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August 1997

# MILITARY OFFSETS

## Regulations Needed to Implement Prohibition on Incentive Payments



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**United States  
General Accounting Office  
Washington, D.C. 20548**

**National Security and  
International Affairs Division**

B-277280

August 12, 1997

The Honorable Russell D. Feingold  
United States Senate

Dear Senator Feingold:

This report responds to your request for information on the implementation of the statutory prohibition governing incentive payments on offset programs, known as the “Feingold Amendment.”<sup>1</sup> Specifically, you asked us to address (1) the status of the Department of State’s efforts to issue implementing regulations and (2) the need for such regulations.

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## Results in Brief

The Department of State has made little progress in developing regulations implementing the Feingold Amendment because of internal disagreements over which organizational component should draft implementing language and the low priority assigned to completing this task. Regulations are needed to clarify key definitions contained in the law and establish how State will implement the law’s enforcement and penalty provisions.

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## Background

Foreign governments obtain U. S. military items and services in two major ways—U.S. government sales under the foreign military sales (FMS) program and commercial sales by individuals and business entities. The Department of State approves (1) the sale of items and services sold under the FMS program and (2) export licenses for military items sold by contractors as a direct commercial sale.<sup>2</sup>

Offsets are a range of industrial and commercial compensations provided to foreign governments and firms as inducements or conditions for the purchase of U.S. military goods and services. Offset arrangements are not new to defense export sales. The use of offsets began in the late 1950s in Europe and Japan. In 1984, we reported that offsets were a common practice and that demands for offsets on defense sales would continue to

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<sup>1</sup>Section 733 of P.L. 103-236, April 30, 1994, amended the Arms Export Control Act (AECA) by inserting a prohibition on incentive payments, 22 U.S.C. 2779a.

<sup>2</sup>AECA authorizes the Department of Defense (DOD), under the FMS program, to sell defense articles and services to foreign governments or international organizations from existing stock (section 21), as well as in cases where DOD procures defense articles or services from a defense contractor for ultimate sale to the foreign country (section 22), 22 U.S.C. 2761 and 2762, respectively. Agreements reached under either of these FMS arrangements are subject to Department of State review. Also, State controls direct commercial sales under authority provided in section 38 of AECA, 22 U.S.C. 2778.

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increase.<sup>3</sup> In 1996, we reported that demands for offsets in defense export sales had increased; countries that previously pursued offsets were demanding more and countries that previously did not require offsets required them as a matter of policy.<sup>4</sup>

The Feingold Amendment, enacted in April 1994, prohibits U.S. contractors from making incentive payments to a U.S. company or individual to induce or persuade them to buy goods or services from a foreign country that has an offset agreement with the contractor.<sup>5</sup> It only applies to defense articles or services “sold under” the AECA. It does not apply to commercial sales, which are licensed under, but not sold under, the AECA. However, for consistency purposes, the majority of the seven defense contractors we contacted said that they act as if the amendment applies to both FMS and direct commercial sale contracts. Violations of the Feingold Amendment are punishable by civil fines (not to exceed the greater of \$500,000, or five times the amount of the incentive payment) and administrative sanctions.

A July 1994 presidential memorandum delegated implementation of Feingold Amendment functions to the Secretary of State and authorized the Secretary to redelegate implementing responsibility within the Department. The Secretary, on October 5, 1994, redelegated responsibility for implementing the Feingold Amendment to State’s Under Secretary for International Affairs (now the Under Secretary for Arms Control and International Security Affairs).

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## Lack of Regulations on Prohibition on Incentive Payments

Three years after State was given responsibility for implementing the Feingold Amendment, it still has no finite plan for carrying out the legislation and has not issued implementing regulations. According to State officials, the following factors have contributed to the delay: (1) disagreement over which organizational component within the Department should be responsible for drafting implementing language and (2) assignment of higher priorities to other initiatives. Specifically, two offices serving under the Under Secretary for Arms Control and International Security Affairs—the Office of Arms Transfer and Export Control Policy and the Office of Defense Trade Controls—have not been able to agree on which office should proceed with implementation efforts.

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<sup>3</sup>Trade Offsets in Foreign Military Sales (GAO/NSIAD-84-102, Apr. 13, 1984).

<sup>4</sup>Military Offsets: Offset Demands Continue to Grow (GAO/NSIAD-96-65, Apr. 12, 1996).

<sup>5</sup>P.L. 103-236, section 733, April 30, 1994, 22 U.S.C. 2779a.

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According to State Department officials, implementing the Feingold Amendment was a low priority for them.

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## Regulations Are Needed

There are several uncertainties regarding the Feingold Amendment that warrant clarification in implementing regulations. These relate to (1) the term “incentive payments,” (2) the terms “owned” and “controlled” within the definition of “United States person,” and (3) the law’s enforcement and penalty provisions.

One of the key terms in the Feingold Amendment is the term “incentive payments.” This term is defined in the act<sup>6</sup> and further explained in the conference report on the legislation.<sup>7</sup> As indicated in the definition, the prohibition applies to incentive payments in the form of direct monetary compensation. The conference report explains that this includes cash payments, payments made by checks, and the extension of credit or inducements to encourage the extension of credit from a bank at lower interest rates. The report further explains that the legislation is not intended to prevent defense contractors from paying (as a bonus) “success fees” to consultants, brokers, or agents the contractors retain for the lawful implementation of offset agreements; however, it does not explain how brokers or agents, who often shared fees with purchasers, would need to change their business practices. It would be useful for State to inform defense contractors of these important distinctions through the issuance of regulations.

Another uncertainty involves the definition of the term, “United States person.” The Feingold Amendment prohibits defense contractors from making incentive payments to a United States person, which includes companies that are “owned or controlled in fact” by a U.S. individual. It is unclear exactly what facts would be sufficient to constitute “owned or controlled” under the Feingold Amendment. Regulations on this point would be beneficial for defense contractors to comply with the prohibition.

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<sup>6</sup>This term is defined as meaning “. . . direct monetary compensation made by a United States supplier of defense articles or defense services or by any employee, agent or subcontractor thereof to any other United States person to induce or persuade that United States person to purchase or acquire goods or services produced, manufactured, grown, or extracted, in whole or in part, in the foreign country which is purchasing those defense articles or services from the United States supplier. . .” 22 U.S.C. 2779a(d)(2).

<sup>7</sup>H.R. Rep. No. 103-482, at pp. 259-260 (1994).

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The legislation generally authorizes the exercise of the same powers by the State Department that are provided for in certain sections of the Export Administration Act (EAA), which is administered by the Department of Commerce.<sup>8</sup> These sections contain various penalty and sanction provisions for violations of the EAA, as well as provisions for Commerce's enforcement of the EAA. In implementing these provisions, Commerce has issued detailed regulations covering such matters as procedures for reporting violations, as well as administrative proceedings, including rules for discovery, subpoenas, and hearings.<sup>9</sup>

Six of the seven defense contractors we talked with agreed on the need to clarify the terms "owned" and "controlled" as used in the amendment. In addition, three of the contractors said that clarifying the term "incentive payment" would be helpful. In this regard, two contractors commented that clarification is needed as to whether some nonmonetary forms of payment (such as credit-related inducements) are prohibited; the other said that clarification on the circumstances under which foreign brokers can and cannot be used would be helpful. Additionally, two of the contractors commented on the need to clarify that the amendment's prohibition on incentive payments only applies to FMS contracts.

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## Recommendation

Because the Under Secretary of State for Arms Control and International Security Affairs has not issued needed regulations for implementing the Feingold Amendment, we recommend that the Secretary of State establish a specific time frame for the Under Secretary to develop the regulations to implement the Amendment. At a minimum, these regulations should (1) clarify the term "incentive payments," (2) define the terms "owned" and "controlled" as used to define a U.S. person, and (3) spell out how State intends to enforce the amendment and impose and administer penalties for violations.

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## Agency Comments and Our Evaluation

We obtained comments on a draft of this report from the Departments of State, Defense, and Commerce, each of which have a role in collecting data and developing policy on offsets. State, Defense, and Commerce took different positions on our recommendation. State asserted that it was confident the Feingold Amendment was being implemented in an

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<sup>8</sup>Specifically, subsections (c), (d), (e), and (f) of section 11 and subsection (a) of section 12, 50 U.S.C. App. 2410 and 2411, respectively.

<sup>9</sup>These regulations can be found in 15 C.F.R. Parts 764 (Enforcement and Protective Measures) and 766 (Administrative Enforcement Proceedings).

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appropriate fashion under existing DOD procedures, thereby indicating that regulations were not necessary. DOD, on the other hand, agreed with us that regulations were needed and that State ought to develop them. Commerce did not express an opinion as to whether regulations were needed, but provided a technical correction that we have incorporated in the text.

State indicated that it had taken its position for the following reasons:

- Existing DOD mechanisms would reveal whether commissions and agent fees are paid in connection with FMS contracts.
- DOD frequently conducts audits of U.S. defense contractors to ensure contract compliance and could become aware of illegal activities involving incentive payments through this process.
- Information contained in notifications to the Congress of planned FMS contracts indicates that since the Feingold Amendment was enacted, no offsets have been proposed in connection with FMS contracts and, therefore, no incentive payments could have been made.

Our analysis indicates that DOD mechanisms, which were designed for other purposes, can contribute relevant information to help implement the Feingold Amendment, but they are not adequate substitutes for having specific regulations that provide a guide for the practical implementation of the legislation. How the terms will be defined for operational purposes and what the enforcement mechanisms will be have yet to be established. DOD also commented that while it agrees with State that controls in place (such as contract audits) help to detect violations, DOD's position is that a need still exists for State to issue regulations that clarify terms and eliminate confusion. Moreover, according to data we obtained at the Defense Security Assistance Agency, 17 of the congressional notifications sent between May 1994 and September 1996 indicate that offset agreements have been proposed in connection with FMS contracts. We also found that contractor data reported to Commerce for fiscal year 1995 indicate that new offset agreements were established in connection with four other FMS contracts.<sup>10</sup>

Furthermore, the President delegated the responsibility for implementing the Feingold Amendment to State, not DOD, and State has not sought administrative relief from that responsibility. Therefore, we continue to

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<sup>10</sup>The Defense Production Act Amendments of 1992, 50 U.S.C. App. 2099, require that U.S. firms entering into offset agreements associated with contracts for the sale of defense articles and/or services to foreign governments or companies provide Commerce certain information regarding those agreements when they exceed \$5 million.

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believe State needs to establish a specific timeframe for developing regulations.

Comments from State and Commerce are reprinted in their entirety in appendixes I and II, respectively. DOD comments were provided orally by the Director of Foreign Transfer, Office of the Under Secretary of Defense for Acquisition and Technology.

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## Scope and Methodology

To determine the Department of State's efforts to develop and issue a regulation to implement an April 1994 amendment to the AECA, we met with officials from Offices of Defense Trade Controls, Arms Transfer and Export Control Policy, and the Legal Adviser, Department of State. Also, by letter dated April 3, 1997, we requested the Department of State to respond in writing as to: (1) its intentions to issue regulations implementing the Feingold Amendment; (2) the current development status of the regulations and expected time frame for publishing them; and (3) what impediments, if any, were perceived to the effective implementation or enforcement of the amendment. As of June 25, 1997, the date we transmitted a draft of this report to the Department of State for its review, State had not responded to our April 3, 1997, letter of inquiry. However, in its July 8th response to a draft of this product, State addressed some of the issues raised in our April letter.

To address the need for implementing regulations, we reviewed the language and legislative history of the Feingold Amendment to the AECA establishing a prohibition against certain incentive payments. We also discussed the need for implementing regulations with officials from seven major defense contractors. We interviewed officials from the Department of Commerce and the Defense Security Assistance Agency to determine their role, if any, in implementing the Feingold Amendment.

We performed our review between March and July 1997 in accordance with generally accepted government auditing standards.

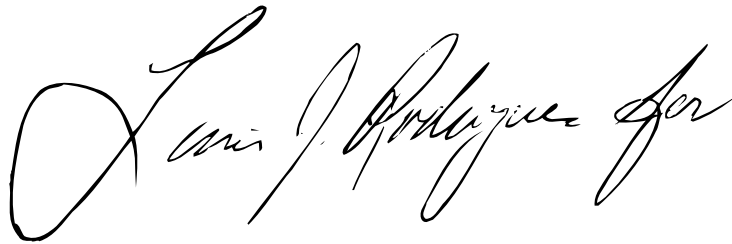
We are sending copies of this report to the Secretaries of State, Defense, and Commerce; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others upon request.



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Please contact me at (202) 512-4383 if you or your staff have any questions concerning this report. Major contributors to this report were John D. Heere, William T. Woods, Raymond J. Wyrch, and Karen S. Zuckerstein.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Katherine V. Schinasi". The signature is fluid and cursive, with a large initial 'K'.

Katherine V. Schinasi  
Associate Director  
Defense Acquisitions Issues

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## Abbreviations

AECA	Arms Export Control Act
DOD	Department of Defense
EAA	Export Administration Act
FMS	foreign military sales

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# Comments From the Department of State

Note: GAO's comment supplementing those comments in the report text appear at the end of this appendix.



**United States Department of State**

**Chief Financial Officer**

**Washington, D.C. 20520-7427**

July 8, 1997

Dear Mr. Hinton:

We appreciate the opportunity to review and provide enclosed Department of State comments on your draft correspondence to Senator Feingold entitled "Defense Exports: Incentive Payments Under Offset Programs," GAO/NSIAD-97-189R, GAO Job Code 707268.

The enclosed comments also respond to related questions about the implementation of the Feingold Amendment posed in the April 3, 1997, letter to the Department from Mr. Benjamin F. Nelson, your Director for International Relations and Trade Issues.

If you have any questions concerning this response, please contact Mr. Robert W. Maggi, Bureau of Politico-Military Affairs, at (202) 647-4231.

Sincerely,

  
Richard L. Greene

Enclosure:

As stated.

cc:

GAO - Mr. Nelson  
- Ms. Zuckerstein  
STATE/PM - Mr. Suchan  
/PM/A TEC - Mr. Maggi  
/L/PM - Mr. Buchwald

Mr. Henry L. Hinton, Jr.,  
Assistant Comptroller General,  
National Security and International Affairs,  
U.S. General Accounting Office.

**Appendix I**  
**Comments From the Department of State**

Department of State Comments on the GAO Draft Correspondence  
"Defense Exports: Incentive Payments Under Offset Programs  
GAO/NSTAD-97-189R, GAO Job Code 707268

The following explanation is being supplied in response to the GAO's initial letter of April 3, 1997, to the Secretary of State concerning implementation of the Feingold Amendment (hereinafter "Amendment"), enacted in April 1994 (22 U.S.C. sections 2776(b) and (c), 2779(a) which correspond to certain provisions of sections 36(b) and (c), and to section 39A of the Arms Export Control Act (AECA)). We are also in receipt of the GAO June 1997 draft report on implementation. We feel confident that the full explanation of implementation procedures actually in place and described below will clarify that the Amendment is being implemented in an appropriate fashion under those existing procedures.

The Amendment's requirements are twofold and are being implemented by the Departments of State and Defense in parallel in the following manner. First, under the Amendment's additions to AECA section 36, notifications or "numbered certifications" transmitted to the Congress relating to proposed major sales made by DoD under the Foreign Military Sales (FMS) program (sec. 36(b)) and to license applications for commercial export (sec. 36(c)) of major defense equipment (in the amount of \$14 million or more) or of defense articles or defense services (of \$50 million or more) must indicate whether any offset agreement is proposed to be entered into in connection with such proposed sale or export if such information is known on the date of transmittal of such certification. The Department of State clears the section 36(b) certifications prepared and transmitted by DoD relating to any such proposed sales, and transmits directly, as part of its defense export licensing function, the section 36(c) certifications relating to proposed exports.

Section 39A, as added by the Amendment, prohibits the making of any incentive payment with respect to an FMS sale of any defense article or defense service to a foreign country by a U.S. supplier for the purpose of satisfying any offset agreement with that country. Civil penalties may be imposed for violations of this prohibition. DoD has advised that in administering its FMS program, it has mechanisms in place that would reveal whether commissions and agents fees are made in connection with FMS sales. Furthermore, DoD frequently conducts audits of U.S. defense contractors to ensure contract compliance and could become aware of illegal activities of this

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**Appendix I**  
**Comments From the Department of State**

nature through this process. Should such an illegal activity be suspected, we are advised that DoD would notify its investigative service or take other appropriate steps to develop information necessary to determine whether to refer the matter for civil action.

The relevant section 36(b) certification information available at the time of transmittal of such certifications prepared by DoD since enactment of the Amendment revealed (pursuant to routine State review) no offsets that were proposed with respect to any of the underlying sales. Thus, based on this information, there appear not to have been offsets to which payments (either permissible or impermissible) could have been related. Neither has additional information been otherwise disclosed concerning offsets entered into subsequently in connection with such section 36(b) sales and with respect to which there may have been prohibited incentive payments through other DoD mechanisms and procedures in place. Furthermore, DoD has a firm policy of not encouraging, entering into or committing U.S. firms to offsets associated with FMS sales.

Within the parameters of the resources available to DoD and State for these purposes, the Department of State is satisfied that there are no impediments to continuing to implement the Amendment as described above. The Department of Defense concurs with this explanation.

See comment 1.

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The following is GAO's comment on the Department of State's letter dated July 8, 1997.

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**GAO Comment**

1. State's assertion that the Department of Defense (DOD) concurs with its position is inconsistent with the comments we obtained directly from DOD. As discussed on page 5, DOD stated that while it agrees with State that controls in place help to detect violations, DOD's position is that a need still exists for State to issue regulations that clarify terms and eliminate confusion.

# Comments From the Department of Commerce



**THE SECRETARY OF COMMERCE**  
Washington, D.C. 20230

**JUL 18 1997**

Ms. Katherine V. Schinasi  
Associate Director  
Defense Acquisitions Issues  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Ms. Schinasi:

Thank you for the opportunity to comment on the General Accounting Office's draft report titled "Defense Exports Incentive Payments Under Offset Programs." We recommend that you change footnote 9 on page 5 to conform to the renumbering of the Export Administration Regulations so that it reads as follows:

"These regulations can be found in 15 C.F.R. Parts 764 (Enforcement and Protective Measures) and 766 (Administrative Enforcement Proceedings)."

Other than this technical correction, we have no comment on or recommended changes to your draft report.

Sincerely,

A handwritten signature in black ink, appearing to read "W. Daley".

William M. Daley

See footnote 9 on page 4.



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