used in military jet aircraft engines by a Hong Kong firm that had dealings with the People's Republic of China. CFIUS was not notified of this transaction until about 18 months after it occurred. The other involved a European firm's purchase of a U.S. company that produced precision tooling for manufacturing jet engine turbine blades used in military aircraft and missiles. CFIUS did not become aware of this transaction until 10 months later when the company applied for an export license to ship some of this equipment to China.

The first case was cited in the Cox Committee report, which recommended mandatory reporting to CFIUS. Mandatory reporting was considered in the last legislative session, but did not pass, and is among issues being assessed by the General Accounting Office (GAO). Treasury, on behalf of CFIUS, believes mandatory reporting would impose an added burden on foreign investors, increase CFIUS staffing requirements, and could negatively affect U.S. open investment policy. Absent mandatory reporting, CFIUS needs a more proactive approach to identifying non-filers. Electronic file comparison efforts may be a means of accomplishing this, and forego the need for mandatory filing requirements.

The Department of Commerce OIG also reviewed CFIUS' activities. Its report raises similar concerns regarding CFIUS' ability to identify non-filers under the Exon-Florio provision. Commerce OIG also expressed concern about the low number of investigations that had been conducted, and a possible conflict of interest regarding placement of the CFIUS chair in Treasury's Office of International Investment. Accordingly, it suggested that a study be undertaken by an interagency OIG review team from the Departments of Commerce, Defense and the Treasury to determine the scope of the foreign investment problem and CFIUS' overall effectiveness. However, GAO is currently performing work in

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this area and the results of their effort may preclude the necessity for additional review.

Recommendation

We made one recommendation directed at improving the identification of Exon-Florio non-filers. Specifically, we recommend that the CFIUS chair coordinate efforts with other Committee members to identify and evaluate all sources of available data that can assist it in identifying Exon-Florio non-filers. Once data sources are identified, CFIUS needs to develop a methodology and establish procedures as to how these data sources can be effectively used to meet its responsibilities.

Management Response and Auditor Comments

The Treasury Under Secretary for International Affairs concurred with the above recommendation and indicated that the CFIUS chairperson would initiate appropriate action to address this concern. The response also included an explanation of the rationale for voluntary reporting and discussed adversities associated with mandatory reporting. The full text of this response is presented in Appendix 1 to this report. When completed, the proposed action will satisfy the intent of our recommendation.

BACKGROUND

During the past two years congressional interest has been raised over the illicit acquisition of U.S. military technologies by foreign countries. Committees of both the U.S. Senate and House of Representatives have initiated reviews of these activities, and the General Accounting Office has issued several reports and related products² concerning high technology exports. Illicit transfers of U.S. military technologies threaten both U.S. national and world security.

In January 1999, Representative Christopher Cox, Chairman of the House Select Committee on U.S. National Security and Military/Commercial Concerns with the People's Republic of China reported³ to Congress and the President that China had stolen U.S. nuclear weapons secrets, and attempted to illicitly acquire other U.S. military technologies. Such thefts have reportedly accelerated China's nuclear weapons development program. Public hearings were held and legislation was subsequently passed to intensify oversight in this area of all countries and entities of concern.⁴ Specifically, the National Defense Authorization Act for Fiscal Year 2000 (PL 106-65) contains the following provisions:

Section 1402(c) requires the Inspectors General (IGs) of the Departments of Commerce, Defense, State, the Treasury and the Central Intelligence Agency (CIA) to assess the adequacy of export control and counterintelligence measures to prevent illicit acquisition of U.S. military sensitive technologies and technical information by certain countries and entities of concern.

² GAO Reports T-NSIAD-98-222 (9/17/98), T-NSIAD-98-250 (9/16/98), NSIAD-98-196 (9/16/98), T-NSIAD-208 (6/10/98), etc. (see GAO's internet website <http://www.gao.gov> for more reports).

³ Referred to as the Cox Report. (Available on internet website <http://hillsouth.house.gov/CoxReport>)

⁴ Appendix 2 contains a description of the countries and entities of concern, and technologies involved.

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Also, Section 1402(b)(3) requires annual audits through FY 2007 by the Departments of Commerce, Defense, Energy, and State IGs concerning the adequacy of the U.S. Government's export policies and procedures in preventing such illicit acquisitions.

Although Treasury enforces export controls, it is not required to participate in the multi-year audits, but may do so in those years in which it has involvement in the topics being addressed.⁵ Interagency IG working groups were formed to address and coordinate the above efforts.

Section 1402(c) above is the basis for this assessment report. Treasury did not participate in Section 1402(b)(3) requirements for FY 2000 because this year's audit effort focuses on "Deemed Exports at Federal Laboratories,"⁶ an area in which it has no involvement.

The Cox Report addressed various methods used by China to illicitly acquire U.S. military technologies. Methods applicable to Treasury included controlled or prohibited exportations and, to a more limited extent, foreign investment in U.S. high technology companies.

A review of Treasury's export enforcement controls was completed in June 1999 in response to a request by the Chairman of the Senate Governmental Affairs Committee. This was part of a multi-agency effort to determine the adequacy of export licensing policies and procedures over dual use commodities and munitions, and covered the technologies included in the scope of this review.

⁵ Topics scheduled for review include: FY 2000 - Deemed Exports at Federal Labs; FY 2001 Development of the U.S. Munitions List; FY 2002 - Enforcement of Export Controls; FY 2003 - Databases; FY 2004 - Cumulative Effect; FY 2005 Contractor and University Deemed Exports; FY 2006 - The Licensing Process; and FY 2007 - implementation of Working Group Recommendations.

⁶ A "deemed export" occurs when a foreign national has access or is exposed to restricted technology information.

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Participants included the IGs of the Departments of the Commerce, Defense, Energy, the Treasury, State and the CIA. Each IG issued individual audit reports to their respective agencies, and participated in the of a consolidated report⁷ to the Committee. A public hearing was held with the IGs on June 23, 1999 to discuss their respective audit findings and recommendations. Treasury's report⁸ was addressed to the Commissioner of Customs and contained 4 findings and 11 recommendations, the majority of which pertained to strengthening controls over export licensing enforcement efforts. Customs agreed to take action on all of the recommendations and, as of November 16, 1999, had completed three and was in process of addressing the remainder.

The Cox Report addressed the theft of U.S. military technologies by China, and one of the issues raised was the monitoring of foreign commercial activities in the U.S. The Report indicated that, although U.S. capital markets could be used to finance military and commercial development projects as a means of cloaking acquisitions by front companies, no country specific monitoring of these activities was being performed. The report stated that neither the Departments of Commerce, the Treasury or Defense, or the CIA and Federal Bureau of Investigation (FBI) had a program, system, or effort underway to specifically monitor China's involvement with U.S. companies. The Report pointed out that Treasury played an indirect role in such matters. It mentioned that Customs investigated violations of export laws; the Offices of the Comptroller of the Currency (OCC) and Thrift Supervision (OTS) reviewed foreign entity acquisitions of national banks and savings and loan institutions; and Treasury chaired CFIUS, which

⁷ *Interagency Review of the Export Licensing Processes for Dual-Use Commodities and Munitions* dated June 18, 1999 (DoD Report No. 99-187) (3 volumes)

⁸ *Interagency Report on Export Licensing Procedures* dated June 15, 1999 (OIG-99-090) (Limited Official Use)

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reviewed foreign acquisitions of U.S. businesses with national security implications.

For the purpose of this review, Webster's Dictionary defines intelligence as information concerning an enemy or possible enemy, and also an agency engaged in obtaining such information. Counterintelligence refers to information gathered and activities conducted to protect against espionage, sabotage, and other intelligence activities, conducted for or on behalf of foreign powers, organizations or persons, or international terrorist groups. Foreign intelligence means information relating to the capabilities, intentions and activities of foreign powers, organizations or persons, but not including counterintelligence except for information on international terrorist activities.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this review was to assess the adequacy of Treasury's counterintelligence measures, export controls and monitoring of foreign investments in U.S. businesses to prevent illicit transfers of U.S. military technologies to countries and entities of concern described in Appendix 2.

Contacts were made with personnel responsible for related activities within and outside of Treasury. Treasury offices and bureaus contacted included those involved with intelligence, export enforcement, banking oversight, and foreign investment monitoring and reporting. At the Departmental level, this consisted of the Special Assistant to the Secretary (National Security) for intelligence matters, and the Executive Assistant to the Director, Financial Crimes Enforcement Network (FinCEN) for enforcement issues. Also, officials from Treasury's Offices of International Investment and Program Services were contacted regarding their role in the reporting and oversight of foreign investments in the U.S.

Treasury bureau contacts included Customs and the Office of Foreign Asset Controls (OFAC) for intelligence and export enforcement matters; and the OCC and OTS for banking oversight activities. We also contacted the Federal Reserve Board (FRB) and Federal Deposit Insurance Corporation (FDIC) regulatory officials to determine the extent of their efforts in banking oversight matters not under Treasury control. Review efforts were also coordinated with the Departments of Commerce, Defense, Energy, State and the CIA IG staffs. At all locations, responsible program officials were interviewed and related program documentation was reviewed. Research was also conducted on the internet.

Audit work was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the U.S. and included such audit tests as were deemed necessary. The scope included a broad spectrum of related programs and activities since their inception through

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FY 1999. Related fieldwork was conducted from September 1999 through February 2000.

AUDIT RESULTS

Treasury Counterintelligence Responsibilities

Treasury has only peripheral responsibilities with regard to counterintelligence efforts involving national security. Although a member of the intelligence community, Treasury has no designated national security counterintelligence responsibilities. However, Treasury cooperates with and supports agencies involved in these efforts. One Treasury Bureau, Customs, enforces export requirements that could yield useful counterintelligence information, and arrangements exist for appropriate sharing of this information.

Federal agency responsibilities for intelligence activities are established primarily by Executive Order (EO).⁹ The EO designated Treasury as a member of the U.S. intelligence community and generally limited its authorities to the gathering of foreign economic and financial information, and information pertaining to presidential security. Agency responsibilities for counterintelligence activities are set forth in a Presidential Directive,¹⁰ and Treasury was not a named participant in these activities. The directive provided for the establishment of the National Counterintelligence Policy Board, Operations Board and Center. Further, it designated the CIA, FBI, National Security Agency (NSA), the intelligence components of the Departments of Defense, State and Justice, plus certain executive level advisors as participants. However, in 1994 the Policy Board expanded its membership to include participation by all departments and agencies with counterintelligence components at semi-annual meetings. Although Treasury had no counterintelligence components, it was invited to participate because of its involvement in enforcement activities.

⁹ Executive Order 12333 dated December 4, 1981.

¹⁰ Presidential Decision Directive Number PDD/NSC-24 dated May 3, 1994.

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U.S. Customs Service

Customs is responsible for enforcing export laws and regulations for passengers and goods exiting the U.S. With regard to military technologies, this primarily consists of the Arms Export Control Act and the Export Administration Regulations. Intelligence activities are managed and coordinated by its Intelligence Division, which is within the Office of Investigations. The level of scrutiny brought to bear by the Intelligence Division on any given export is determined by commodity, rather than country.

Customs also has no designated counterintelligence program responsibilities. However, it receives and exchanges intelligence information with other agencies and sources. This is accomplished through a variety of secure communication networks and direct terminal hook-ups.¹¹ Intelligence information is also exchanged through employee details and participation in interagency working groups.¹² The CIA and NSA have liaison officers assigned to Customs' Intelligence Division as coordinators. Customs has two liaison units, each comprised of a supervisory level senior Special Agent and senior Intelligence Research Specialist, assigned to both the FBI National Security Division's Weapons of Mass Destruction Operations Unit, and the CIA's Non-Proliferation Center. The Director of Customs Strategic Investigations Division stated that the employee interchange arrangements and participation in interagency working groups worked well, and have been an effective means of sharing intelligence information with other agencies involved in intelligence and counterintelligence activities.

¹¹ Details were omitted to minimize security classification of the report.

¹² Missile Technology Advisory Group (MTAG), Nuclear Export Violations Working Group (NEVWG), Technology Transfer Working Group (TTWG) and SHIELD (a chemical/biological weapons work group).

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Customs' export enforcement programs and outreach activities could potentially surface useful counterintelligence information. Virtually every export investigation could have counterintelligence implications, depending upon whether the perpetrator is a criminal enterprise or a hostile intelligence service. A brief overview of these activities is presented below, and any intelligence or counterintelligence information developed therefrom would be conveyed through the mechanisms previously discussed.

- Operation EXODUS was initially established by Customs in 1982 to stop the illegal exportation of controlled items, most of which involved the technologies in the scope of this review. Such items include weapons of mass destruction (nuclear and biological/chemical weapons), licensed munitions and high technology equipment having both military and civilian application (dual-use), plus shipments to sanctioned countries or entities. Historically, EXODUS included all related export interdiction, investigation and prevention efforts. Currently, it refers to interdiction efforts only. Since its inception, EXODUS efforts have resulted in more than 9,000 seizures valued in excess of \$1 billion.
- Project GEMINI is a domestic partnership outreach effort initiated by Customs to apprise U.S. businesses and exporters of export requirements, and encourage their reporting of attempts to illegally acquire or export sensitive military equipment or technologies.
- Project AMBER is a foreign outreach program¹³ in which Customs participates with the Departments of Defense and State to prevent the spread of weapons of

¹³ Established in 1994 under the Freedom of Support Act (Section 504).

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mass destruction and advanced conventional weapons, their delivery systems and related technology in certain Eastern European countries.¹⁴ It involved Customs personnel traveling to Europe to provide basic and specialized training to foreign customs officers regarding the identification, detection, interdiction and investigation of the above items. Program funding was initially provided in the amount of \$250,000, but was increased by \$450,000 in FY 1996 to extend the training and furnish detection equipment.

- DOD/Customs Counter-proliferation Program¹⁵ extended the concept of Project AMBER to the rest of Eastern Europe and the newly independent states of the former Soviet Union.¹⁶ Up to \$10 million was authorized for this program, which provided training and high technology inspection equipment¹⁷ to the designated countries. As of FY 1999, Customs had trained approximately 2,100 foreign officials from 25 countries. These efforts have reportedly established a bond of trust between U.S. and foreign customs officials that could yield counterintelligence information.
- Operation GOLDEN TIGER was a new initiative that was being established by Customs to address the concerns raised by the Cox Commission report regarding technology transfers to China. The effort would have consisted of a multi-agency task force approach to investigate violations of export laws by the

¹⁴ Latvia, Lithuania, Estonia, Poland, Hungary, the Czech Republic and Slovakia.

¹⁵ Established under the National Defense Authorization Act of FY 1997.

¹⁶ Albania, Romania, Bulgaria, Moldova, Ukraine, Belarus, Russia, Slovenia, Georgia, Armenia, Azerbaijan, Turkmenistan, Uzbekistan, Tajikistan, Kyrgyzstan, Kazakhstan and the former Republic of Yugoslavia (Macedonia, Bosnia, Croatia, and Slovenia).

¹⁷ X-ray vans, radiation detectors, density busters, etc.

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People's Republic of China. The task force was to be led by Customs, and planned participants included the Departments of Commerce and State's export licensing components, and law enforcement elements of the Departments of Commerce, Defense and Justice. The project was expected to last two years and include staffing of about 25 law enforcement, regulatory and support personnel. Although a site had been selected and a memorandum of understanding was being circulated, the effort had to be suspended due to insufficient funding.

- Customs and the FBI have also been working together to monitor U.S. trade with North Korea to identify networks attempting to acquire and illegally export military equipment and technologies to that country.

Office of Foreign Assets Control

OFAC administers trade restrictions and economic sanctions imposed by statute or executive order. This is accomplished through publications to federal agencies, trade and financial entities, and the general public to alert them of countries and entities barred from U.S. trade. OFAC sanctions existed for all but four of the countries of concern (China, Russia, India and Pakistan) included in our review, and all entities of concern (see Appendix 2). Although no specific trade sanctions existed for China, Russia, India or Pakistan, all were subject to export licensing requirements by other agencies. In January 1999, the Department of State suspended all authorized exports of licensable defense articles and services to certain Russian entities. Additionally, in December 1998, the Department of Commerce imposed restrictions on licensable dual-use exports to certain entities in India and Pakistan because of their involvement in nuclear weapons testing.

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Financial Crimes Enforcement Network

FinCEN is a Departmental level office whose primary mission is to provide investigative support to law enforcement agencies involved in drug-related money laundering activities. Consequently, FinCEN does not routinely monitor foreign investments in U.S. businesses, and its efforts would not normally produce counterintelligence information concerning illicit exports of U.S. military technologies. However, FinCEN does provide analytical support to intelligence and counterintelligence activities when requested, but such occurrences are rare.

Treasury Monitors Foreign Investments In U.S. Financial Institutions, Businesses And Securities

Treasury's monitoring of foreign investments in commercial activities in the U.S. is not country specific. Although bank regulators monitor changes in financial institution ownership, the reviews focus on the individual investors' managerial competence and financial worthiness rather than national security issues. Related background checks also included referrals to agencies involved in counterintelligence activities. In addition, Treasury collects data on foreign investments in the U.S. long term securities (portfolio investments) for economic analysis purposes. However, this data is not pertinent for national security reviews.

Treasury also chairs CFIUS, which reviews foreign direct investment in U.S. businesses with national security implications. CFIUS reviews have deterred some foreign acquisitions, but concerns exist whether the voluntary notification system assures that all foreign acquisitions of U.S. companies with national security implications are reported to CFIUS. Mandatory reporting has been considered. CFIUS was not timely notified of two significant acquisitions, indicating it needs a more proactive approach

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to encouraging voluntary reporting. This could possibly be accomplished through electronic file comparison efforts with data maintained by various government and/or private industry sources, thus avoiding the need for mandatory reporting.

Regulators Monitor Ownership in U.S. Financial Institutions

OCC, OTS, the FRB and FDIC monitor significant changes in ownership of U.S. financial institutions. As a matter of clarity, OCC is the primary supervisor of national banks and reviews individual investor acquisitions thereof. The FRB reviews all bank holding company¹⁸ acquisitions of national banks and state member¹⁹ banks. The FDIC supervises and reviews the acquisition of all federally insured state-chartered nonmember banks. OTS supervises all thrift acquisitions. The point of involvement by each of these regulators varies depending upon the degree of ownership involved, or other circumstances.

None of the above regulatory agencies maintained ownership application records by foreign country. Although available, retrieval of information in this format would require special queries. The primary purpose of the reviews is to determine investors' managerial competence and financial worthiness in order to protect the soundness of the financial institutions. However, associated background check procedures provide for the referral of foreign investors to the Department of State and the CIA for review. Regulatory officials with whom we met were not able to recall the denial of any past applications due to national security concerns.

¹⁸ A bank holding company is generally any company, corporation, or business entity that owns stock in a bank or controls the operation of a bank through other means.

¹⁹ State member banks are state-chartered banks that become members of the Federal Reserve System.

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CFIUS Deterred Some Foreign Investments, But Needs To Do More To Identify Non-Filers

The U.S. has an open investment policy and does not screen foreign direct investments in domestic businesses. However, the Department of Commerce collects data on foreign direct investment in U.S. businesses for economic analysis and statistical purposes, including preparation of the national economic accounts. Treasury also collects information on foreign portfolio investments in support of this effort.

Foreign investments in U.S. firms involved in classified defense work are monitored by the Department of Defense, National Industrial Security Program. For national security reasons, U.S. laws restrict foreign investment in certain sectors of the economy, such as nuclear energy, coastal and domestic shipping, and air transport. Foreign acquisitions of U.S. companies involved in leading edge or highly advanced technology and processes, and other activities important to U.S. national security are reviewed by CFIUS pursuant to Exon-Florio legislation.²⁰ If necessary, this statute provides the President with authority to prohibit or suspend a foreign acquisition of a U.S. company that threatens the national security.

Notices of foreign mergers and acquisitions of U.S. companies are provided to CFIUS under a voluntary system and the information is propriety (business confidential).²¹ Implementing regulations provide for a 30-day review to

²⁰ Section 5021 of the Omnibus Trade and Competitiveness Act of 1988 amended Section 721 of the Defense Production Act of 1950 (50 U.S.C. app. 2170) to provide the President with authority to suspend or revoke foreign acquisitions, mergers or takeovers of U.S. companies that threaten U.S. national security. This legislation is commonly referred to as the "Exon-Florio Provision." The President subsequently delegated related review and investigative authority to CFIUS by Executive Order 12661, but retained final authority to suspend or prohibit a foreign transaction that threaten national security.

²¹ 32 CFR 800.401 and 800.702, respectively.

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determine whether the transactions involve foreign control or national security issues that warrant further investigation. When CFIUS decides to investigate a transaction, it must provide a report and recommendation for the President within 45 days. The President is lawfully bound to announce a final decision within 15 days after completion of the investigation. However, he can only exercise his authority to suspend or prohibit the acquisition if credible evidence is found that the foreign entity exercising control might take action that threatens U.S. national security, and other laws other than the International Emergency Economic Powers Act and Exon-Florio provision do not adequately protect U.S. national security.

The CFIUS program has deterred some foreign acquisitions that may have had national security implications. A total of 1,232 notices were filed with CFIUS since Exon-Florio was implemented in 1988 through the end of FY 1999. Investigations were initiated on 17 of these, but 7 notices were withdrawn with CFIUS' concurrence after filers were notified investigations had been initiated. Investigations of the remaining 10 were completed and results were forwarded to the President for decision. The President concurred with CFIUS' recommendations in these cases, taking no action on nine of these, and, for the other one, ordering divestiture of a Chinese firm in a U.S. aircraft parts company.

The CFIUS chairperson cautioned, however, that examining only the statistics on notices, investigations and blocked transactions does not completely depict the program's impact. She explained that the program's existence alerts potential foreign investors in U.S. companies to national security concerns. Although it cannot be quantified, she maintained that, because of Exon-Florio, anecdotal evidence exists that investors consider national security concerns when structuring mergers or acquisitions of U.S. companies. Moreover, she stated the program has protected U.S.

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national security without compromising the country's open investment policy.

There is some concern that the voluntary notification system does not assure that all foreign acquisitions of U.S. companies with national security implications are reported to CFIUS. GAO reviewed the implementation of the Exon-Florio legislation in 1995.²² It examined all transactions notified to CFIUS, which included companies in defense-related and high technology industries. In order to assess the scope of non-notifications, GAO examined two private sector databases²³ and found that, while many foreign companies notified CFIUS of their investments in U.S. companies, many others involved in high-technology industries²⁴ had not. However, GAO was unable to establish a national security link with the unreported transactions. This was due to the data's insufficiency in identifying whether the acquired companies operated in the national security sector (i.e., had defense contracts, produced products subject to U.S. export controls, or met other national security criteria). GAO attributed the potential non-filings to the voluntary notification system, but noted that Exon-Florio was not intended to provide a comprehensive screening mechanism for all foreign direct investments. It pointed out that the Government has other means of protecting national security, such as export controls and industrial security regulations that protect classified facilities.

²² GAO Report entitled *Implementation of Exon-Florio and Related Amendments*, NSIAD-96-12, December 1995

²³ Economic Strategy Institute (ESI) database, which tracks foreign investments in and acquisitions of U.S. companies involved in high, key, or critical technologies; and Securities Data Company (SCD) database which tracks investments, acquisitions and mergers worldwide (but was limited to U.S. transactions).

²⁴ The high technology industries cited in the GAO report included telecommunications, advanced materials, biotechnology, electronics, semi-conductors, computers and aerospace.

AUDIT RESULTS

Nevertheless, we believe that CFIUS needs to take a more proactive role in identifying potential non-filers. In 1996, a Hong Kong company that traded with the People's Republic of China acquired a U.S. company which manufactured ball bearings used in U.S. military aircraft. However, CFIUS was not notified of the transaction until a legal review by a new law firm hired by the company determined a filing was due, nearly 18 months later. CFIUS was subsequently notified of the transaction, which resulted in an investigation. However, just prior to completion of the investigation in December 1998, the foreign owner agreed to liquidate its interest in the firm. Pending divestiture, the U.S. company was placed under the control of a DOD-approved trustee.

More recently, in early 1999 a European firm purchased a U.S. company that produced precision tooling used to manufacture jet engine turbine blades used in military aircraft and missiles. It was not until the firm recently applied for an export license to ship some of this equipment to China that it was learned CFIUS had not been notified of the transaction.

Although controls prevented the above items from being exported, months elapsed before CFIUS was ultimately notified of the transactions. This could have provided the foreign entities with access to information concerning the technologies involved. This is indicative that CFIUS needs to take more proactive efforts to promptly identify non-filers in order to limit foreign access to the technologies involved.

A recent attempt has been made to make Exon-Florio reporting mandatory, apparently to expand the coverage of notified transactions. Legislation was introduced in the last legislative session to accomplish this,²⁵ but was ultimately withdrawn. In response to a congressional request, GAO is

²⁵ Senate Bill 1059 would have amended Section 1409 of the National Defense Authorization Act of FY 2000 to require notification to CFIUS of all acquisitions of U.S. businesses involving foreign government control that affect the national security. However, this requirement was omitted from the final legislation.

AUDIT RESULTS

currently updating its 1995 work in light of the Cox Committee's recommendation to change voluntary reporting of foreign mergers and acquisitions to mandatory. Treasury, on behalf of CFIUS, strongly opposed mandatory reporting requirements. They maintained it would impose an added burden on investors and could reduce foreign direct investments in the U.S. without providing meaningful additional protection to national security. Treasury observed that Congress carefully crafted current requirements over a decade ago to protect national security in a manner that preserves U.S. open investment policy. The CFIUS chairperson estimated that mandatory reporting requirements would increase filings from about 70 to 700 per year, which would require substantial staffing.

Our review indicated that the scope of coverage of national security reviews of foreign acquisitions and mergers might be enlarged through electronic file comparison efforts. Non-filers could potentially be identified through comparisons of CFIUS data with foreign investment and other data maintained by various government and/or private industry sources. For example, the Department of Commerce's BEA collects comprehensive foreign direct investment data for economic analysis and statistical purposes, including preparation of the national economic accounts.²⁶ However, usage and disclosure of the data are restricted by statute,²⁷ and CFIUS officials were uncertain as to whether the data included sufficient information to identify transactions with national security concerns. GAO also identified two private foreign investment databases in its 1995 Exon-Florio review,

²⁶ The International Investment and Trade in Services Survey Act (Public Law 94-472, 90 Stat. 2059, 22 U.S.C. 3101-3108l, as amended by Public Laws 98-573 and 101-533) authorizes BEA to collect foreign direct investment data for statistical and analytical purposes. Foreign direct investments represent affiliated (foreign) ownership interests or control (direct or indirect) by one person of 10 percent or more of the voting securities of an incorporated business or equivalent interest in an unincorporated business.

²⁷ 22 U.S.C. 3104(c) provides that the data may only be used for analytical and statistical purposes, and imposes penalties regarding improper disclosure.

AUDIT RESULTS

but this data also lacked sufficient information to identify national security concerns. The Department of Defense maintains information concerning defense contractors that, in combination with CFIUS and some of the above data, might provide a means of identifying foreign acquisitions with national security implications not reported to CFIUS.

The Department of Commerce OIG also reviewed CFIUS activities as part of its assessment of counterintelligence measures and export controls to prevent illicit transfers of U.S. military technologies. In its initial draft report, the Commerce OIG also raised concern regarding the adequacy of CFIUS' efforts in identifying non-filers, and mentioned electronic file comparison efforts as a possible means of identifying non-filers. However, it also raised concern regarding the CFIUS' overall effectiveness in preventing foreign acquisitions of U.S. high technology companies. Accordingly, the Commerce OIG will be suggesting that an interagency OIG team from the Departments of Commerce, Defense, and the Treasury conduct a comprehensive review of these activities. However, it should be noted that GAO is currently performing work in this area that may preclude the necessity of these efforts.

The CFIUS chairperson indicated that the Committee would be open to considering a proposal designed to augment the current voluntary foreign acquisitions notification system, if legally and technically feasible.

Other Issues

In its review of CFIUS activities, the Commerce OIG also questioned whether Treasury's dual mission of promoting open investments and investigating questionable foreign investments, created a potential conflict of interest for Treasury with respect to its investigative role as chair of CFIUS. The Commerce OIG points to the fact that Treasury's Office of International Investment, whose primary

AUDIT RESULTS

mission is to support open investment policy, also acts as secretariat for CFIUS. It also points to the fact that Treasury, acting on behalf of CFIUS, strongly opposed legislation recently proposed to make reporting to CFIUS mandatory. It should be noted that, although Treasury chairs CFIUS, all members participate equally in issues considered by the Committee. As the chair, Treasury does not have the authority to undertake actions on behalf of the Committee without the concurrence of all participating agencies.

The Commerce OIG does acknowledge that it has no evidence to indicate that the Treasury Office of International Investment had not handled CFIUS notifications properly. While we did not test for this, we also are not aware of any mishandled CFIUS notifications within Treasury. Therefore, we do not have a basis to question Treasury's capability to carry out its responsibilities as chair of CFIUS.

Conclusion

Concerns have been raised whether the voluntary system of notifications of foreign acquisitions of U.S. companies with national security implications assures all cases are notified to CFIUS. Mandatory reporting has been proposed and, is among issues being considered by GAO in its review of Exon-Florio activities. The Department of Commerce OIG has also reviewed CFIUS' efforts and is planning to suggest that a comprehensive review of the program's overall effectiveness be conducted. Our review indicates that, although CFIUS' efforts have deterred some foreign investments with potential national security concerns, CFIUS needs to take a more proactive role to identify non-filers. Automated file comparison efforts may be a means of accomplishing this and foregoing the need for mandatory reporting requirements.

AUDIT RESULTS

Recommendation

1. We recommend that the CFIUS chairperson coordinate efforts with other Committee members to identify and evaluate all sources of available data that can assist in identifying Exon-Florio non-filers. Once data sources are identified, CFIUS needs to develop a methodology and establish procedures as to how these data sources can be effectively used to meet its responsibilities.

Management Response and OIG Comments

The Treasury Under Secretary for International Affairs concurred with the above recommendation and indicated that the CFIUS chairperson would initiate appropriate action to address our concern. The response also included an explanation of the rationale for voluntary reporting and a discussion of adversities associated with mandatory reporting. The full text of the response is presented in Appendix 1 to this report. When completed, the proposed action will satisfy the intent of our recommendation.

MANAGEMENT RESPONSE



UNDER SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

March 17, 2000

**MEMORANDUM FOR DENNIS S. SCHINDEL, ASSISTANT INSPECTOR GENERAL
FOR AUDIT**

FROM: Timothy F. Geithner *TFG*
Under Secretary (International Affairs)

SUBJECT: Comments on the Draft Audit Report on the
Department of Treasury Efforts to Prevent Illicit Transfers
of U.S. Military Technologies (A-NO-99-075)

This memorandum is in response to your March 10 transmittal of the Draft Audit Report prepared by Treasury's Office of the Inspector General ("OIG") which requested Treasury's position on the Report's recommendation. As chair of the interagency Committee on Foreign Investment in the United States ("CFIUS"), we circulated your Report to all CFIUS agencies to apprise them of your recommendation.

CFIUS, on behalf of the President, implements the Exon-Florio provision, which provides for a national security review of foreign acquisitions of U.S. businesses. The following comments pertain to the recommendation and seek to clarify some of the issues raised in the Report.

Recommendation

We concur with the recommendation that Treasury, as chair, coordinate a CFIUS review of available sources of data that could assist in identifying non-filers under the current system of voluntary notification and develop a method of utilizing this data. However, we note that while the Report is critical of CFIUS's implementation of Exon-Florio, which provides for a voluntary system of notification, it does not fully explain the rationale for a voluntary system. Without this explanation, it is difficult to accept the implication of the Report that the voluntary system does not meet the objectives of the Exon-Florio statute.

When Exon-Florio was enacted, one of the major assumptions behind the legislation was that the President already had at his disposal a number of laws and regulations designed to protect the national security. These range from laws that restrict foreign ownership of U.S. air carriers to laws that regulate the export of sensitive technology or that restrict access to classified information. And, in recognition of these other laws and regulations, the Exon-Florio provision provided criteria for invoking its authority that would be presumptively necessary in very few cases, i.e., when no other law, other than the International Emergency Economic Powers Act ("IEEPA") or Exon-Florio itself, is deemed adequate and appropriate to protect the national security.

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Many foreign acquisitions of U.S. businesses are not notified to CFIUS because they do not have national security implications. However, there are strong incentives for companies to file when there is a possible link to national security. Transactions not notified are subject to potential adverse Presidential action indefinitely. In addition, there are safeguards to help assure that transactions that affect the national security are notified. There is a procedure in place to uncover non-notified transactions with national security implications, which includes, as provided in the Exon-Florio regulations, that any CFIUS member agency may notify a transaction that has not been notified by the parties to a foreign acquisition.

Moreover, the United States receives the largest share of the world's foreign direct investment. This provides numerous benefits to our economy, including introducing new capital, technology, managerial expertise, and jobs. Some of these benefits accrue to sectors of the economy that enhance the U.S. defense industrial base. Therefore, we have to weigh the potential negative impact on the U.S. climate for foreign direct investment against the benefit of a "more pro-active role to assure that voluntary reporting is occurring."

Gay Sills, as staff chair, will coordinate a CFIUS review of sources of available data that could be used to identify transactions in the national security area not notified and to discuss additional procedures that might best utilize this data to augment the voluntary system of notification.

Other Issues

Examining only the statistics on notices, investigations, and blocked transactions does not give the complete picture of the impact of the implementation of Exon-Florio. The existence of the process raises the awareness of potential foreign investors in U.S. companies to national security concerns. Moreover, while it cannot be quantified, there is anecdotal evidence that, since the enactment of Exon-Florio, investors consider national security when structuring mergers or acquisitions of U.S. companies.

The Committee is open to considering appropriate proposals which are legally and technically feasible and which would serve to improve the voluntary system of notification of foreign acquisitions of U.S. companies subject to the Exon-Florio provision. The Report recommends utilizing available sources of data to augment the voluntary system. The recommendation does not explain how such data would improve the voluntary system. OIG staff has not informed us of any available sources of data on foreign acquisitions of U.S. companies that would provide sufficient information to identify effectively a transaction not notified that potentially should have been.

In support of its recommendation for a more pro-active role for CFIUS, the Report cites two foreign acquisitions of U.S. companies reviewed by CFIUS after the transactions closed. The Report discussed one transaction that involved a small U.S. ball bearing manufacturer which was acquired by a Hong Kong company. In the course of undertaking its review, CFIUS found the company was not in compliance with U.S. export control laws. The CFIUS review resulted in

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actions that brought the company into compliance with export control laws and, ultimately, led to the foreign company's establishing a trusteeship for the U.S. company until it could be sold to a suitable buyer. Thus, CFIUS was able to protect the national security without having to engage the President.

The other transaction mentioned in the Report is one involving a Swiss firm purchasing a U.S. machine tool company. Because of information supplied by a CFIUS member agency, a CFIUS review will be initiated soon. The Report criticized the time delay in CFIUS's learning of the transaction and suggested the foreign entity could have used this time to gain access to technological information the company possessed. However, if the technology is subject to U.S. export control laws, access by a foreign person would require an export license. If the company did not apply for a license, it would be in violation of U.S. export control laws.

Augmentations of the existing voluntary system alone or mandatory notification alone cannot guarantee a timely CFIUS review, if companies have an illegal or otherwise inappropriate purpose. These examples show that CFIUS can take effective action to mitigate potential national security problems. In the one case, CFIUS action brought the U.S. company into compliance with U.S. laws and required the foreign company's agreement to divest the U.S. company. In the other case, a CFIUS agency brought attention to a non-notified transaction that, because of CFIUS action, will soon be notified.

Voluntary vs. Mandatory Notification

The Report raises the issue of a voluntary system vs. a mandatory system of notifying foreign acquisitions of U.S. companies to CFIUS. CFIUS believes a voluntary system offers benefits, including compatibility with an open U.S. investment policy, which make it the overwhelming choice when compared with a mandatory system. Moreover, there are safeguards already available to identify non-filers.

CFIUS has deliberately adopted a flexible approach to implementing Exon-Florio in order to preserve the President's ability to protect the national security in a wide range of situations where other laws and regulations may not be adequate and appropriate. The regulations which implement Exon-Florio do not define "national security" and broadly define the important threshold concept of "foreign control" in the context of an acquisition. This gives the President the necessary latitude to address foreign acquisitions that may harm national security. This flexible approach works well with a voluntary system of notification, but would work poorly with a mandatory system.

A mandatory system would require CFIUS to define fairly precisely the types of transactions subject to notification. There are two drawbacks to this approach. First, clearly defining which companies operate in the national security sector and/or what constitutes foreign control would limit the flexibility of the President's protecting the national security. Companies could more readily structure transactions to avoid the reach of the statute. Second, over time businesses and

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technologies evolve as do their implications for our national security. A static and precise definition of the national security would fail to keep abreast of these changes.

A mandatory system of notice would transform Exon-Florio from a statute that essentially supplements other laws to a screening device. It would impose an added burden on foreign investors and increase the cost and risk for investing in the United States. Higher costs and risks mean that some beneficial investments may not be made, resulting in a loss to the U.S. economy, including the potential loss of foreign capital and technology.

The voluntary system has safeguards to maximize the likelihood that a transaction with national security implications will be subject to Exon-Florio review. In the normal course of CFIUS member agency activities, which include government contracting, export control activities, and industry analysis, agencies become aware of proposed mergers and acquisitions of U.S. companies. Any CFIUS member agency may notify a transaction that has not been notified by the parties to a transaction, according to the Exon-Florio regulations.

The voluntary system serves to protect the national security without imposing an undue burden on foreign investment in the United States. Since the United States is the host country for the largest amount of foreign investment and U.S. investors are the largest investors abroad, it is important for U.S. economic well-being to maintain our traditional open investment policy.

3/15/00

**DESCRIPTION OF TECHNOLOGIES AND
COUNTRIES AND ENTITIES OF CONCERN**

TECHNOLOGIES

Due to large number of technologies involved, OIG staffs met with House Armed Services Committee staff to identify items deemed most critical by the Committee. As a result, the following technologies were identified and represent the focus of our review:

Ballistic-missile technology
Biological and chemical weapons technology
Radar and infrared missile guidance systems
Nuclear weapons technology
Space systems technology
High performance computers

COUNTRIES AND ENTITIES OF CONCERN

Section 1406(f) of the Act defines countries and entities of concern as:

- (1) any country the government of which the Secretary of State has determined, for purposes of Section 6(j) of the Export Administration Act of 1979 or other applicable law, to have repeatedly provided support to acts of international terrorism;
- (2) any country that (a) has detonated a nuclear explosive device (as defined in section 830(4) of the Nuclear Proliferation Prevention Act of 1994 (22 U.S.C.3201 note)); and (b) is not a member of the North Atlantic Treaty Organization; and

**DESCRIPTION OF TECHNOLOGIES AND
COUNTRIES AND ENTITIES OF CONCERN**

- (3) any entity that (a) is engaged in international terrorism or activities in preparation thereof; or (b) is directed or controlled by the government of a country described in paragraph (1) or (2) above.

In order to clarify and assure proper audit coverage, the Department of Defense's IG developed a listing of countries and entities of concern from Department of State advisories, Executive Orders and other statutory restrictions based upon the above criteria. This listing is as follows and serves as the scope of the related audit coverage:

COUNTRIES OF CONCERN

Afghanistan	Cuba	China
India	Iran	Iraq
Libya	North Korea	Pakistan
Russia	Sudan	Syria

**DESCRIPTION OF TECHNOLOGIES AND
COUNTRIES AND ENTITIES OF CONCERN**

ENTITIES OF CONCERN

- | | |
|--|---|
| 1. Abu Nidal Organization | 15. Liberation Tigers of Tamil Eelam |
| 2. Abu Sayyaf Group | 16. Majahedin-e Khalq Organizations |
| 3. Armed Islamic Group | 17. National Liberation Army |
| 4. Aum Supreme Truth, a.k.a. Aum Shinrikyo | 18. Palestine Islamic Jihad-Shaqaqi Faction |
| 5. Basque Fatherland and Liberty | 19. Palestine Liberation Front-Abu Abbas Faction |
| 6. Al-Gama'at al-Islamiyya | 20. Popular Front for the Liberation of Palestine |
| 7. HAMAS (Islamic Resistance Movement) | 21. Popular Front for the Liberation of Palestine General command |
| 8. Harakat ul-Mujahidin | 22. Al-Qaida |
| 9. Hizballah | 23. Revolutionary Armed Forces of Colombia (FARC) |
| 10. Japanese Red Army | 24. Revolutionary Organization 17 November |
| 11. al-Zjihad | 25. Revolutionary People's Liberation Party/ Front, a.k.a. Devrimci Sol, a.k.a. Dev Sol |
| 12. Kach | 26. Revolutionary People's Struggle |
| 13. Kahane Chai | 27. Sendero Luminoso |
| 14. Kurdistan Worker's Party | 28. Tupac Amaru Revolutionary Movement |

ABBREVIATIONS

BEA	Bureau of Economic Analysis (Commerce)
BXA	Bureau of Export Administration (Commerce)
CFIUS	Committee of Foreign Investments in the United States
EO	Executive Order
FDIC	Federal Deposit Insurance Corporation
FinCEN	Financial Crimes Enforcement Network (Treasury)
FRB	Federal Reserve Board
GAO	General Accounting Office
NSA	National Security Agency
OCC	Office of Comptroller of the Currency (Treasury)
OFAC	Office of Foreign Assets Controls (Treasury)
OTS	Office of Thrift Supervision (Treasury)

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