

XI. PROPRIETARIES

Proprietaries are business entities, wholly owned by the Central Intelligence Agency, which either actually do business as private firms, or appear to do business under commercial guise. They are part of the "arsenal of tools" the CIA believes it must have to be an effective intelligence component.¹ In recent years, particularly during the Vietnam War, serious questions were raised about this proprietary capability.

Much of the accompanying criticism stemmed from a lack of understanding of the role of proprietaries in both United States foreign policy and the intelligence operations. Some of the criticism arose from the suspected entrance of proprietaries into areas where they would be in competition with legitimate business interests, such as the airline industry. It has been feared that their profits were used to provide secret funding for covert operations, thus avoiding scrutiny by the Executive and the Congress through a "back door" funding process.

In addition, there have been allegations that the domestic impact of these entities has effectively violated the Agency's charter, which generally proscribes domestic activity of a police or internal security nature. Concerns have been expressed that favored treatment has been given these proprietaries by other Government agencies, such as the Internal Revenue Service and the Civil Aeronautics Board. The fact that the size and number of these mechanisms is unknown has caused concern about potentially pervasive influence on the free enterprise system. Questions have arisen about whether Agency policy included using these entities to engage in illegal activities to make profits which could be used to fund clandestine operations. Most notably, the latter charges have involved allegations that the Agency's air proprietaries were involved in drug trafficking.²

Concern has been expressed about the Agency's financial and management control over proprietaries and about the treatment of funds related to such entities.³ It is understandable that there would be misgivings and suspicion, since much that would have explained the role of these proprietaries has remained classified. The Committee has, nonetheless, been able to conduct broad review of these operations. This review has included examination of documents at the CIA, and testimony from present and former Agency employees.

In general, these mechanisms have operated with a proper concern for legality, propriety and ethical standards at the headquarters level. The deviations that have occurred were in the field and generally in

¹ Testimony of Chief of Cover and Commercial Staff (CCS), 1/27/76, p. 20.

² The Committee found no substance to these charges.

³ A careful review has revealed that the CIA's proprietaries are appropriately limited and controlled with careful consideration given to restrict their use within the spirit and letter of the law by headquarters-level personnel.

the area of operators, rather than management personnel. Moreover, the use and past expansion of the proprietaries was a direct result of demands placed upon the Agency by Presidents, Secretaries of State and the policy mechanisms of government. This is particularly true of the large air proprietary complex used to support paramilitary operations in Southeast Asia. The only exception to this pattern is the insurance complex, which was partially established on Agency initiatives to fill a pressing need.

A conceptual problem which continually confronts the intelligence community, applies with full force in the proprietary area. As certain kinds of covert action were developed to deal with the perceived communist threat, the use of certain mechanisms had to be limited. In a totalitarian society for example, governmental and "private" enterprises are essentially one. The government can and does use these entities for intelligence and other official purposes. In our society, however, that which is governmental is generally distinct from that which is private. Traditionally, problems have developed when the government has crossed into the private sector. Proprietaries are no exception to this dilemma. They are, in fact, the embodiment of it.

Thus, the fundamental question presented in this portion of the Committee's inquiry is: can a free and open society tolerate such a confluence of conflicting roles? The Committee concludes that it can, provided that the Congress plays a role in the supervision of these mechanisms to ensure that the delicate balance struck in our society between governmental and private actions is maintained. While there may have been a temptation to view proprietaries as "abusive" *per se*, this attitude was eschewed by the Committee. Although there are potential problems with proprietaries, the Committee feels that aggressive oversight can protect the rights of American citizens and institutions without the need for a ban on the use of proprietaries which serve a legitimate intelligence function.

A. OVERVIEW

Acting under broad authority granted them by the National Security Act of 1947 and Central Intelligence Act of 1949, the various Directors of Central Intelligence have established proprietaries (Government-owned business enterprises, foundations and quasi-business enterprises) to serve a variety of intelligence and covert action purposes. Chief among those purposes have been:

1. *Provision of Cover for Intelligence Collection and Action Projects*

Commercial firms established in foreign countries provide plausible reasons for the presence of CIA case officers. Agency-funded foundations serve as conduits of funds for a variety of purposes, including clandestine activities and contributions to scholars conducting research which supports United States foreign policy positions.

2. *Extension of Agency Influence and Information Network in Overseas Business Community*

The very act of establishing a proprietary firm requires banking, insurance, and other services. Acquiring these services entails support, communications, and intimate business relationships with bona fide

commercial entities here and abroad. At a minimum, these relationships require the clearance of those in top management positions for access to CIA business. On occasion this relationship includes the Agency using commercial contacts for information or assistance.

3. Provision of Supporting Services for Covert Operations

In paramilitary operations, airlift and sealift by Agency-owned carriers has many advantages: flexibility, security, ability to implant technical collection devices, etc. CIA agents, who engage in hazardous activities which would ordinarily make them uninsurable, can obtain commercial insurance at standard or subsidized rates via a conglomerate of CIA-owned insurance companies. In foreign locations where actual contact with the nearest CIA station is not operationally discreet, proprietaries provide payroll channels and other administrative services for Agency personnel. Firms based in locations with permissive corporate laws and regulations can also engage in many activities unrelated to their charters. For example, insurance firms can acquire real estate for operational purposes on a non-attributed basis.

4. Operation of Propaganda Mechanisms

In establishing the clandestine radios (Radio Free Europe and Radio Liberty) in the 1950s, the CIA acquired a means of directly influencing populations behind the Iron Curtain. These proprietaries were eventually disposed of and placed under the aegis of the Department of State.

5. Management of Private Investments

The Agency would deny that private investment is a *purpose* of proprietaries. Agency officials state that standing policy prohibits the investment of CIA operational funds in the private sector without explicit authorization by the DCI. Actually, the existence of proprietary enterprises which occasionally returned sizable profits, indicates that private investment may indeed have been a widespread Agency policy. Moreover, the Agency has specifically authorized its insurance complex to act as an institutional investor for its own funds and those of other proprietaries. Thus, the extent of private investment by the Agency is actually a question of definition and shading.

B. STRUCTURE

Proprietaries fall into two broad categories:

- (1) *Operating* companies which *actually* do business as private firms; and
- (2) *Non-operating* companies which *appear* to do business under commercial guise.

These entities may be legally constituted as corporations, partnerships, or sole proprietorships; or they may have no such legal standing, i.e., they may be "notional" entities financed by the Agency. Corporate proprietaries are incorporated in accordance with the statutory provisions of the jurisdiction of incorporation, are subject to the same review as any corporate entity within that jurisdiction, file applicable state and Federal tax returns, and obtain the necessary licenses to conduct business.

Both operating and non-operating companies serve two purposes: (1) they provide cover, attribution for funding, and administrative assistance to agents and clandestine activities; and (2) they provide services not available through normal commercial facilities. Because these instrumentalities are established as private organizations, they must be organized and managed in accordance with normal business practices and requirements for the types of enterprises they appear to be.

The Agency has generally employed proprietaries when they have been the only way, or clearly the best way, to achieve an approved objective. Under Agency rules proprietaries are established or allowed to continue only so long as they contribute to accomplishment of the CIA's mission, and remain the most effective means to achieve Agency objectives. While current policy does limit the use of operating proprietary mechanisms, the Agency does retain its capability to use these mechanisms, although it limits the size of the actual entities being maintained.

A review of Agency files shows that the number of operating proprietaries has been consciously pared by about 50 percent since the mid-1960s. These reductions were the result of both the Katzenbach guidelines associated with the National Student Association disclosures in 1967, and a survey conducted by the CIA Inspector General in that same year. In addition, the need for proprietaries has declined as a result of: (1) a general shift in emphasis away from covert action; (2) the transfer of Radio Free Europe and Radio Liberty to the Board of International Broadcasting with funding through State Department; (3) the liquidation of the assets of the Air America complex as requirements for CIA support in Southeast Asia diminished; (4) the sale of Southern Air Transport and the liquidation of assets of Intermountain Aviation with their exposure in the press; and (5) a change in the Agency's approach to contingency requirements.

The evidence received by the committee indicates that the activities of all agency proprietaries support the CIA's foreign intelligence collection or covert action missions. Some proprietaries are located within the United States for reasons of operational or administrative necessity, thus there is a domestic infrastructure, but their ultimate impact is overseas. Some of the questionable domestic uses of these entities are detailed in the sections of this Report on "MERRIMAC" and related programs.⁴ In one area, the insurance complex, serious questions remain as to the propriety of using such a mechanism to provide insurance and retirement benefits for agency employees.

1. Operating Proprietaries

Operating proprietaries conduct business in the commercial sphere. While they may compete directly with privately-owned corporations such competition is limited by the agency so that private companies will not be deprived of substantial income. The Agency has been careful to limit the amount of commercial business engaged in by these proprietaries to that necessary to support the viability of the commercial cover. Revenues have been used to partially offset operating costs, and aggregate profits over the years have been relatively

⁴ See the Select Committee's detailed report on CHAOS.

small. Only two proprietaries have shown significant profits: the Air America complex, primarily by fulfilling Government contracts in Southeast Asia; and the insurance company, by handling trust funds and insurance.

Depending upon the functions they perform, operating proprietaries vary in terms of capitalization and total assets. When the commercial purpose of an operating proprietary is incidental to its CIA mission (such as an export-import firm which engages in commercial operations only to the extent necessary to provide cover for a CIA officer in a foreign country) a minimum capitalization, usually in the neighborhood of \$25,000 or less, is all that is required.

Operating proprietaries whose commercial purposes are in themselves essential to the CIA mission require much larger capitalization and investment. They are staffed by Agency personnel and cleared commercial employees. Among the Agency's operating proprietaries of this type are a few management companies and non-operating proprietaries with substantial assets. The Agency's largest operating proprietaries have been Air America, the insurance complex, and Intermountain Aviation, Inc.

Air America, the Agency's largest proprietary, provided air support for CIA operations in Southeast Asia. This support was under cover of a commercial flying service fulfilling United States Government contracts. Corporate headquarters were in Washington, D.C., with field headquarters in Taipei, Taiwan.

The insurance complex provides a mechanism for both the payment of annuities and other benefits to sensitive agents, and self-insurance of risks involved in covert operations. The complex was formed in 1962 as a clandestine commercial support mechanism to provide death and disability benefits to agents or their beneficiaries when security considerations precluded payments which might be attributable to the United States Government. This function was broadened to include assumption of many risks incurred by operational activities. The complex has administered agents' escrow accounts and life insurance, and provided annuity and pension programs for selected agent personnel employed by the Agency. These programs are solely for the purpose of meeting the Agency's obligations to personnel who have rendered services over a substantial period of time, and who are not eligible for normal United States Government retirement programs.

Individuals who qualify for the CIA Retirement System or the Civil Service System are not handled through the proprietary system. The complex has also been used to provide a limited amount of support to covert operations—specifically, for the acquisition of operational real estate and as a conduit for the funding of selected covert activities.

Intermountain Aviation, Inc. provided a variety of nonattributable air support capabilities which were available for quick deployment overseas in support of Agency activities. The assets of Intermountain have been sold, with operations ceasing February 28, 1975, and the corporation is in the process of being dissolved.

The combined net worth (assets minus liabilities) of the operating proprietary companies is approximately \$57.3 million. Although some

are commercially self-supporting, such as those in the insurance complex, most of these companies usually require budgetary support.

Three of these operating proprietaries will be described in the following pages to indicate: why they came into existence; what they did; the management, operations and control environment in which they operated; and what impact they may have had on the private sector. In addition, this discussion will supply the necessary factual reference for the Committee's recommendations. These recommendations reflect the considered judgments of the Committee, which were formulated after hearing the views of current and former CIA employees, and those of other knowledgeable individuals.

The Security Project

In 1958, at the time construction of the new CIA headquarters building in Langley was initiated, a small counterintelligence operation was established to maintain surveillance of the site to prevent hostile penetration and sabotage. It was successful in its objectives and, upon occupancy of the building in 1962, the Security Project was established.

From a single office in Virginia the project expanded to four field offices and grew from a single firm into three separate corporations. The parent organization operated in the greater Washington area. This operating proprietary was a commercial corporation which performed security services on a competitive basis. The firm also conducted operations for the CIA's Office of Security. This operation was successful, with customers utilizing the proprietary for document destruction, consultation, guard work, and security clearance investigations.

This company developed business contracts with agencies of the Federal Government and commercial firms. Because the provisions of the "Anti-Pinkerton Act"⁵ prohibit a company engaged in investigative work from contracting with the Federal Government, the Agency formed a separate company to manage commercial firms as funding mechanisms for investigative work levied by the Office of Security. The new company was headquartered in California. As activity expanded and work increased, a third corporation was organized and headquartered in California.

In early 1966, the original company merged with the third firm, which remained incorporated in the state of California. The corporate officers and the board of directors of all three companies consisted of the same persons. Subsequently, the merged corporation was sold and new legal straw men were introduced as officers, directors and shareholders. In March 1966, a new home office was established in Virginia to enhance administrative efficiency, monetary controls, and cover viability. This "home office," with its investigative charter, has been used to conduct covert investigations.

In addition to conducting investigations, the project was used in the following activities:

- (1) Covert monitoring of construction of CIA headquarters building;
- (2) Monitoring of construction of buildings which were to be occupied by Agency components;

⁵ 5 U.S.C. 3108.

(3) Covert monitoring of construction of CIA printing services building;

(4) Surveillance of Department of Defense civilian employees suspected of being potential defectors to the Soviet Union;

(5) Testing security effectiveness at domestic Directorate of Science and Technology sites and contractor facilities;

(6) MERRIMAC—monitoring of dissident groups in Washington, D.C.;⁶

(7) Hiring and paying contract guards;

(8) Contracting with a civilian firm for the guard force at an installation;

(9) An operation to recruit, process and train undercover internal security agents for the Bureau of Narcotics and Dangerous Drugs;

(10) Security support for Directorate of Science and Technology projects consisting mainly of badging and entry controls, background investigations, and escort of sensitive material—this is the only such activity currently being serviced by the project;

(11) Physical surveillance of an Agency courier suspected of living beyond his means including a surreptitious entry into his apartment;

(12) Physical surveillance of an Agency employee “who maintained contact with people of questionable loyalty” including an audio penetration of the employee’s apartment and a mail cover.

Only one office is currently in operation as part of the project. Over the past years, its commercial projects have included badging operations for private companies, i.e., airlines, schools, etc. The company has never made a true profit. To maintain its image among its competitors, however, its books reflect a small profit on which Federal and state taxes are paid. The office presently employs four staff agents, five contract agents and fourteen proprietary employees. During fiscal year 1974, the project expended 2.9 percent of the Office of Security budget.

As noted, this security project has provided the Office of Security and Agency operators support on sensitive covert operations and investigative matters, counterintelligence and counterespionage support for Agency components, custodial support, technical and physical support in surveillances, and Agency proprietary support. The project has also conducted special nongovernmental and sensitive inquiries. Its commercial activities have included: internal security management, security surveys, counteraudio measures and inspection, management of security protective equipment and devices, classified material storage, secure destruction of classified waste, incinerator equipment sales, personnel investigations, and industrial undercover activities.

A unique example of its Agency security function was a project which utilized both security “probes” and security “penetrations.” A security probe is a test of the current effectiveness of a security system within an Agency installation. A security penetration is an internal investigation and search which attempts to locate subversive elements at a facility. Such a penetration seeks to detect those who may be en-

⁶ This particular project and other aspects of the project’s domestic activities are treated in greater detail in the Committee’s Staff Report on CHAOS.

gaged in foreign intelligence or sabotage, and those who, by lack of security discipline or gross malfeasance, may be weakening the security structure of the facility. In essence, penetrations are counterintelligence against a domestic installation.

In one instance, an agent was sent under the natural cover of a union construction man to an Agency contractor to gain employment as a pipefitter.⁸ He succeeded in gaining access to the target, and developed information on the installation and its personnel. Similar probes were also conducted against other companies contracting with the Federal Government. The proprietaries which are part of the security project have helped maintain the security required by sensitive Agency operations. Their utility, however, as in the case of nearly all proprietaries is relative to policy demands and "flap" potential. As one Agency commentator phrased it when *Newsweek* revealed the relationship of two Boston lawyers with the CIA in setting up proprietaries:

Proprietaries have been and will continue to be an important tool to achieve selected operational objectives. Their use, however, has been drastically cut back, more because of changes in the international scene and in operational priorities, than as a result of embarrassing exposures.⁹

As has been the case with nearly all other proprietaries, not everyone within the Agency has been satisfied with the existing mechanisms of the security project. There has been constant review, criticism, and internal restraint due to a fear and suspicion that entities which are "out there" may not readily respond to the leash. For example, in June of 1964, the Chief of the Operational Support Division wrote to the Deputy Director of Security (Investigations and Operational Support) concerning project policy and procedures. In terms of operational objectives, he noted that they had "created an operational support entity of dubious capability and with ill-defined objectives or purpose." He suggested that they "look this ugly duckling in the face" and see if it could be terminated gracefully or "see if we can nurture it into a productive and responsible bird of acceptable countenance."¹⁰

The Chief of the Operations Division wrote that he "received the definite impression that there may be some grey area with regard to the internal channels of command and administrative direction." He noted that there was confusion resulting from lack of a clear-cut distinction "at just what level policy matters may be decided . . ." Management procedures for the project were such that "under the current

⁸ He was, in fact, a legitimate tradesman.

⁹ *Newsweek*, 5/19/75, pp. 25-28.

¹⁰ Memorandum from Chief, Operational Support Division to Deputy Director of Security, 6/64.

In many cases these concerns dealt with the inability of the entity to provide adequate cover for itself in order to more adequately fulfill its role. In one instance, the physical backstopping of this project was inadequate. After this was rectified, one official noted:

"It is felt that this step has strengthened the [Corporation's] cover, [in two East coast cities] so that now the company would withstand any inquiries, except that of an official Government investigation."

status everyone may take credit but no one could be blamed." With regard to operational capability he noted :

Quite candidly, I am somewhat concerned about the operational capability of [the] Project. It seems, as a result of its Topsy-like growth, to be oriented toward the military and the building trades. Quite candidly, it is felt that the base must be broadened. Further, I am far from convinced that we have yet developed anywhere near the professional status necessary to "sell" this Project as one having unique operational capabilities sufficient to justify its existence. In other words, I am not impressed with the capability as it now exists nor am I sure that we can sell this product and then be assured that it can perform in a satisfactory manner.¹¹

His comments concerning the attitude of Agency personnel were not unique to this proprietary. They are included here to illustrate the special problems posed by these entities. His remarks also show the dangers inherent in some areas of this activity.

It would seem that this Agency, particularly operating components, are insistent upon pursuing an "ostrich policy" when it comes to their operational security procedures. I have personally witnessed almost hysterical reactions to criticisms as well as total rejections of practical suggestions with regard to operational security procedures. Now it seems to me that we are going about this in a very awkward and embarrassing manner. WE ARE, IN EFFECT, ALLOWING THE WRITERS OF SENSATIONAL BOOKS SUCH AS THE "INVISIBLE GOVERNMENT" TO PROVIDE THE NECESSARY INFORMATION AND PRESSURE ON TOP AGENCY MANAGEMENT TO CORRECT GLARING AND STUPID COURSES OF ACTION BEING PURSUED AT THE WORKING LEVEL. I have been the object of considerable personal ridicule due to my stand in opposition to the unrealistic cover and operational security procedures as they relate to certain aspects of [CIA Operational Base] for example. IF we had the *authority* and *capability* to have made an objective probe of this sensitive activity we may have been able to have surfaced these obviously ridiculous procedures in such a manner that corrective action would have been taken. Now is the time to present the case in light of the abiding fear of publicity currently permeating the Agency. I recommend that we go after the authority to make independent (unilateral) probes and/or probes requested and known only at the very highest levels of the Agency with the results discreetly channeled where they will do the most good. There necessarily follows the unpleasant subject of money. As distasteful as it may be, it is no good to have the authority without a sufficiently large confidential

¹¹ *Ibid.*

fund set aside and earmarked for independently initiated activities.¹² [Emphasis in the original]

He emphasized that if the Agency did not take the above kind of action to monitor its "image" at the operational level, it would "continue to be plagued with the unsolicited and uncontrolled critique through the newspapers, periodicals and books." He critically concluded:

Further, I challenge anyone to deny that such exposes to date are largely true and usually the result of our own "ostrich policy" and refusal to face the fact that we have operated in some relatively amateurish manners over the years.¹³

Such concerns have extended beyond these operational levels to general issues of propriety and legality. As noted earlier, the so-called "Anti-Pinkerton Act" prohibited the Office's continued contractual relationship with private companies or their employees for purposes of conducting investigations or providing cover. The General Counsel responded as follows:

I am aware that in fulfilling the responsibilities placed upon your office in support of the Agency's mission, many investigations must be conducted without revealing Government interest. Absent the relationships you question, you could not discharge your responsibilities. It is this inability to accomplish your tasks which causes recourse to the Agency's rather broad statutory authority to expend funds as contained in Section 8 of the CIA Act of 1949, as amended. This authority provides

(a) Notwithstanding any other provision of law, sums made available to the Agency by appropriation or otherwise may be expended for purposes necessary to carry out its functions, including—

(1) personal services, including personal services without regard to limitations on types of persons to be employed, . . .

(b) The sums made available to the Agency may be expended without regard to the provisions of law and regulations relating to the expenditure of Government funds; and for objects of a confidential, extraordinary, or emergency nature, such expenditures to be accounted for solely on the certificate of the Director and every such certificate shall be deemed a sufficient voucher for the amount therein certified.

It is my opinion that this authority permits the Agency to continue the two practices as set out above without fear of violation of the Anti-Pinkerton Statute.^{13a}

He closed, however, with the following admonitions:

There are, of course, other dimensions of the question you raise. As a matter of policy I believe the practices should be reviewed at the highest levels within the Agency and, per-

¹² *Ibid.*

¹³ *Ibid.*

^{13a} Memorandum from General Counsel to Director of Security, 6/64.

haps, cleared with the Agency's oversight committees. In addition, if one of these relationships became public, it must be recognized that there will be allegations that the law has been violated. On balance, it is my view that these considerations are not so significant as to warrant a termination of the two practices with the three companies. It is suggested, however, that any subsequent projected association with a detective company or private investigative company beyond the three present companies be reviewed with this Office prior to its initiation.¹⁴

The Insurance Complex

This proprietary is a complex of insurance companies, most of which are located abroad, operated by the Agency to provide the following services:

- (i) Handling of risks ostensibly covered under commercially issued policies;
- (ii) extending term life insurance, annuities, trusts and workmen's compensation to Agency employees who are not entitled to United States Government benefits;
- (iii) handling escrow accounts for agents; and,
- (iv) limited operational support and investment activities.¹⁵

Origin.—Prompted by the Bay of Pigs losses, the complex was created in 1962 to provide death and disability benefits to agents and beneficiaries when security considerations preclude attribution to the United States Government. Lawrence Houston, retired General Counsel of the Agency, testified that his office established the insurance-investment complex, because his staff was responsible for all problems related to the death or disability of employees during the course of their Agency work. These problems were all handled in what Houston called a very "sketchy way" which he felt was undesirable from all points of view. When the Agency went into air proprietaries on a large scale, additional risks arose which simply could not be underwritten commercially.

So somewhere in the late 1950s or around 1960, I think I was the one that posed that we might organize our own insurance entities.¹⁶

A single event served as the catalyst for the establishment of the complex. Houston recalled in latter testimony that

the event that brought it into focus was the death of four airmen in the Bay of Pigs. These men were not supposed to have engaged in the fighting and were training on the mainland, but when the Cubans were either exhausted or unable to fly anymore, they pitched in, went over the beach, and were shot down.

¹⁴ *Ibid.*

¹⁵ Escrow accounts are established when an agent cannot receive his full payment from the CIA without attracting suspicion. The funds not paid to the agent go into escrow accounts and are invested under the complex.

¹⁶ Lawrence Houston testimony, 1/15/76, p. 61.

We heard of this for the first time the next morning and Allen Dulles called me over and said, you'll have to make some provision for the families of those four fliers

Through [an ad hoc] mechanism we paid benefits to the family for a considerable length of time until we were able to turn it over to the Bureau of Employees Compensation.

This was a very makeshift arrangement, and so based on that I came to the conclusion that we needed a much more formal and flexible instrument. And so after long consideration within the Agency we acquired the first two insurance entities which had been in being before and then we flushed them out a little bit.¹⁷

Thus, the formation of this entity represented the "culmination of experience" in this support area, according to Houston. Although the complex originally operated under the Domestic Operations Division, a special board of directors later assumed control of the proprietaries and their investments. In July 1973 control of the complex was transferred to the Commercial and Cover Staff.

The Current Status.—All of the clients of the project are Agency employees.^{17a} The complex was originally capitalized in 1962 with \$4 million. Most of the assets are held outside the United States and the companies do not write insurance in the United States. Each of the United States companies pays little tax and is audited by a proprietary firm. This method of self-insurance enables the Agency to funnel money where needed in any of its project categories. Currently, 60 percent of the investments are in long-term interest bearing securities abroad, 20 percent in off-shore time deposits in United States banks, and the balance is in common stocks, debentures and commercial paper of various types. In the past twelve years the sale of stocks has resulted in profits in excess of \$500,000 accruing to the CIA. The combined total assets of the complex are in excess of \$30 million, including its retained net earnings of approximately \$9 million.

In 1970 the Inspector General examined the insurance complex. His report raised questions about briefing congressional oversight subcommittees which indicate that Congress had never been informed of the existence or extent of the insurance complex which had grown to an organization with assets of \$30 million without oversight, knowledge, or approval. While annual audits of the complex were conducted, there was no annual allotment and no annual operational review within the CIA, because the insurance activity was no longer a true project after its removal from the Domestic Operations Division.

¹⁷ Houston, 1/27/76, p. 8.

^{17a} The complex itself is only for covert non-staff officers of the CIA. In essence, it only works for what would broadly be described as "agents", those not entitled to participate in the CIA retirement plan or in the Civil Service Retirement Plan. They are primarily foreigners, and usually work for DDO. In the case of most agents, the CIA contributes 7 percent and the agent contributes 7 percent, in keeping with CIA practice for regular employees. In cases where the agent is well along in years and contributions from the Agency and the agent would not provide enough funds to capitalize an annuity, the Agency provides the initial capitalization; however, such an arrangement must be approved by the DDO.

Houston indicated that the complex had been operating "for some time" before

we told our committees any detail. I think it was mentioned as a problem that we had to make arrangements to cope with insurance problems fairly early on. But the fact that it was a business and a business of this substance was not done for some time. My recollection is there was not deliberate avoidance; we just didn't get to it.¹⁸

With regard to buying and selling securities, the Committee sought to discover whether the CIA has any method of preventing personal profit-taking by Intelligence Directorate analysts who have access of clandestinely collected economic intelligence. The CIA has indicated that such an analyst would be in the same conflict of interest position as a staff member of the Securities and Exchange Commission, Department of Agriculture, or any other Government agency for misuse of confidential material. Moreover, financial reporting requirements are imposed upon CIA employees.

Similarly, the Committee attempted to determine whether financial transactions were made by the complex to influence foreign stock markets or currencies. The 1970 review by the Inspector General found no evidence of such influence. Neither did the Committee. All witnesses and documentary evidence indicated that the complex was never so used. Indeed, all agreed that the amounts involved in the fund were insufficient to destabilize any currency or market, even if such an effort had been made.

The complex was subject to an audit in 1974 which concluded that it "continued to be administered in an efficient and effective manner, and in compliance with applicable Agency regulations and directives." Prior audit reports had commented on the need for a revised administrative plan. In accordance with earlier reports, the 1974 audit noted, a "new plan was approved in March 1975." In addition, "minor administrative and financial problems surfaced during the audit were discussed with [project] officials and resolved." The audit noted that *total income* for that year (from interest, premiums, gain or loss on sale of securities, dividends, rentals, professional fees, gain on foreign exchange, gain on sale of property and from miscellaneous transactions) was in excess of \$4 million. The *total expenses* for that year (allocation of premium income to reserve for claims, interest, salaries, rent, accounting fees, taxes, loss on property write-off, legal and other fees, communications, depreciation and amortization, travel, equipment rent, real estate expenses, pensions, due and subscriptions, directors fees, entertainment and miscellaneous) were nearly \$2.5 million. These combined for a net income in excess of \$1.5 million.¹⁹

The current Chief of the Cover and Commercial Staff has focused on the insurance-investment project in a number of interviews with both the Rockefeller Commission and the Committee. He has suggested that the real question for the complex is what its role and shape should be after the termination of many of the Agency's proprie-

¹⁸ Houston. 1/15/76. p. 81.

¹⁹ 1974 Audit of Insurance Complex.

taries. With their liquidation, he believes a reorganization and redefinition of the insurance-investment complex is needed.

As to the issue of a safeguard against misuse of project funds or "insider" information by the Agency, the Chief of CCS has told the Committee that the guarantees against such abuse are (1) compartmentation; (2) the integrity of the Chief of CCS; and (3) display of portfolios to appropriate congressional committees.²⁰

Houston agreed with the three safeguards outlined by the CCS Chief. However, he added a fourth:

When we were investing in stock, I would have the list of stock, the portfolio, reviewed by our contract people, and if I found we had any contract relationship with any of the companies involved, we'd either refuse to—Well, a couple of times our investment advisor recommended a stock which I knew we had big contracts with, and I told the board no, this involves a conflict of interest. We won't touch it. And if we had anything from the Agency contract office that indicated a relationship, we would either sell the stock or wouldn't buy it.²¹

Houston believes that the complex should continue in some form and that the current method, while not perfect, is the best that can be devised. The problem is that the generation of funds for these companies must be demonstrably legitimate and nongovernmental if beneficiaries are to be protected; i.e., the absence of investment by an insurance corporation could well indicate to outsiders that its funding is actually coming from the Federal Government.

Beyond "Doing Business": Peak Non-Government Security Investments by Proprietaries Active as of Dec. 31, 1974.—The insurance and pension complex has sizable investments in both domestic and foreign securities markets. Its portfolio runs the gamut of notes, bonds, debentures, etc. But other proprietaries have also used this investment route as a method of increasing capital and insuring adequate cover.

For example, a domestic corporation purchases general merchandise in a manner which cannot be traced to the United States Government. It provides covert procurement for the CIA Office of Logistics.

While this corporation has no outside commercial business and only five employees, as of December 31, 1974, it had invested over \$100,000 in time deposits. A second domestic corporation purchases arms, ammunition, and police-related equipment for the Office of Logistics. This company has no employees and is managed by Headquarters officials under alias. As of December 31, 1974, this corporation had invested more than \$30,000 in a certificate of deposit.

A travel service proprietary was recently sold to an Agency employee at the time of his retirement. This employee had ostensibly owned the firm, but had in fact managed it for the Agency. As of

²⁰ Chief, CCS, 1/27/76, pp. 15-16.

²¹ Houston, 1/15/76, p. 80.

The current charter for the insurance complex and the administrative plan forbid further acquisition of U.S. stocks and require the divestiture of American equity investments in the immediate future.

December 31, 1974, this corporation had invested more than \$30,000 in a certificate of deposit.²³ An investment proprietary, which was later dissolved, had invested about \$100,000 in Mexico as of March 31, 1973. A Delaware corporation, which has provided secure air support for Agency employees and classified pouches between Headquarters and other Agency facilities in the United States, has nearly \$150,000 invested in a certificate of deposit.

A former youth activity proprietary, in which the Agency no longer retains an interest, had approximately \$50,000 invested in time deposits as of March 31, 1972. Another proprietary is part of a complex managed by the Cover and Commercial Staff which provides operational support for foreign operations. It is a Delaware corporation used to collect proceeds from the sale of Agency proprietary entities and to refund such proceeds to the Agency. Its total assets were nearly three-quarters of a million dollars and its total stockholders equity was in excess of \$15,000 as of December 31, 1973. It has no employees. As of December 31, 1974, it had invested almost half a million dollars in a convertible subordinated debenture from the sale of a company and almost \$50,000 in notes receivable.

Another company in this complex is a foreign company which has been used as an investment vehicle for funds earmarked for new commercial operations requiring Agency investments. This investment project has been terminated and all funds were returned to the Agency. The company has no employees. As of December 31, 1973, it had invested nearly a quarter of a million dollars in a Security Note of a private domestic corporation.

A proprietary which was part of the air support complex had invested over \$200,000 in a certificate of deposit as of December 31, 1974. This entity was later sold. Another is part of the management and accounting complex. As of December 31, 1974, it had nearly half a million dollars invested in time deposits.

The Air Proprietaries

History.—Lawrence R. Houston, former CIA General Counsel, was involved in the establishment of the first set of Agency proprietaries, and has concluded that they should be a mechanism of last resort. Houston maintains that the Agency learned this “the hard way and almost all of the lessons involved probably came out one way or the other in connection with a major aviation proprietary in the Far East. Others had their own special problems, but I think the Air America complex had pretty near everything.”²⁴

The Agency acquired Air America in 1949 ostensibly to deny the assets of this company to the Communist Chinese. The CIA first arranged cash advances to the company in 1949. These advances were eventually credited to the Agency's purchase of the corporation. At that time, Houston described the airline as follows:

This normal aviation organization, this would have no meaning at all, was completely at all, it would have no standing

²³ The Agency today uses this firm for the purchase of airline tickets for travel in support of sensitive projects. It is estimated by the Agency that CIA business represents about 30 percent of the gross airline ticket sales of the entity on an annual basis.

²⁴ Houston, 1/15/76, p. 5.

in international law, aviation rights, or any of that. But it worked for what they wanted, which was to take supplies up-country into inland China and then to bring back whatever cargo they could get commercially: tallow, hides, bristles, all that sort of trade, and then they traded that off for their own account. And for awhile the operation was fairly successful, the C-47's and C-46's.²⁵

To finance this activity the lawyer for the airline organized a company, Civil Air Transport, which was funded by a Panamanian corporation. The two owners of Air America approached the Agency in connection with a foreign operation in the spring of 1959, and indicated that unless they received financial assistance, the airline would go out of business.

A series of meetings were held subsequently in which it was determined that the Agency needed to contract for air transport in some of its operations, particularly those involving arms and ammunition.

And so we entered into an arrangement, I think in about September of 1949 whereby we would advance them, the figure of \$750,000 sticks in my mind, against which we could draw for actual use of the planes at an agreed on rate. . . . And we did draw down, I think, all the flying time and expended the \$750,000 between September and about January, at which time we suspended any further payments or draw-downs. I think the money was exhausted.²⁶

The owners came to Washington in early 1950 for a series of discussions with the CIA. As a result of these negotiations, the Agency agreed to advance more funds, and received an option to purchase the assets of Civil Air Transport. Any unused portion of the advances was to be credited toward the purchase price. Air America operated under this arrangement until the owners "came in in the summer of 1950 and said again they were in desperate straits for funds."²⁷ Another series of meetings was held at the Agency in which it was concluded that the operations in the Far East would have a continuing need for secure airlift. There was also a general estimate that the loss of this airlift to the Chinese Communists would substantially assist them. Thus "the Agency then made the decision that they would exercise the option given there was no objection otherwise."²⁸

The Agency felt that it was necessary to obtain approval from the Department of State, so the head of the CIA's Office of Policy Coordination (who was responsible for conduct of covert actions) and Mr. Houston visited the Assistant Secretary of State for the Far East:

He and I went to see [the Assistant Secretary] and explained the situation. And [he] reminded us that it was basic U.S. policy not to get the government in competition with U.S. private industry. But under the particular circumstances, in particular as there was really no U.S. private industry in-

²⁵ *Ibid.*, p. 6.

²⁶ *Ibid.*, pp. 7-8.

²⁷ *Ibid.*, p. 8.

²⁸ *Ibid.*, p. 9.

volved in the area, and they agreed it was important to deny the assets to the Red Chinese. State would go along on the understanding that we would divest ourselves of the private enterprise as soon as such a divestment was feasible, and all of the circumstances that might obtain.²⁹

The divestiture of these air proprietaries was not initiated until 1975, and some of the entities have not yet been fully divested. Mr. Houston noted, however, that:

We did not disregard that guidance because after very considerable use of this asset during the early '50's, there was a question of whether to continue it, and the matter was taken up in the National Security Council. And Allen Dulles, as Director, proposed that we continue the ownership and control of the assets of Air America, as it then was known including the subsidy as needed. And there was a subsidy at that time. . . . It was about \$1,200,000 per year.³⁰

The National Security Council considered whether this asset should be retained in 1956 and, on Dulles' recommendation, decided to continue the subsidy to Air America.

The air proprietary's business consisted almost entirely of Agency cargo carriage under contracts carrying military designations. The company was not organized, according to Houston, to fly common carriage and had no status in the international air business. The evidence indicates that during the early 1950s, there were two internal struggles: one was where control should lie in the Agency, and the other was what policies should apply to the operation of the company itself:

The struggle within the Agency ranged all the way from sort of quiet management discussions as to what was good management, to sometimes rather vociferous arguments of who's in charge here. And the operators always said, "Well, we need to call the shots because it's our operation. . . . And this is what we were running into all the time, of red hot operators opposed to what we would consider good management."³¹

The air proprietary was managed by elements of the Office of Policy Coordination. From the very outset there were problems in this management structure. One such example is the acquisition of Air America in August 1950. Houston was participating in the negotiations at the invitation of the Head of the Office of Policy Coordination.

OPC was a curious organization, determined as being attached to the Agency for quarters and rationing with policy

²⁹ *Ibid.*, pp. 9-10.

³⁰ *Ibid.*, p. 10.

Houston indicated that there had been a subsidy running to the entities since 1949. "\$1.2 million represented about the maximum subsidy given until, I believe, about 1958 was the turning point, and from 1958 on, there was no subsidy as such that went into it." The reason for that, of course, was that the air complex had become "money-making."

³¹ *Ibid.*, pp. 12-13.

guidance from State, which was an impossible situation. Very nice fellows were doing the negotiating with [OPC] . . . quite unknown to me, when they made the agreement to purchase carrying out the option, they gave the vendors the right to repurchase at any time within two years. And I thought this was really inconsistent with our whole position. And during the next two years they negotiated out that repurchase agreement and in its place substituted an agreement to give them a first refusal, if we were to dispose of the airline. That first refusal plagued us for years. They used to make all sorts of extraordinary claims under it and it was never exercised and eventually it was sort of forgotten when [the owners] died. It ran to them personally, whether it ran to them and two others personally, and they all are dead now. But this shows a part of the learning curve, which was the thing we were going through.³²

In the summer of 1954, Houston and a consultant traveled to the Far East to observe the operation. The consultant went "specifically to look at the organization of the airline." At the time of the airline's purchase, the Agency had formed a Delaware corporation to buy it. The corporate counsel and the consultant were both very concerned about the technical organization, or lack of it, in the operation. According to Houston, they demonstrated:

to my satisfaction that it was an absolute situation and that no one out there had the slightest understanding of the problem or what they were up against, or wanted to do anything about it [in terms of airline management].³³

Following this review, a new organization, designed to be more responsive to the Operations Directorate, was created.

Pacific Corporation held title to 40 percent of the equity in Air America, while the remainder was ostensibly owned by Chinese, who gave deeds of trust to the Agency for their shares. For purposes of international law this overt arrangement demonstrated that the company was majority-owned and controlled by Chinese.

Air America originally had several DC-4's and began modest operations between Hong Kong, Taipei and Tokyo. The corporation soon acquired DC-6's, and it was at this time that the question of competition with private corporations first arose. Northwest Orient Airlines was then flying to Tokyo, Seoul, and Manila. A Northwest executive had noted the Agency's interest in this area when he was Chairman of the Civil Aeronautics Board in the late 1940s and early 1950s. Houston told the Committee:

He became head of Northwest, a very tight manager, a very capable fellow, and he used to complain that we were interfering, we were taking passengers off his airline, and we would go to him and say, we have to keep the airline in this business because the Chinese say they need an international airline. They're not ready to start their own yet. And it is

³² *Ibid.*, pp 13-14.

³³ *Ibid.*, p. 17.

necessary to its overall cover status as a going commercial concern.³⁴

By 1959 the executive had decided to ask the Civil Aeronautics Board for a decision. A meeting was held with the entire Board, where the executive maintained "that he was a private industry, he should not be interfered with by government competition."³⁵ The Agency explained its situation, the need for cover, and their efforts to restrict carriage to the minimum necessary to retain their cover.

And it ended up by one of the members of the Board turning to [the executive] and saying, "You ought to be glad that you don't have a really good, reliable competitor in there." He said, "If you were being competed with by private business, you'd have real headaches. You ought to be real glad that it's not worse than it is."³⁶

In these proceedings, Houston conceded that some passengers were traveling on CIA aircraft rather than Northwest planes, but maintained that the impact was minimal and unavoidable. The CAB participated in discussions with both the Agency and Northwest. After hearing both sides, the CAB "came down on the side of the Agency after making a reasoned judgment."³⁷

By 1960 the airline's international commercial business was not making money. Maintenance work in Taiwan, however, was "normally a money-maker, and this was [contracted] primarily, although not exclusively, with the U.S. Air Force."³⁸

There were management problems in the maintenance operation, which originally stemmed from the fact that field personnel were not particularly astute in setting costs for their contracts. Houston cited one instance when the Agency consultant replaced a corporation comptroller who was very able, but "had his own ideas of bookkeeping and controls." The consultant insisted that the corporation implement bookkeeping practices and controls consistent with CAB and FAA regulations. The military maintenance contracts were constantly audited by on-site teams.³⁹

In the early 1960s, the CIA received an exemption from the Contract Renegotiation Board on the grounds that renegotiation personnel might recognize that Air America was not a commercial operation and discover that the CIA was involved. The Agency went to the head of the Contract Renegotiation Board with a letter from the Department of Defense requesting an exemption on what it considered "perfectly legitimate grounds."⁴⁰ There was indeed a basis for exemption under the Renegotiation Act as the business was conducted entirely overseas, and the exemption was granted. The Agency was concerned that it had made a type of profit (over 40 percent on the Air Force maintenance contracts), which may well have been the subject of rene-

³⁴ *Ibid.* p. 21.

³⁵ *Ibid.*, p. 22.

³⁶ *Ibid.* pp. 22-23.

³⁷ *Ibid.*, p. 24.

³⁸ *Ibid.*, p. 25.

³⁹ *Ibid.*, p. 26.

⁴⁰ *Ibid.*

gotiation, had it not been subject to the exemption. "So the question was what to do about it. And finally, we made a voluntary repayment against part of the profit on that contract to the Air Force."⁴¹

As noted previously, the commercial airline aspect of the operation operated mostly at a loss. While there were periods when Air America cargo carriers were very busy on CIA contracts, the Korean War, Diem Bien Phu, and other paramilitary operations; there were also periods between these activities when there was nothing for the airlines to do. During these periods of inactivity, the airline was still saddled with expenses such as crews' salaries and the maintenance of grounded aircraft. To alleviate this problem,

. . . we finally organized the stand-by contract, which was an apparent military entity on Okinawa. It was our entity, but it had a military designation. I can't remember the name for it. And that entity contracted with Air America for so many hours of cargo stand-by to be available any time on call, and that they would pay so much for that capability being maintained . . . so that is how we kept the subsidy going to maintain them during periods when there was not profitable flying.⁴²

Another area of concern was the proprietary's relationship with the Internal Revenue Service. From the outset, the company's management was informed that they would be required to pay appropriate taxes. While there were the usual arguments about whether certain items were appropriate for taxation and whether certain deductions should have been granted, the relationship maintained with the IRS was basically a normal one.

Houston recalled that in the mid-1950s Air America received notice of an upcoming audit by the IRS. Company officials came to the Agency and indicated that this might pose a security problem. The CIA went to the Commissioner of the Internal Revenue Service and indicated that they wished to have the audit conducted by an IRS team on an unwitting basis to see what they could learn. "We thought it would be a good test of the security of our arrangements."⁴³ Later, the IRS personnel would be notified that they had begun to audit an Agency proprietary, and the audit would be discontinued:

They put a very bright young fellow on and he went into it. They came up with discrepancies and things that would be settled in the normal tax argument, corporate-IRS argument, and all of these were worked eventually, and then we went to this fellow and said, "Now, this was owned and backed by the CIA, the U.S. Government. What was your guess as to what was happening?"

And he said, "Well, I knew there was something there, and I thought, what a wonderful asset it would be for the Russians to have, but I came to the conclusion that it was Rockefeller money."⁴⁴

⁴¹ *Ibid.*, p. 27.

⁴² *Ibid.*, p. 29.

⁴³ *Ibid.*, p. 30.

⁴⁴ *Ibid.*

As the operations of Air America developed, problems arose involving large cargo carriers. In the early days of its operation the airline used C-54's, which had an extremely limited range, but were able to perform under demanding circumstances. Discussions proceeded during that period about modernizing the equipment and the Agency, through Air America, bought DC-6AB's. These aircraft were a conversion of the DC-6 with large cargo doors installed. Air America did not maintain any jet equipment at that point.

In the early 1950's Air America became deeply involved in a military Air Transport System. This system was originally known as MATS, and later as MAC.

They got MATS contracts, and Air America got these, and these were very good to keep a constant utilization at a good rate, the MATS rates were usually good, because the policy was not to do competitive bidding for the lowest bidder because then you got the poorest service, but give good rates to the carriers, and then require the carrier belong to the Civil Reserve Air Fleet.⁴⁵

In 1956 MATS changed its policy and required that bidders on their contracts be certified. Because Air America could not become certified, the Agency decided to purchase Southern Air Transport. While this corporation was technically a separate entity, not involved with Air America, it was actually an integral part of the complex from a management perspective. All management decisions for Southern Air Transport were made by the same CIA consultant and advisory team that established Air America policy.

Eventually, MAC decided to require that bidders not only be certified, but that they also have equipment qualified for the Civil Reserve Air Fleet, i.e., jet aircraft. As a result, the Agency acquired Boeing 727's and convinced Boeing to modify the 727 by enlarging the ventral exit, enhancing its airdrop capability.

So the theory was that the 727's would be used on MAC contracts to be available on an overriding basis if needed for major national security operation. They were used, usually when they had spare time. To my recollection, they were only called off once, off the actual contract time, and this was for a possible use which didn't go through. But the White House asked if we had the capability to move something from here to there, I think from the Philippines to somewhere in Southeast Asia. I don't recall, and so they sent word to management that they wanted a plane available at the earliest opportunity at Clark Field. They pulled one of them off the MAC contract and had it available. I think ready to go, in twelve hours, all set for the operation. And the operation was never called. But it showed what the capability was. And what they had to do was get substitute service for the MAC contract.⁴⁶

During the late 1960s several Chinese airlines began operations on a limited scale. With the establishment of these indigenous airlines

⁴⁵ *Ibid.*, 36.

⁴⁶ *Ibid.*, p. 39.

flying Far East routes, the CIA considered reducing its international carriage work. The Agency decided to retain the MAC contracts because they did not compete with the native enterprises, but plans to reduce Air America's international common carriage were initiated.

Another CIA proprietary, Civil Air Transport Company, Ltd., which had been organized in 1954, had been the first Agency entity to engage in common carriage. Later, Air America did the American contracting, followed by Southern Air Transport which also performed MAC and MATS contracts with planes leased from Air America.⁴⁷

Houston noted that in the late 1960s an internal decision was made that:

. . . we probably couldn't justify this major airlift with the big jets, and so we started getting rid of them. See, they had no utilization to speak of down in Southeast Asia. A couple of supply flights went into [another area] and I think we used prop planes for that, to my recollection.^{47a}

So the Agency began to phase out the 727s, which contributed to the decision to divest itself of Southern Air Transport and Air America.

Internal management was streamlined in 1963 by the establishment of an executive committee consisting of the boards of directors of the Pacific Company, Air America and Air Asia. The overt board of directors in New York City passed a resolution organizing an overt executive committee, which consisted of the CIA consultant and two other directors. Covertly, the Agency added its own representatives to this committee, which allowed representatives of management, Agency and the operators to meet, consider policies, and give guidance to the company. Houston indicated that this mechanism was extremely effective in controlling the company:

So I think for the last, oh, fifteen, eighteen years, the proprietary management system was on the whole pretty effective from the Agency point of view. I think we knew what was going on. I think we were able to get things up for decisions, and if we couldn't resolve them at the staff level, we would take them up to the Director for decisions; quite different from the early days in the early 50's that I described, and the operators at least made the claim that they had the right to call the tune.⁴⁸

During this period of time Operations Directorate personnel

were getting themselves involved in the acquisition of aircraft and which were getting awfully damned expensive at this time, and separate projects were going after some of this expensive equipment without consideration of what might be available elsewhere to the Agency by contract or old aircraft. And so the Director of Central Intelligence set up EXCOMAIR, of which I was Chairman, and had representation from both the operation and management and fi-

⁴⁷ SAT actually owned one 727 and leased two from Air America.

^{47a} *Ibid.*, p. 42.

⁴⁸ *Ibid.*, pp. 46-47.

nance out of the Agency, to try and coordinate the overall control and acquisition and disposition of aircraft.⁴⁹

A February 5, 1963 memorandum entitled "Establishment of Executive Committee for Air Proprietary Operations," noted that the committee was "to provide general policy guidance for the management of air proprietary projects, and review and final recommendations for approval of air proprietary project actions." Houston indicated that this committee, dubbed EXCOMAIR, "was . . . an amorphous group" which worked on a very informal basis. He indicated that EXCOMAIR was an effective method of achieving overall coordination; it was responsible for conducting a thorough inventory of all the equipment that the Agency had in the aviation field and was generally able to keep track of who needed what.⁵⁰

According to Houston, a general shift in thinking at the Agency occurred between 1968 and 1972 as to the desirability of maintaining a substantial airlift capability. The records appear to indicate that Houston convinced the Director in the early 1970s that such a capacity was no longer necessary to retain. Houston commented on this assessment as follows:

Through what knowledge I had of the utilization of the various assets, it seemed to me that utilization, particularly of large assets, that is, heavy flight equipment, was going down to the point where there was very little of it. Consequently, we couldn't forecast a specific requirement. Such requirements as you could forecast were highly contingent. But I also remember a couple of times putting the caveat into the Director that with a changing world and with the complications in the aviation field, once you liquidate it, you could not rebuild, and so you ought to think very, very carefully before getting rid of an asset that did have a contingent capability.⁵¹

Allegation of Drug Trafficking.—Persistent questions have been raised whether Agency policy has included using proprietaries to engage in illegal activities or to make profits which could be used to fund operations. Most notably, these charges included allegations that the CIA used air proprietaries to engage in drug trafficking. The Committee investigated this area to determine whether there is any evidence to substantiate these charges. On the basis of its examination, the Committee has concluded that the CIA air proprietaries did not participate in illicit drug trafficking.

As allegations of illegal drug trafficking by Air America personnel grew in the spring and summer of 1972, the CIA launched a full-scale inquiry. The Inspector General interviewed a score of officers at CIA headquarters who had served in Asia and were familiar with the problems related to drug trafficking. After this initial step, the Office of the Inspector General dispatched investigators to the field. From August 24 to September 10, 1972, this group travelled the Far East

⁴⁹ *Ibid.*, p. 51.

⁵⁰ *Ibid.*, p. 52.

⁵¹ *Ibid.*, p. 57.

in search of the facts. They first visited Hong Kong, then eleven Agency facilities in Southeast Asia. During this period they interviewed more than 100 representatives of the CIA, the Department of State, the Agency for International Development, the Bureau of Narcotics and Dangerous Drugs, the U.S. Customs Service, the Army, Air America, and a cooperating air transport company.

This inspection culminated in an Inspector General's report in September 1972, which concluded that there was

no evidence that the Agency, or any senior officer of the Agency, has ever sanctioned or supported drug trafficking as a matter of policy. Also, we found not the slightest suspicion, much less evidence, that any Agency officer, staff or contract, has ever been involved in the drug business. With respect to Air America, we found that it has always forbidden, as a matter of policy, the transportation of contraband goods aboard its aircraft. We believe that its Security Inspection Service, which is used by the cooperating air transport company as well, is now serving as an added deterrent to drug traffickers.⁵²

But there were aspects of the situation in Southeast Asia which were cause for concern:

The one area of our activities in Southeast Asia that gives us some concern has to do with the agents and local officials with whom we are in contact who have been or may be still involved in one way or another in the drug business. We are not referring here to those agents who are run as penetrations of the narcotics industry for collection of intelligence on the industry but, rather, to those with whom we are in touch in our other operations. What to do about these people is a particularly troublesome problem, in view of its implications for some of our operations, particularly in Laos.⁵³

The Inspector General noted that there was a need for better intelligence not only to support American efforts to suppress drug traffic in Southeast Asia, but also to provide continuing assurance that Agency personnel and facilities were not involved in the drug business.

His report began by placing the allegations against the CIA in historical perspective. It allowed that when the United States arrived in Southeast Asia "opium was as much a part of the agricultural infrastructure of this area as was rice, one suitable for the hills, the other for the valleys."⁵⁴

The record before the Inspector General clearly established that official United States policy deplored the use of opium as a narcotic in Southeast Asia, but regarded it as a problem for local governments. It was equally clear that Agency personnel in the area recognized its dangers to U.S. paramilitary operations and "took steps to discourage

⁵² CIA Inspector General's Report, "Investigation of the Drug Situation in Southeast Asia," 9/72, p. 2.

⁵³ *Ibid.*, pp. 2-3.

⁵⁴ *Ibid.*, p. 5.

its use by indigenous paramilitary troops.”⁵⁵ For example, Meo troops were ejected from various camps when they were caught using the drug. But, the I. G. noted:

We did not, however, attempt to prevent its use among the civilian population in those areas where we exercised military control, believing that such intervention would have been resisted by the tribals with whom we were working and might have even resulted in their refusal to cooperate.⁵⁶

Nor did the Agency interfere with the movement of the opium from the hills to market in the cities farther south. In this regard, the I.G. remarked candidly:

The war has clearly been our overriding priority in Southeast Asia and all other issues have taken second place in the scheme of things. It would be foolish to deny this, and we see no reason to do so.⁵⁷

Although it maintained this posture, the CIA was reporting information on opium trafficking long before any formal requirements were levied upon it. As far back as the mid-1960s, when CIA case officers began to get a picture of the opium traffic out of Burma as a by-product of cross-border operations, they chronicled this information in their operational reporting. As more information came to light in Laos and Thailand, this information began to appear in intelligence reporting. Indeed, the Agency “had substantial assets [in two Southeast Asian countries, which] could be specifically directed against this target when it assumed top priority in 1971.”⁵⁸

Air America

As early as 1957, Air America’s regulations contained an injunction against smuggling. This regulation later came to include opium. The Report indicated that the airline’s effort at this time was concentrated on preventing the smuggling of opium out of Laos on its aircraft. Although still not a crime in Laos, shipment of opium on international flights was clearly illegal and was grounds for dismissal of any pilot or crew member involved. The Inspector General stated that:

Air America has had a few cases of this kind (all of which are documented in the files in the Agency) and has, in each case, taken prompt and decisive action upon their discovery.⁵⁹

Air America was less able to control drug traffic involving its aircraft within Laos. Although it had a rule that opium could not be carried aboard its planes, the only thing that could be done if the rule was violated was to put the opium and its owner off at the nearest airstrip.

⁵⁵ *Ibid.*, p. 6.

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

The report related a statement of a case officer which typified the CIA position in the matter during the period 1966–1968. The officer said that he “was under orders not to get too deeply involved in opium matters since his primary mission was to get on with the war and not risk souring relations with his indigenous military counterparts by investigation of opium matters.”

⁵⁸ *Ibid.*, p. 7.

⁵⁹ *Ibid.*

Moreover, as a charter carrier, Air America did not have full control over its traffic. It hauled what its customers put on the aircraft. Air operations officers, in the case of Agency traffic, were responsible for authenticating the passengers and cargo they wished to put on the plane. In some locations, the air operations officers had to rely on indigenous assistants for much of the actual details of preparing manifests, checking cargo, and supervising the loading of the aircraft. In areas where active military operations were in progress, this process could become cursory if not actually chaotic. In such circumstances, the Inspector General concluded that:

it was hardly fair to blame Air America if opium happened to get aboard its aircraft. There is no question that it did on occasion.⁶⁰

With the realization that drug abuse among American troops in Vietnam was growing and that Southeast Asian heroin was finding its way to U.S. markets, the CIA's early attitude toward the opium problem began to change. The Agency joined the effort that began in 1971 to halt the flow of opium and heroin from Burma, Laos, and Thailand, and pursued a vigorous intelligence program against these targets.

In terms of staff and contract personnel, the Inspector General was impressed that "to a man, our officers overseas find the drug business as distasteful as those at headquarters."⁶¹ Indeed, many of the CIA's officers were restive about having to deal with Laotian officials who were involved in the drug business:

One young officer even let his zeal get the better of his judgment and destroyed a refinery in northwest Laos in 1971 before the anti-narcotics law was passed, thus risking being charged with destruction of private property.⁶²

But, the I.G. reported, CIA officers generally tolerated the opium problem, regarding it as just another of the frustrations one encounters in the area.

From what the Inspector General contingent was able to observe in the field, "the pilots in the employ of Air America and the cooperating air transport company merit a clean bill of health."⁶³ While it was true that narcotics had been found aboard some of their aircraft, in almost every case the small quantity involved could only have been for the personal use of the possessor. The Inspector General felt that

Given the strict anti-contraband regulations under which these two airlines have been operating for years, it is highly unlikely that any pilot would knowingly have permitted narcotics or any other contraband aboard his aircraft.⁶⁴

Although they noted, "if it is a truism to say that they're in the business for the money," the investigators concluded that these pilots

⁶⁰ *Ibid.*, p. 8.

⁶¹ *Ibid.*, p. 11.

⁶² *Ibid.*

⁶³ *Ibid.*, p. 12.

⁶⁴ *Ibid.*

were deeply committed to their job, and that the subject of drugs was as much an anathema to them as it is "to any decent, respectable citizen in the United States."⁶⁵

The Inspector General indicated how one pilot felt about the subject. He stated:

You get me a contract to defoliate the poppy fields in Burma, and I'll take off right now and destroy them. I have a friend whose son is hooked on drugs, and I too have teenage children. It scares the hell out of me as much as it does you and the rest of the people in the States.⁶⁶

The report also established that the pilots were well paid, averaging close to \$45,000 a year. Almost half of their salary was tax-free. In this context the I.G. concluded that

Although the temptation for big money offered by drugs cannot be dismissed out of hand, it helps to know that the pilots are making good money. Further, an American living in Vientiane can bank a substantial part of his salary without much difficulty, and a common topic of conversation among pilots is how and where to invest their fairly substantial savings.⁶⁷

The milieu in which these pilots found themselves did serve to evoke images of them as mercenaries or soldiers of fortune. The Inspector General indicated that a "number of them do like their wine and women, but on the job they are all business and very much like the average American."⁶⁸

The investigators, however, could not be as sanguine about the behavior of the numerous other individuals who worked for Air America and the cooperating air transport company as mechanics or baggage handlers. The nature of their work allowed these employees easy access to the airplanes, and created real opportunities for concealing packages of narcotics in the airframes. The records indicated that there were several instances where employees had been fired because they were suspected of handling drugs. The Inspector General advised that:

Despite the introduction of tighter security measures, it would be foolish to assume that there will not be any further attempts by mechanics and baggage handlers to conceal narcotics on airplanes.⁶⁹

In a startling revelation concerning indigenous officials in Southeast Asia, the I.G. bitterly reported that

In recent testimony to Agency officers in Vientiane, Laotian officials who had been involved in the drug business stated that there was no need for drug traffickers to use Air America facilities because they had their own. We certainly found

⁶⁵ *Ibid.*

⁶⁶ *Ibid.* p. 13.

⁶⁷ *Ibid.*

⁶⁸ *Ibid.* p. 14.

⁶⁹ *Ibid.*

this to be true. In addition to the Royal Lao Air Force (RLAF), there are several commercial airlines in Laos, including Royal Air Lines, Lao Air Development, Air Laos, and perhaps others, all of which evidently have ties with high Laotian government officials. It is highly problematical whether these airlines have a full platter of legitimate business.⁷⁰

Another factor which had the effect of making Air America a less desirable target for the drug trafficker was that there were virtually no regular, pre-arranged flight schedules for the pilots. Ordinarily, the pilot did not know until he reported for duty which airplane he would be flying or what his flight schedule would be for the day.

Air America's Security Inspection Service, which was established early in 1972, also had five inspection units in Laos. Similar units were eventually established elsewhere in Southeast Asia. Each unit consisted of an American chief and three or four indigenous personnel. The baggage of the pilot and all passengers traveling in CIA-owned aircraft was inspected in the presence of an American official before anyone was permitted to board. All cargo was inspected unless it had been exempted under established procedures. The very existence of the system was considered a deterrent to drug smuggling on Air America aircraft and did result in several discoveries of drugs among the baggage of passengers, although only one or two of these involved quantities of sufficient size to be as commercial.

Agents and Assets

This is one area where the CIA is particularly vulnerable to criticism. Relationships with indigenous assets and contacts are always broad. In Laos, clandestine relationships were maintained in every aspect of the Agency's operational program—whether paramilitary, political action, or intelligence collection. These relationships included people who either were known to be, or were suspected of being, involved in narcotics trafficking. Although these individuals were of considerable importance to the Agency, it had doubts in some instances. For example, the investigators were troubled by a foreign official who was alleged to have been involved in one instance of transporting opium. He was evidently considered "worth the damage that his exposure as an Agency asset would bring, although the Station insists (a) that he is of value to the Station as an agent of influence [deleted] and (b) that his complicity in the [deleted] incident has never been proved."⁷¹

Among liaison contacts, which in the military arena included virtually every high-ranking Laotian officer, the Inspector General warned that the Agency was "in a particular dilemma."

The past involvement of many of these officers in drugs is well-known, and the continued participation of many is suspected; yet their goodwill, if not actual cooperation, considerably facilitates the military activities of the Agency-supported irregulars.⁷²

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² *Ibid.*, p. 18.

The Inspector General concluded, that

The fact remains . . . that our continued support to these people can be construed by them, and by others who might become aware of the association, as evidence that the Agency is not as concerned about the drug problem as other elements of the U.S. mission in Laos. The Station has recently submitted, at headquarters' request, an assessment of the possible adverse repercussions for the Agency, if its relationship to certain assets were exposed. We think that, on the whole, that assessment was unduly sanguine. We believe the Station should take a new look at this problem, using somewhat more stringent criteria in assessing the cost-benefit ratio of these relationships. We realize that it is impossible to lay down any but the most general kind of rules in judging whether to continue, or to initiate, a clandestine relationship with Laotians. Each case has to be decided on its own merits, but within a framework that attaches appropriate importance to its possible effect on the U.S. Government's anti-narcotics efforts in Laos. It is possible that the Station will need additional guidance from headquarters as to current priorities among our objectives in Laos.⁷³

2. Nonoperating Proprietaries

Nonoperating proprietaries vary in complexity according to their Agency task. They are generally corporate shells which facilitate foreign operations and clearly pose no competitive threat to legitimate businesses. The most elaborate are legally licensed and established to conduct bona fide business.

All nonoperating proprietaries do have nominee stockholders, directors, and officers and are generally directed by one of the Agency's proprietary management companies. The company address may be a Post Office box, a legitimate address provided by a cleared and witting company official or private individual or the address of a proprietary management company. The nonoperating proprietaries maintain bank accounts, generate business correspondence, keep books of account which can withstand commercial and tax audit, file State and Federal tax returns, and perform normal business reporting to regulatory authorities. They are moderately capitalized, generally at around \$5,000, and their net worth at any one time varies according to the Agency task they are performing. As of December 31, 1973, more than 60 percent of the combined net worth of these proprietaries was operating capital for companies which provide cover to agency personnel.

Legally incorporated companies require less elaborate commercial administration due to the nature of the tasks they perform for the CIA. This kind of proprietary is directly managed by headquarters specialists operating in alias. No commercial book or accounts are kept, and in the event of a tax audit the Agency has to brief the auditing authority.

Depending on use, administration may be as simple as maintaining bank accounts and filing annual franchise taxes, or as extensive

⁷³ *Ibid*, p. 19.

as that required to obtain Employee Identification numbers, to pay personnel taxes, and to file tax returns.

There are also *sole-proprietorships*, which are proprietaries in the sense of being Agency-owned and administered. The Agency establishes and registers these sole-proprietorships. Arrangements are made to provide an address for these entities. Like the proprietary corporations administered by Agency Headquarters specialists, these companies provide cover, salaries, and tax attribution for Agency personnel.

Another type of entity used by the Agency is a proprietary only in the sense of being Agency-owned and administered. These are the *notional* companies which are not legally registered, but have names and bank accounts controlled by the Agency. The Agency arranges domiciliary addresses and any queries are referred to the Agency specialists concerned. These notional entities are used to provide status and operational cover for Agency personnel involved in all types of high-risk intelligence operations.

C. OPERATION OF PROPRIETARIES

1. Statutory Authority

The Agency's statutory authority to spend money for proprietary corporations in support of Agency operations is derived from Section 8(b) of the CIA Act of 1949. This act states:

The sums made available to the Agency may be expended without regard to the provisions of law and regulations relating to the expenditure of Government funds; and for objects of a confidential, extraordinary, or emergency nature, such expenditures to be accounted for solely on the certificate of the Director and every such certificate shall be deemed a sufficient voucher for the amount therein certified.⁷⁴

The language contained in Section 8(b) is adequate authority to exclude the operation of these proprietary corporations from the law governing Government corporations in 31 U.S.C. 841 *et seq.* However, the CIA General Counsel ruled in 1958 that the CIA should comply with the principles in that act to the extent possible, and this has been done. A classified Memorandum of Law by the CIA General Counsel on the Agency's authority to acquire and dispose of a proprietary without regard to provisions of the Federal Property and Administrative Services Act, outlines the CIA's position. This position was upheld by the U.S. District Court in the Southern District of Florida in dismissing the suit *Farmer v. Southern Air Transport* on July 17, 1974.⁷⁵ That result was not appealed and remains the law.

2. Specific Controls

The formation and activities of proprietaries are controlled through various mechanisms to assure their proper use. These include internal

⁷⁴ 50 USC 403(b).

⁷⁵ See p. 246.

Agency regulations which establish the administrative procedures to be followed in the formation, operation, and liquidation of proprietaries. An Administrative Plan (specifying the operational purpose, administrative and management procedures, and cost) and a Liquidation Plan (specifying details of liquidation and disposition of funds when liquidation is contemplated) must be coordinated among the effected CIA components and approved at appropriate management levels. This regulatory control along with policy memoranda are intended to assure proper conduct by proprietaries. Each Agency component involved in the operation of a proprietary enterprise is responsible for compliance. The Chief of the Cover and Commercial Staff, the Director of Finance, and the Comptroller are assigned particular responsibilities.

The controls and procedures applicable to each operating proprietary specify that a project outline and an administrative plan must be approved at the Deputy Director level. Routine control and administration is executed by a project officer at Headquarters. The Agency conducts semi-annual reviews to determine whether operational needs still exist, and performs regular audits to assure proper management and financial accountability. Proprietaries are liquidated as their usefulness ends and new ones are formed as needed.

3. Treatment of Profits

The CIA General Counsel ruled in January 1958 that "income of proprietaries, including profits, need not be considered miscellaneous receipts to be covered into the Treasury but may be used for proper corporate or company purposes."⁷⁶ This subject was reviewed and the opinion reaffirmed by the General Counsel in July 1965. The policy of retaining profits has continued, although only a very few Agency proprietaries have ever been profitable. The CIA's legal basis for retaining profits for the use of the operating corporate entities is discussed below.

Section 104 of the Government Corporations Control Act provides that Congress shall enact legislation necessary to make funds or other financial resources available for expenditure and limit the use thereof as the Congress may determine. It is further provided that "this section shall not be construed as preventing the Government corporations from carrying out and financing their activities as authorized by existing law . . ."⁷⁷ The legislative history explaining this section of the act states that "in cases where no other law required a congressional authorization of expenditures, the corporation, if it had means of financing other than annual appropriations, could continue to operate in the absence of any action by Congress on its budget program."⁷⁸ The statute creating a particular Government corporation may provide specifically how that corporation may use its profits in the conduct of its business.

The Government Corporations Control Act clearly did not contemplate Government corporations of the type that the CIA has established. Furthermore, it is not feasible for Agency proprietaries to be created by act of Congress or overseen precisely as provided for normal

⁷⁶ CIA General Counsel Memorandum of Law, 1/6/58.

⁷⁷ 31 U.S.C. 849.

⁷⁸ Senate Banking and Currency Committee Report 694, 11/2/45.

Government corporations in the Act. Nevertheless, the Agency has felt that the appropriate and reasonable policy would be to treat and control proprietaries in accordance with the terms of the law. The Agency maintains that there is no need to have more restrictive rules applied to its corporations in the use of funds, including profits, than are applied to government corporations under existing statute. Thus, the Agency considers the use by a proprietary of its earnings to carry on its corporate affairs without an offset against Agency appropriations to be a legitimate practice which does not constitute an illegal augmentation of appropriations.

With rare exception, operating proprietaries have not been self-sustaining from real income. Income, including profits, is retained by the proprietaries consistent with the usual operating practices of business enterprises.

The use of proprietaries' profits is controlled by annual CIA reviews and audits of the total capital, investment and profits situations in the context of operational objectives and cover needs of the corporations. The CIA maintains that, in effect, the annual project review is based upon an audit as searching as that required for statutory government corporations. While this may be technically true, such audits do not raise broad questions of program duration and effectiveness. There is no broad management audit in program terms, but rather only a financial audit to determine essential security and integrity. Moreover, there have been no outside audits of any kind, especially those to determine performance and effectiveness. One former CIA employee intimately involved with this process suggested strongly that these provisions were inadequate. This needs to be rectified, and the Committee recommends that such audits be reported to the new legislative oversight committee.⁷⁹

4. Disposition of Funds

Any proprietary with funds in excess of its current or foreseeable needs is required to return such funds to the Agency. Funds generated by the liquidation or termination of a proprietary are returned to the Agency, except in a limited number of situations when they are transferred to another proprietary for "similar use." On the basis of a CIA General Counsel opinion of February 3, 1975, the Agency has revised its policy on the treatment of all returns of funds from proprietaries. All such returns are to be remitted to the United States Treasury as "Miscellaneous Receipts." Prior to this change in policy, returns were treated as refunds of the previously recorded expenses, up to the amount of such expense for a particular proprietary with any excess amounts returned to the Treasury as "Miscellaneous Receipts."⁸⁰

D. THE DISPOSAL OF PROPRIETARIES

1. Overview

The Agency has emphasized the degree to which the extensive proprietary system it has maintained in the past has been disposed of in recent years. According to the current Chief of the Cover and Com-

⁷⁹ See Recommendation 50.

⁸⁰ See Recommendation 52.

mercial Staff, at least as far as large proprietaries are concerned, "because of multitudinous reasons they will be viewed as the solution of last resort."⁸¹ Size was a problem and made it "inevitable that cover would not last." Moreover, there simply is not a need, according to the Agency, for the kind of capabilities supplied by an Air America either now or in the foreseeable future. In this regard, the Agency has also indicated that no "real proprietaries" are in planning because there are no such operational requirements before the Cover and Commercial Staff.

The Committee has learned from its study that the Agency retains the capability "in being" to create large proprietaries.⁸² Moreover, numerous "shelf" corporations are kept available to provide cover. These entities are generally of the notional variety which do not compete with legitimate enterprises. Nonetheless, the Agency has emphasized the need to maintain this general vehicle for at least one purpose: to retain assets. Notionals are a very effective cover mechanism when they are small, and can be very effective in securely providing various support items. In addition, the Chief of the Cover and Commercial Staff told the Committee that, in order to carry out operational functions, the CIA needs a variety of tools:

We need a variety of mechanisms. We need a variety of cooperating personnel and organizations in the private sector.

Proprietaries, in the largest sense as we have used it throughout these investigations, are part of this arsenal of tools that the Agency must have in order to fulfill its job. I said earlier on this morning that on the basis of our experience with proprietaries we have come to the conclusion that wherever possible we try to use other means of providing cover and hiding the CIA hand than proprietaries. But where there is no other way, or where it is the best way in order to achieve the operational objective, we have used proprietaries in the past and we propose to continue to use proprietaries. So we are not getting out of the proprietary

⁸¹ Chief, CCS, 1/27/76, pp. 15-16.

The Deputy Director of Operations noted recently in testimony:

"I think by and large that the day of the big proprietary is over. We have attempted over the past few years to try to squeeze down on those kinds of proprietaries and I think we have really gone now to a fairly small number, and a fairly tightly controlled group of proprietaries who are doing legitimate operational jobs, particularly in the media field.

"Our experience with proprietaries in the past has been if left by themselves, they tend to absorb larger and larger amounts of government money and are not particularly for a business. They are not very viable in the business sense and quickly become suspect as not having any commercial validity. And we have, I think in the past ten years, we have in this past ten years gotten rid of an enormous number of proprietaries in this field. I don't foresee us getting in the immediate future into any expansion of that proprietary record. I think we are about right in terms of where we are now."

⁸² The DDO closed his recent testimony with a caveat:

"I can visualize, however, depending on what happens to the Agency in the future, the possibility that we might want to use more proprietaries, particularly in the field of cover if this gets terribly tight or terribly difficult. But the average operational purpose, except for some of these media operations, all we need is cover and I think that most of the proprietaries that we have fall into that category."

business as such. But it is true that the proprietaries that we are using at the present time and what I can foresee for the immediate future is going to be of a smallish variety.⁸³

The former General Counsel of the CIA, Lawrence R. Houston, concurred in this judgment. It should, he said, be used only as a "last resort."⁸⁴ The Chief of CCS noted that these operations are run for specific purposes unrelated to profit and that, "I am not in the business to make money."⁸⁵

Only two proprietaries, the insurance complex and Air America, returned continuing profits or did large volumes of business. For this reason, the Committee sought to discover if the CIA would ever again seek to establish a large proprietary conglomerate such as the Air America complex. The Chief, CCS responded in this manner:

These kind of facilities, any kind of facilities of this kind get established and are used because they are needed in the pursuit of an existing operational requirement.

If such an operational requirement should again arise, I would assume that the Agency would consider setting up a large-scale air proprietary with one proviso—that we have a chance at keeping it secret that it is CIA.⁸⁶

Mr. Houston noted that he did not believe it was possible to keep such an activity secret:

I'll answer to that. I don't believe it's possible. The aviation industry, everybody knows what everybody is doing and something new coming along is immediately the focus of thousands of eyes and prying questions, and that combined with the intricacies of a corporate administration these days, and the checks and balances, I think make a large aviation proprietary probably impossible I don't think you can do a real cover operation, is my personal assessment.⁸⁷

The Committee reviewed those proprietaries which had been sold or otherwise disposed of during the period from 1965 to 1975. It sought to discover which of those proprietaries disposed of in the last ten years maintained a significant relationship with the Agency by contract or informal understanding. More specifically, the Committee sought answers to the following questions:

(1) How have proprietaries been disposed of by the Agency?

(2) Have proprietaries or their assets been sold to persons who had previously served as directors, officers or employees of the proprietaries?

(3) How often were proprietaries sold pursuant to an agreement or understanding that the purchased proprietary would provide the Agency with goods, services or other assistance?

⁸³ Chief, CCS, 1/27/76, pp. 19-20.

⁸⁴ Houston, 1/15/76, p. 5.

⁸⁵ Chief, CCS, 1/27/76, p. 80.

⁸⁶ *Ibid.*, p. 21.

⁸⁷ Houston, 1/27/76, p. 21.

Our study revealed that during the indicated period, a large number of proprietaries were dissolved, sold, or otherwise disposed of, thus substantiating the Agency's claim that it had moved decisively to extricate itself from this area of activity. In a very real sense, it is nearly impossible to evaluate whether a "link" still exists between the Agency and a former asset related to a proprietary. In some cases, even though formal and informal Agency ties are discontinued, social and interpersonal relationships remain. The impact of such liaisons is difficult to assess.

At its peak, Air America, the Agency's largest proprietary, had total assets of some \$50 million and directly employed more than 5,600 individuals (the total number of employees for the Air America complex was in excess of 8,000). The company is in the process of being liquidated because it is no longer required. The Air America complex included a number of other companies with the Pacific Corporation as the holding company. The general plan for liquidation of Air America is for the Pacific Corporation to sell off Air America, Inc., and its affiliates. A private New York firm was engaged to estimate a fair market value for the complex. Although the Agency conducted an intensive search for competitive bidders, it was able to find buyers for only one of the affiliated companies. The sale of this company was closed on January 31, 1975. The remaining parts of Air America are being liquidated by sale of individual assets upon completion of existing contracts. Funds realized from the sales could be as much as \$25 million and will be returned to the Treasury.

Agency financial support for Radio Liberty and Radio Free Europe, both sizeable proprietaries, was terminated in FY 1971 and responsibility for their funding and operation was assumed by the Department of State.

Southern Air Transport was sold on December 31, 1973 because its contingency capability was no longer needed. The Agency realized \$6,470,000 from this sale, of which \$3,345,000 was in cash (including a \$1.2 million award in arbitration of a dispute over the proceeds of the sale of an aircraft by Southern Air Transport after the sale of the company by the Agency). The purchaser paid the balance to Air America to retire a debt owed by Southern Air Transport. A group of employees of Southern Air Transport filed a civil action disputing the propriety of the sale of the company by the Agency, but the case was dismissed with prejudice on July 17, 1974 by a Federal court.

Most of the entities of which the Agency has divested itself were either sold or given to witting individuals (former officers, employees, managers, contractors, etc.). A handful were sold or given to witting individuals who had no formal relationship with the proprietary. In several cases, transfer of the entity was conditioned as an agreement that the proprietary would continue to provide goods or services to the CIA. Other methods which have occasionally been used to dispose of entities include: merger with another Agency proprietary; transfer or sale of a proprietary to another Government department; and liquidation, with the remaining assets of the proprietary being given to previously uncompensated participants in the venture, or to other Agency proprietaries.

2. The Sale of Southern Air Transport, Inc.

Southern Air Transport Incorporated (SAT) is an American air carrier, incorporated in the State of Florida on October 31, 1949. From its inception until its purchase in 1960 by the Central Intelligence Agency, it was privately owned. It was purchased by the CIA on August 5, 1960, and owned by the CIA through December 31, 1973 when the Agency sold the firm back to one of its original owners.

The decision to acquire Southern Air Transport was triggered by a change in the regulations governing the award of Military Air Transport Service (MATS) contracts. On April 1, 1960, Air America had begun flying a seven month MATS contract operating out of Tachikawa Air Force Base in Japan, to other Pacific locations. In June of 1960, the Department of Defense and the Civil Aeronautics Board changed the regulations governing the awarding of MATS contracts to require that bidders hold at least a Supplemental Certificate of Convenience and Necessity for an air carrier and that they participate in the Civil Reserve Air Fleet Program. Air America did not meet either of these new criteria and could not obtain appropriate waivers.

The Air America heavy airlift capability represented an American asset for use in future operational contingencies throughout the Far East area. Loss of the MATS contract would result in underutilization of aircraft and air crews, and the revenues were needed to sustain these assets. Therefore, the CIA proposed that either Air America should obtain the necessary certification, or that the Agency should buy another commercial firm that already held these certifications. The October 1, 1960 contract date, the need for public hearings, and lengthy proceedings militated against Air America applying for the certificate. In order to avoid lengthy public hearings, which would be time-consuming and generate public exposure, it was decided that the ownership of the company to be acquired must be kept completely separate from Air America. This solution was concurred in by the CAB, DOD, the CIA, and Air America management.

It was anticipated that if the new company were awarded an ongoing MATS contract, it would actually perform the flying service but would use equipment under conditional sale from Air America and would employ personnel transferred from Air America. Under inter-company agreements Air America would provide all maintenance work, ground handling, and other services for which it would be reimbursed by the new company. In this way, Air America would share in the revenues generated by the MATS contracts. The proposal to purchase a supplemental carrier and operate it under the above arrangement was approved by Director of Central Intelligence Allen Dulles on July 15, 1960. Funds from the Clandestine Services budget for FY 1962 were made available for the purchase.

After World War II there had been over 200 supplemental carriers in existence. By 1960 only 18 were still operating. Air America management made a survey of the 18 and determined that Southern Air Transport in Miami, Florida, was the most attractive as a purchase possibility. It operated two C-46s—one owned, one leased—between

Miami and points in the Caribbean and South America. Its associated company owned the four acre property on which SAT was located. Moreover, it operated at a modest profit and had no long term debts.

Negotiations for the purchase of SAT were successful and on August 5, 1960, the CIA exchanged \$307,506.10 for all outstanding shares of capital stock of SAT and its real property owning affiliate. The Agency owned these shares in the name of a former board member of Air America.

Under CIA management Southern Air Transport operated with two semi-autonomous sections: the Pacific and Atlantic Divisions. The Pacific Division performed the MATS contract and supported Agency "heavylift" requirements in East Asia. The Atlantic Division continued to operate in the Caribbean and South America; doing the same sort of flying SAT had done prior to Agency acquisition. The Atlantic Division was also able to furnish support for certain sensitive operations. At the peak of its activities, the SAT fleet, comprised of both owned and leased aircraft, included Douglas DC-6, Boeing 727, and Lockheed L-100 Hercules aircraft.

The Sale

In 1972 it became apparent that the Agency's air capabilities exceeded its needs, and that political realities and future operational requirements in the post-war era of Southeast Asia would not require large air proprietary assets. On April 21, 1972, the Director of Central Intelligence authorized the divestiture of CIA ownership and control of the Air America complex and Southern Air Transport. He approved recommendations calling for: Air America to be retained until the end of the war in Southeast Asia; the immediate elimination of the Pacific Division of SAT; the sale of two 727 aircraft leased to SAT by Air America; and subsequent divestiture of Agency ownership and control of the remainder of SAT.⁸⁸ Specific note was made that conflict of interest should be avoided and that no employee should receive a windfall benefit as a result of these transactions.⁸⁹

In May 1972, two Agency officials met with the Chairman of the Civil Aeronautics Board and his Administrative Assistant to seek informal advice as to the best way to disengage from SAT. Three alternatives were discussed: (1) dissolve the company and sell the assets; (2) sell the assets to the current operators of the company; (3) sell SAT to, or merge SAT into, one of the other supplemental carriers.

The CAB chairman discouraged option (3) because it would involve public hearings and would be subject to criticism by the other supplementals: Option (1), although least troublesome from the legal

⁸⁸ The Director determined that "we no longer should retain air proprietaries purely for contingent requirements and that on the record, therefore, the Agency should divest itself of the Southern Air Transport complex entirely." He stated that the desirable course of action would be dissolution, although he realized that the problems were many and complex. Also, he did not rule out other solutions which might achieve the end and yet better satisfy the interests of all concerned.

⁸⁹ A condition imposed by the DCI was that "in the disposition of any of the assets involved nothing inure to the benefit of Agency employees or former employees or persons whose relationship with the Agency has been or is of such a nature as might raise a question of conflict of interest."

and security standpoints, would further reduce the shrinking number of U.S. supplementals (by 1972, there were only eleven supplemental carriers left) and would be unfair to SAT employees. The CAB officials had no objections to option (2).

On May 5, 1972 the DCI was presented with the results of the meeting with the CAB chairman. He approved the recommendation to explore the sale of the equity in SAT to the current management. It was noted that SAT had been operating as a supplemental carrier for 25 years, that none of the employees of SAT had ever been an employee of the Agency, and that both the Department of Defense and the chairman of the CAB considered it in their best interests to keep SAT as a viable carrier. The rationale behind selling SAT intact to its management was:

(1) Liquidation would deprive the United States of a useful air carrier and would be unfair to the employees.

(2) Sale of SAT on the open market would generate an unacceptable level of public interest and scrutiny. A publicly advertised disposition would run contrary to the Director's statutory mandate to protect intelligence sources and methods.

(3) Although a potential for conflict of interest and windfall profit existed, the sale of SAT to its management would best satisfy the requirements of everyone involved.

The DCI was, apparently, allowed this flexibility in method of disposal by statute. 40 U.S.C. § 474(17) provides that nothing in the regulations relating to disposal of surplus government property shall affect any authority of the CIA. In addition, 50 U.S.C. § 403(d)(5) provides that the Director of Central Intelligence is responsible for protecting intelligence sources and methods from unauthorized disclosure. It was determined that sale of SAT stock to one of its former owners in a confidential manner would prevent damage which could result from disclosure of CIA ownership.

Agency officials began exploring ways in which SAT could be sold to its management, without permitting a windfall to accrue to the buyer, and in a way that could not be construed as a conflict of interest. To establish a reasonable selling price, the Agency asked a Certified Public Accounting firm to perform a valuation study. The accounting firm in turn engaged an aviation consultant firm to conduct an evaluation of the aircraft. The following values were established:

	<i>Millions</i>
(1) Book value of SAT.....	\$3. 900
(2) Estimated total value of SAT capital stock on open market.....	2. 645
(3) Disposal as going concern.....	2. 100
(4) Liquidation value.....	1. 250
(5) Agency investment.....	1. 500

Based on these figures, the Executive Director-Comptroller on August 17, 1972, approved an asking price of \$2.7 million. Sale at this price to the management would require simultaneous payment in full of the \$3.2 million note payable to Air America through an associated land holding company, and would not include any equity in the lease purchase agreement between SAT and Air America for a Lockheed L 100-30 Hercules aircraft. Although this \$2.7 million price was less than the \$3.9 million book value, it did exceed the fair market value of the company as calculated by professional appraisers. The appraisals were based not on depreciated purchase prices for assets, as

reflected in book values, but on the earning power of the assets adjusted to "present value" and the current resale value for all assets.

On August 23, 1972, the former owner was advised that the asking price for SAT was \$5.9 million; \$2.7 million for the acquisition of stock and \$3.2 million for payment of debt to Air America. A deadline date of October 1, 1972 was established; otherwise the firm would be dissolved and the assets liquidated. Although the former owner contended the asking price should be reduced because the outstanding loan to Air America had been reduced since the date of the study, he stated that he would attempt to work out financing within the deadline date of October 1, 1972. This deadline was extended by the Agency to December 4, 1972.

On December 5, 1972, the former owner submitted an offer to buy SAT for \$5 million: \$1.875 million for the acquisition of SAT and \$3.125 million to pay off the debt to Air America. On December 26, 1972, the Executive Director-Comptroller approved the recommendation that the offer be rejected and that if the former owner was unable to raise by January 20, 1973, the additional funds required for the original purchase price of \$5.9 million, including the Air America debt, that the Agency proceed with liquidation plans and the dismissal of SAT employees not later than February 1, 1973.

On January 11, 1973, a new proposal was submitted to purchase SAT for a total price of \$5,605,000. The former owner cited a tentative commitment for a loan of \$4.0 million and his offer was contingent upon an additional loan. The offer called for a total payment of \$5,605,000 broken down as follows:

	In millions
Acquisition of SAT stock-----	\$2.145
Payment of debt to Air America-----	3.125
Credit for payments to Air America since 10 June 1972 in liquidation of long term debt-----	.335
Total payment-----	5.605

Prior to accepting the offer, CIA officers again discussed the sale of SAT with a CAB representative, who indicated that the board would be interested in seeing SAT continued. The CAB representative stated that it would not be necessary to surface the Agency's name as the true owner of SAT in the CAB proceedings, and that he did not anticipate any problems with other supplemental carriers as a result of the sale.

On January 19, 1973, the DCI approved the sale of SAT. It was noted that the offer was within 5 percent of the original asking price, was above the independent evaluation for sale as a going concern, and was at a figure which would not seem to give the buyer windfall profit. The sale would constitute a clean break-away of SAT from the Agency with the exception of a one year extension on the lease/purchase agreement with Air America for an L 100-30 aircraft. This agreement for sale between the former owner and the Agency included a provision that any profit derived from the sale of assets within one year would constitute a windfall and would be added to the total sale price.

On February 28, 1973, the Board of Directors of SAT executed corporate action on the Agreement for Sale of SAT to the former owner. Closing date was established at not later than 30 days after CAB approval. On March 1, 1973 application for approval of acquisi-

tion of control of SAT by the former owner was filed with the CAB under Docket No. 252-64. It was anticipated that CAB approval would be forthcoming within 60 days.

Subsequent to the agreement for sale and application to CAB, several supplemental carriers generated a great deal of pressure to prevent SAT from being sold to the former owner and to prevent SAT from operating as a supplemental carrier. This pressure was applied through Congressional representatives, the General Accounting Office, and the General Services Administration. The various supplemental carriers objected to the sale of SAT for a variety of reasons. Basically each supplemental objected to the portions of SAT's operating authority which would allow SAT to compete with it. Specifically, representatives of one competitor indicated that it would not oppose the sale if the new owner would voluntarily renounce his rights to Trans-Pacific routes.

Two other companies objected to SAT operating any aircraft as large or larger than a 727 in the Far East. Another objected to SAT bidding on any domestic MAC contracts. Restricting SAT to satisfy all potential competitors could make SAT sufficiently unattractive as a profitable investment that financing would be unobtainable. With this in mind the Agency took the position that agreement for sale of SAT had been executed, subject to CAB approval. If the CAB ruled against the sale and ownership reverted to the Agency, the Agency would cease any bids or service under MAC contracts and dissolve SAT.

Two supplementals expressed interest in buying SAT. One did not make a cash offer, but on June 29, 1973, the other made a cash offer of about \$2 million in excess of what the former owner had offered. According to the Agency, there were compelling reasons not to pursue these offers. Agency officers had reason to believe that the supplementals were not interested in actually buying SAT as they were attempting to secure a commitment from the Agency which could be used to compromise the CIA's position in future CAB hearings. Three reasons for not accepting either offer were:

- (1) Any merger with another supplemental carrier would necessitate a very difficult series of CAB hearings during which all other major supplementals would certainly voice loud and strenuous objections.

- (2) To sell the firm on a sole source basis to either outside buyer without soliciting public bids would be contrary to sound business practice, and would attract even more adverse publicity.

- (3) Both offers were made directly to officials of the CIA and not to the stockholders of record. Although the relationship between the CIA and SAT was the subject of much public speculation, the relationship was still classified and an acceptance of either offer would be a violation of security and cover.

Dissolution of the firm, or sale to the former owner, continued as the most acceptable method of divestiture, subject to CAB approval.

In view of the objections by other supplemental carriers to the sale of SAT to its former owner, and the award by the Air Force of a Logistics Air contract to SAT, the DCI directed on July 31, 1973,

that SAT be dissolved, that it withdraw from the LOGAIR contract and withdraw its application for renewal of supplemental certificate. The former owner was advised of this decision and made a counter offer to purchase the company under his previous offer. He also proposed that SAT return its supplemental certificate, withdraw application for acquisition for sale from CAB, and operate as a commercial carrier under Federal Aviation Regulation Part 121 authority. Such action would remove SAT from direct competition with the supplementals, but retain a worthwhile market in which to operate. Additionally, no CAB hearing would be necessary to obtain this type of operating authority. On October 1, 1973, the DCI agreed to entertain the proposal to continue the sale of SAT as a Part 121 operator, on the condition that the former owner obtain prompt financing. Otherwise, the firm would be dissolved.

On October 5, 1973, the SAT Board of Directors approved and executed a new agreement for sale including the following provisions.

- (1) The former owner to acquire stock of SAT and Actus for \$2,145,000.
- (2) The former owner to pay off \$3,125,000 owed to Air America.
- (3) Agreement subject to the former owner obtaining \$4 million loan.
- (4) Agreement to be subject to SAT withdrawing application for renewal of its Certificate of Necessity and Convenience for an Air Carrier (Supplemental Certificate).
- (5) Lease/purchase agreement for L-100 between AAM and SAT to be extended one year.
- (6) Anti-windfall provision to be effective for one year from date of sale.

On November 29, 1973, the former owner received a commitment from The First National Bank of Chicago for a loan of \$4.5 million thereby making the October 5, 1973 agreement operative. On November 30, 1973, the DCI approved the sale of SAT in accordance with the October 5 agreement for sale. On the same day, the application to the CAB for acquisition of SAT under Docket No. 252-64 was withdrawn and petition for cancellation of certificate and termination of exemption authority was filed with an effective date of December 30, 1973. On December 31, 1973 the sale was closed, the note to Air America was paid off, and the former owner became the sole owner of SAT.

In early January 1974, CIA officials learned from Air America management that SAT had exercised the purchase option of the lease/purchase agreement between SAT and Air America for the Lockheed L 100-30 Hercules aircraft. The option sale price from Air America was \$3,150,000. SAT immediately resold the aircraft to Saturn Airways for \$4,350,000, for a profit of \$1.2 million. The Agency interpreted this sale as a violation of the anti-windfall provisions of its agreement with the owner. On January 25, 1974, Air America executed an Escrow and Arbitration Agreement on behalf of the CIA with SAT on the disputed \$1.2 million profit. The agreement called for \$750,000 to be placed in escrow with the American Security and Trust Company of Washington, D.C. The escrow funds were to be held as a Certificate of Deposit purchased at the prevailing market

rate. It was further agreed that SAT would also place in escrow a Promissory Note to Air America for the remaining \$450,000 of the disputed amount. The note was to bear interest at the same rate currently being earned on the Certificate of Deposit in escrow. It was arranged that the escrow deposits plus accrued interest would be paid to the party deemed in favor by an arbitrator with each party to pay one-half of the costs of arbitration. On September 5, 1974 the arbitrator ruled in favor of Air America. This decision caused an additional \$1,304,243 to accrue to the Agency from the SAT sale. This was the sum of the \$1.2 million under arbitration plus accrued interest, less the Agency's share of arbitration costs.

3. Declassification of Relationship With CIA

In March 1974 the employees of SAT retained an attorney and brought a class action suit in U.S. District Court for Southern Florida against Southern Air Transport, Inc. and the Central Intelligence Agency. The employees as plaintiffs sued for injunctive relief and damages. In this suit the employees alleged :

- (1) That the CIA sold the stock of SAT to the former owner illegally,
- (2) That SAT had embarked on a program to sell off its assets, depriving the plaintiffs of employment,
- (3) That the plaintiffs were entitled to the benefits of the CIA Retirement and Disability System, and
- (4) That their civil rights had been violated.

In view of the publicity arising from the allegations made by the other supplemental carriers during the CAB proceedings and the publicity arising from this suit, it was determined that no useful purpose would be served by continuing to deny the true ownership relationship of SAT by CIA. The operational activities performed by SAT on behalf of CIA were and remain classified. As a part of the Agency's defense in this suit, an affidavit of the Deputy Director for Management and Services of the CIA was presented in court.

In the affidavit he delineated the relationship between the CIA and SAT and the authorities for purchasing and later selling the capital stock of SAT. He also defined the employment status of the plaintiffs as not being government employees and not being CIA employees, and therefore not being eligible for participation in the CIA Retirement and Disability System.

In the Order Granting Motion for Summary Judgment, the court found that the sale of SAT capital stock was not in violation of law; that the plaintiffs' claim to be U.S. Government employees and entitled to CIA retirement benefits was invalid; and that the SAT employees were not deprived of any civil right under any state law. As a result, the action was dismissed with prejudice as to the plaintiff. Although this suit did cause the relationship between the Agency and SAT to be officially disclosed, it did establish, in a court of law, two points favorable to the Agency :

- a. The sale of SAT violated no laws and was within the authority of the DCI; and
- b. The directly hired employees of CIA owned proprietary firms such as SAT do not necessarily enjoy the status of Federal Government employees.

4. Possible Conflict of Interest

In the SAT divestiture, the Agency took precautions to avoid conflict of interest. A retired staff agent who had been the Managing Director of Air America, Inc., made several offers to acquire SAT. In early 1972 he and some other members of Air America management made an informal offer to buy SAT. On August 7, 1972, the retired staff agent told the Agency official responsible for the management of SAT and Air America, that he, in association with two supplementals, wanted to offer "book value" for SAT. He stated that they were not interested in SAT's certificate, but rather in the equipment and that if allowed to make an offer, it would be one that would not require CAB hearings. In both cases, the CIA General Counsel determined that due to the offeror's close association with the Agency, the offer was unacceptable. In later discussions, the retired staff agent asked to be allowed to bid on SAT in open bidding. The General Counsel's position on this request was that open bids would not solve the conflict of interest problems. In any transaction this complex, selecting the bid is only a preliminary to the negotiated final sale.

Another potential conflict of interest involved another supplemental air carrier. From the time the Agency first decided to divest until the sale was consummated, this company expressed continuing interest in merging with SAT. Their representative was a former Director of Central Intelligence, who made literally dozens of phone calls to Agency officials and arranged many meetings; all for the purpose of pressing this company's case to purchase SAT. The company also proposed to arrange "shadow financing" for the former owner of SAT if he would agree to merge at some later time. These offers were all rejected because merger with another supplemental was not an acceptable solution and the apparent conflict of interest was too great.

The sale of SAT to its former owner was another area of possible conflict of interest. While the former owner was not an employee of the Federal Government during any period of association with SAT or CIA, he had been the owner prior to CIA acquisition, and had been nominal president of SAT during Agency ownership. This potential area of conflict had been recognized at the outset of sale proceedings, and the Agency obtained third party professional evaluation and restricted windfall profits to prevent such conflicts. The underlying philosophy for sale back to the former owner was to restore the *status quo ante*, i.e. return of the corporation to its previous ownership once the need for a Government-controlled entity had terminated.

E. FINANCIAL ASPECTS

1. Relations with Other U.S. Government Agencies

Management and control of proprietaries often requires "cooperative interface" with outside agencies to gain beneficial working relationships and appropriate authorizations. These relationships are described briefly below.

For those proprietaries which maintain commercial books and other financial records, commercial managers prepare United States and State tax returns annually, based on the corporation's financial rec-

ords. For other entities where only internal Agency records are maintained, Agency specialists prepare tax returns which reflect normal operations of a legitimate commercial business. The Agency maintains close coordination with the Internal Revenue Service, which is aware of the CIA's use of proprietary commercial entities but not of specific proprietaries' identities. In the event the IRS singles out an Agency proprietary for an audit, the Office of General Counsel notifies IRS of CIA ownership. The IRS then cancels the audit to conserve manpower.

Operation of the air proprietaries has resulted in contact with the Civil Aeronautics Board, the Federal Aviation Agency and the National Transportation Safety Board. Specific problems have been discussed, usually between the Office of General Counsel of the agency concerned and the CIA General Counsel.

The air proprietaries have dealt with State Department and the Agency for International Development, generally on a contractor/customer basis, although senior personnel of those agencies have been advised by the Agency of its ownership of the companies.

Those proprietaries engaged in the shipment of weapons or other items on the Munitions Control list have required CIA assistance in obtaining the necessary export licenses. The ownership of the companies has been discussed with the State Department Office of Munitions Control, and the Bureau of Alcohol, Tobacco and Firearms. While the radio proprietaries were funded by the CIA, they received policy guidance from the Department of State to ensure that their broadcasts conformed to United States foreign policy. The Agency has intervened with the Department of Labor on behalf of survivors of employees of the proprietaries in order to assist them in receiving the available benefits under the applicable Workmen's Compensation Acts. The Agency has also interceded with the Defense Department to have proprietaries' contracts exempted from the Renegotiation Board.

The CIA has requested that the Air Force consider the interests of the Agency in awarding commercial contracts to proprietaries. Initially this was done in the mid-1950s on the basis of a policy decision by the Operations Coordination Board that Air America was an instrument of value to national security. Air America was then operating at a deficit, and the Agency was able to maintain a standby capability without budget subsidies if it could obtain enough business to support large commercial aircraft. Finally, the United States Forest Service was advised of the ownership of a proprietary and asked to award contracts to the proprietary to assist the development of a commercial posture.

2. Magnitude of United States Financial Stakes

Most proprietaries are small-scale operations. In many cases (the notionals), the overseas proprietary actually conducts no business at all; it simply has a commercial charter, staff, and cover arrangements for Agency collection and action projects.

Proprietary income consists of a mixture of CIA subsidy and income. In some cases, the outside income is from sources outside the United States Government income, e.g., Air America received income

for aircraft maintenance of foreign airlines in Southeast Asia. For the most part, proprietary income is in the form of "cross-orders" from CIA and other Government agencies. For example, a CIA paramilitary project placed orders for aircraft engines and pilot services with the Agency proprietary, Intermountain Aviation, Inc., and AID contracted with Air America to carry rice shipments in Laos. In this sense, many proprietaries are analogous to what are traditionally termed "intragovernmental funds" or "industrial funds" in United States Government budget and accounting manuals.

Compared with earlier years, the current size of proprietary expenditures has markedly declined. The potential for future expansion is nevertheless present. Indeed, new proprietaries have been formed within the last several years.

In terms of United States budgetary impact, proprietaries do not add significant new capital to CIA available resources, i.e., while they have a very large expenditure level and momentum over the years, most of these expenditures originated in the CIA and other United States Government appropriations, and the net profits generated by outside business and investment have been relatively small. Another way of interpreting the figures is to observe that nearly half the \$1.6 billion gross income of CIA proprietaries has been supplied by sources outside the CIA.

The Committee reviewed the pattern of income, expense, and net United States investment for the twenty largest proprietaries now active, including their financial experience in the twelve months preceding June 30, 1975. The two largest proprietaries, Air America and the insurance complex, dwarf the rest. While Air America will be phased out by June 30, 1976, ending the CIA-owned airlift capability and returning an estimated \$20 million to the United States Treasury, the insurance complex will continue.

In programmatic terms, the contrast between the current low levels of proprietary activity and the high levels of five years ago reflects the decline of paramilitary operations in Southeast Asia. Large volumes of outside orders by Defense and AID, along with sizable levies by CIA components, and maintenance and passenger income from commercial operations, were generated by a covert war.

Looking toward the future, will new air proprietaries be established? The CIA thinks not, but the matter is not resolved. The ultimate question is whether there will be future United States involvement in covert wars—and if so, can some substitute for CIA-owned air support meet the operational requirements of secure, well-maintained local aircraft? The Chief of CSS suggested that third-country assets could be used instead. Another possibility is the use of United States military aircraft, overtly or "sanitized."

One thing is clear: CIA sees itself as entering a different era of proprietaries. It has rejected the long-held doctrine of "standby" capability, i.e., the notion that it is worth investing considerable capital and operating resources in airlift, sealift, and other assets primarily targeted toward contingency requirements. Agency representatives maintain that the CIA is keeping proprietaries focused on *current* operational tasks. The test of retention is the utility of a proprietary in executing assigned tasks instrumental to approved Agency projects.

Generally, the notionals have increased by about 30 percent since 1967. This reflects a policy of increasing the number of cutout arrangements to increase security, i.e., to reduce one likelihood of outside discovery of agents or case officers working under cover of the end-point notional by introducing intermediate notionals for payments or identity backstops.

What are the basic distinctions of one type of proprietary from another? First, external registration divides the total in half. Those which have some form of legal standing with domestic and foreign corporate regulatory and tax authorities are subject to external governmental scrutiny. This occasions additional expenses and manpower to assure that in all respects this group of proprietaries operates in accordance with local law and commercial expectations. The second group, the notionals, exist only as names on doors, in phone directories, and on stationary. Backstopping for identification of these proprietaries is provided by Agency switchboards, mailstops, and check issuance.

The next level of distinction is within the class of legally registered proprietaries: those which carry on a commercial income-producing operation as contrasted to those which are simply cover arrangements. Within the class of commercial proprietaries which produce income, there is a distinction between those which are wholly dependent upon CIA for income (in the form of orders placed and subsidies) and those which have mixed outside and inside income. Even for those with mixed income, it is possible to distinguish those which have outside income wholly within the United States Government (i.e., a mix of CIA-derived income and income from other Government agencies) from those which have both United States Government income and income from private contracts.

3. Visibility in the Budget

Budgetary accountability to the President and Congress depends upon the extent to which the Federal agencies' budget requests provide information to facilitate evaluation. Circular A-11, issued by the Office of Management and Budget, prescribes the financial schedules and explanatory data which all Federal agencies must provide in their budget submissions. These provisions are consistent with the Budget and Accounting Acts of 1920 and 1950. The Central Intelligence Agency regards itself as subject to these prescriptions. The Agency limits the application of this principle to providing only the A-11 materials which OMB and the Congress specifically request. This policy has resulted in near invisibility of proprietaries in the CIA budget submission.

Circular A-11 requires agencies to provide schedules and narratives for each public enterprise or intragovernmental fund. This data is to include all sources of funding purposes and levels of expenditure, and approximate indications of performance through comparisons of past and proposed funding by activity. Under these regulations, it appears that the CIA should have been providing a complete set of schedules for the proprietaries which *actually* do business, i.e., excluding notionals.

The question of the programmatic impact of proprietaries should also be considered. While proprietaries have been heavily involved

in CIA intelligence collection and covert action, these activities have not been reflected in the CIA budget submission. A policy review of the budget requires programmatic judgments of the necessity and appropriate use of proprietaries in overseas areas. The Contingency Reserve Fund is an example of why such clear budgetary information is necessary. Recent debate concerning U.S. involvement in Angola has brought into sharp focus the role of this fund. All United States aid to forces in Angola came from the Contingency Reserve.

The only place in the budgets of the CIA where proprietaries have assumed even a limited visibility is in the years when supplemental financing was needed to establish or strengthen a proprietary. When such financing is necessary, the budget shows, tersely, that Contingency Reserve drawdowns have been made. For example, one past budget showed a certain amount to subsidize Radio Free Europe, but provided no justifying materials. This practice reflects the unwritten, *post hoc* nature of the Contingency Reserve financing process. In effect, these practices allow executive branch "supplementals" in which Congress is informed after the OMB has acted.

The budget does not normally indicate Agency intentions to create a proprietary in the budget year ahead. For any other Federal agency, establishing a new publicly owned enterprise without advance notice to the Appropriations and substantive committees of Congress would be proscribed. Proprietaries which require only small subsidies to get under way are funded by the CIA without supplemental financing, i.e., within its regular budget. Therefore, these proprietaries are completely invisible in the Agency budget submission.

F. SOME GENERAL CONSIDERATIONS

1. *The Relationship of Utility to Size*

The Committee's review revealed a dilemma faced by CIA planners. Proprietaries can sometimes be most effective in operations when they are large; indeed, as in Laos, they may be impelled toward enormity by the very nature of the operation. Yet large size conflicts with deniability. In areas of the world where there are few operating firms, and in types of activity which have only limited commercial appeal, where would large-scale enterprises get financing but from the United States Government? Operations in Laos simply could not be concealed in the end. This experience suggests that proprietaries may have only limited utility in future paramilitary operations.

2. *The Factor of Competition with Private Enterprises*

Do CIA proprietaries which produce income compete unfairly with private United States businesses? Is their utility to the Government of such magnitude that CIA proprietaries should be retained regardless of their competitive impact? Generally, the Agency believes that operating proprietaries do not compete with United States private enterprise because they tend to do things which private companies are not equipped, motivated, or staffed to perform.

For example, CIA proprietaries purchase weapons, foreign armaments, and technical devices; conduct security investigations; purchase real estate; insure uninsurable risks; train foreign police forces; and

run airlines in remote areas or on commercially unattractive routes. Would private enterprise do any or all of these things? It is true that private contracts with the Government include highly sensitive contracts with the CIA for technical intelligence collection, research, and development. Would the abandonment of CIA proprietaries and the cooperation of private firms be more desirable in terms of policy, economy or flexibility?

3. Relative Scarcity of Commercial and Official Cover

The continuing CIA desire for more notionals reflects the scarcity of United States Government official cover in many areas of the world, and the developing desire of some United States companies not to cooperate with the Agency.

4. Profits

Some questions concerning profits have been raised. Does proprietary profit constitute a significant addition to the resources available to CIA? How is such profit treated in the budget? How is it controlled? How can the Congress (or the President, for that matter) be sure that proprietary profits are not diverted to projects not included in the regular CIA budget?

First, profits (defined as net income to a proprietary after deduction of operating expenses) are relatively small. Even in the days when the most profitable air proprietaries were operating at peak capacity, the most that any single firm netted was less than \$4 million. Over the entire period 1947-1975, total profits have been \$50 million, an average of about \$1.6 million annually, for the 16 biggest CIA proprietaries. And in these years, a net loss was sustained three times—\$2.5 million in 1971; \$0.5 million in 1973; and \$0.3 million in 1975.

Looking to the future, after liquidation of the air proprietaries has been completed, there is forecast to be only one profitable proprietary: the complex of insurance companies which derives most of its profit from investment portfolios. This entity's net income in 1974 was less than \$2 million and a profit of this general magnitude is expected in the foreseeable future. These profits are to be used only for the insurance, escrow, annuity and related complex functions. Neither the complex, nor profits accruing to it, are used for operational support of any other projects or activities. Nevertheless profits from all proprietaries may be reprogrammed into CIA operations due to a "change in policy" reflected in the General Counsel's decision of February 3, 1975.⁹⁰ Thus proprietaries do not presently provide a mechanism for "back door" funding of covert operations; nor are they currently intended to do so.⁹¹

The current Chief of CCS noted that:

It may be the questions that have been raised by the staffs of this Committee and of the House Committee, have kind of energized certain action as far as our Comptroller is concerned, as far as the Office of Management and Budget is concerned, and a methodology is being developed at the present time that the balance sheets of the salient information of

⁹⁰ Chief, CCS, 1/27/76, pp. 80-81.

⁹¹ *Ibid.*, p. 79.

the operation of proprietaries, particularly those that are having earnings, are annexed to the budgetary presentation process and review process, so that this information is available to the Office of Management and Budget, and I assume to Congress, so that this can be taken into consideration.

And you would then have, it seems to me, a degree of safeguard that money cannot be taken out of there and used as an add-on to appropriated funds.⁹²

According to the testimony, from 1973 to 1975, before the opinion was rendered by the General Counsel of the CIA concerning profits and their treatment, the Appropriations Committees were advised that such profits existed, and "it was taken into consideration at the time of appropriations."

In the future, I would think that any oversight committee could very promptly bring to the attention of the DCI their interest in this question of profit, and ask for an accounting, and certainly could be assured that there was no use of funds derived from a proprietary for an operational purpose unrelated to such activity.

I would think . . . the DCI would be under the same prohibition using funds that were appropriated for the intelligence directorate for operational purposes or any other comparable redesignation of funds.⁹³

When asked whether funds built up in a complex such as the insurance proprietary should be used for purposes beyond those included in an annual authorization, an Agency representative replied:

I would view them as segregated funds to the extent that there was a profit, unnecessary for the purposes of the proprietary, that the profit would have to be turned over to the Treasury and it could not be used for other Agency programs.⁹⁴

As for the treatment in the budget, there are both policy and procedural aspects. The policy of CIA was changed by the February 1975 General Counsel ruling that profits of proprietaries and proceeds of liquidation must be returned to the Treasury as miscellaneous receipts, and cannot be used to augment the Contingency Reserve or otherwise be applied to operations. This ruling overturned the practice of the past which on occasion included the transfer of proprietaries' net proceeds to the Contingency Reserve for later release to operations.

The budgetary presentation and review procedures only partially focus upon proprietary profits. The insurance complex's profits are invisible in the Agency budget; they are taken into account and subject to scrutiny only within CIA. Operationally, the Directorate of Operation's annual review has the most detailed grasp of these monies at the Agency review levels. A standard set of public enterprise fund schedules, as prescribed by OMB Circular A-11, would be appropriate for making this complex visible in the Agency budget. Other commercial proprietaries should show these schedules as well. The Agency has in-

⁹² *Ibid.* pp. 82-83.

⁹³ *Ibid.* p. 84.

⁹⁴ *Ibid.* pp. 84-85.

licated that the Comptroller is working with the Directorates of Operations and Administration to develop more comprehensive budgetary presentation and review procedures for CIA proprietaries.

To what extent can these new procedures prevent abuses of proprietary profits? To what extent do they preclude the need for legislation in this area? What form of Congressional oversight is needed here; at what point should Congress exert control.

Improvement of visibility in the budget of proprietary resources and provision for review of the major proprietaries as a regular part of budget review by CIA, OMB, and Congressional Committees would seem to preclude most of the dangers of abuse. On the other hand, there is one type of abuse for which additional Congressional scrutiny and safeguards may be needed: the possibility of a small-scale, high-risk covert project directed by the President or DCI which is not covered by the regular appropriation but financed by proprietary profits. While no foolproof preventives can be designed by law or regulation, the possibility of such abuse, or the avoidance of congressional review, can be minimized by requiring that all CIA proprietaries report operational activities to the congressional oversight committee.⁹⁵

5. Private Investment by CIA

Two types of general issues are raised by investments made by the Agency:

(1) Should the CIA engage in investments which could accumulate funds outside the budget process and thus be available for operations that have no public scrutiny outside CIA?

(2) Is CIA investment policy too restrictive in regard to bank deposits? Specifically, should the CIA place large amounts of money in commercial banks without drawing interest?

A sizable percentage of the Agency's annual appropriated and advanced funds are deposited here and abroad in commercial accounts on an incremental basis to fund operational needs. If accounts are maintained at levels above the minimum balance necessary for offset costs to the bank, the banks selected earn an interest or investment bonus. The selection of these institutions is non-competitive, rooted in historic circumstance, albeit in institutions that have shown themselves flexible and responsive in providing the Agency services. Further investigation of this area is needed, and we encourage the new oversight committee to study this issue in greater detail than we have been able. This is one area where the exclusion of the General Accounting Office from CIA audits has had an unfortunate effect: there is no outside reviewer of a complex set of financial records and, consequently, confidence in the Agency's role in this area may have been eroded.

6. What is the Future for Proprietaries?

No new proprietaries are in formation or planned. This past fiscal year, 1975, one new proprietary was created which rented office space for an East Coast CIA base and provided cover for Agency employees. The main provision for new growth is the plan of some years standing for establishment in the insurance complex of several corporate

⁹⁵ See Recommendation 50.

“shells” i.e., legally constituted and registered companies that do very little commercial business but which can be adapted to various new CIA missions. To adapt to these new missions, as noted, would require CIA to amend the insurance complex Administrative Plan. But this could be done quickly; the existence of the shells avoids the leadtime of creating new corporate entities, with all the complications of local laws and risk of exposure.

While CIA proprietaries are now smaller than previously, they are so largely for administrative reasons, i.e., response to executive branch directions. Although the CIA may never find proprietary expansion to be operationally desirable, there is currently no statutory constraint on such expansion. Congress should be a partner in the process of reviewing any such expansion by providing for changes in the charter process. Another approach is establishing substantive guidelines for proprietary operation. This approach is typified by the post-Katzenbach guidelines that prohibit CIA operation of tax-exempt foundations.

Lawrence R. Houston, the former General Counsel of the Agency, was intimately involved with all of the proprietaries for his entire tenure with CIA. Consequently, his views have been invaluable to the Committee in reviewing and evaluating the history and the role of these mechanisms. In the course of far-ranging testimony with the Committee on several occasions Houston concluded that proprietaries “should be the last resort for use to backstop Agency activities.” He grounded his opinion on the fact that:

they are cumbersome. To be properly run they take many, many man-hours of many, many different parts of the Agency, so they are expensive in man-hours. There are built-in difficulties in running what appears to be a normal business for operational purposes. There's really a built-in dichotomy there that leads to a continual conflict with policies. And due to the number of people involved, there is a security problem on the old grounds that security doesn't go by the mathematical increase in the number of people. It goes geometrically as to the number of people, the security risk.⁹⁶

This assessment appears to be correct based on the evidence reviewed by the committee.

The current Director of Central Intelligence has insisted on streamlining such operations and is keenly aware of the potential for abuse. It is, for example, the current written policy of the Agency that “to the degree that domestic proprietary or cover companies are required, a clear justification will be developed as to the relationship of their support of our overseas operations.”⁹⁷

In the one area of continuing large-scale activity, the investment complex, the Agency has moved to insure propriety even in an area where there is no evidence that any illegal conduct has occurred. The current policy, established as of June 1975 is:

[The project] will be operated in conformance with appropriate legal restrictions. Arrangements are being made for the

⁹⁶ Houston, 1/15/76, p. 4.

⁹⁷ Memorandum of the DCI, 6/75.

briefing of the appropriate Congressional committees. Particular attention will be given to avoiding any possible conflict of interest situations with firms with which the Agency has contracts. Particular concern will also be exhibited over possible improper influence on the stock market or stock dealings through the investments involved in [the project].⁹⁸

The Committee is mindful of the potential danger inherent in such operations. Therefore, it recommends that the review of this and other similar projects by the appropriate oversight Committees be most stringent.

The disposal of proprietaries has also generally proceeded along legal and ethical lines with more than due concern for conflicts of interest. Most notable in this spectrum of actions was the degree to which the Agency avoided conflicts of interest in the sale of Southern Air Transport. Such internal vigilance no doubt should and will continue. Moreover, with the establishment of a permanent oversight committee, the CIA's reporting will be made easier because it will be able to report on its dealings on a regular basis to informed Members of Congress.

⁹⁸ *Ibid.*