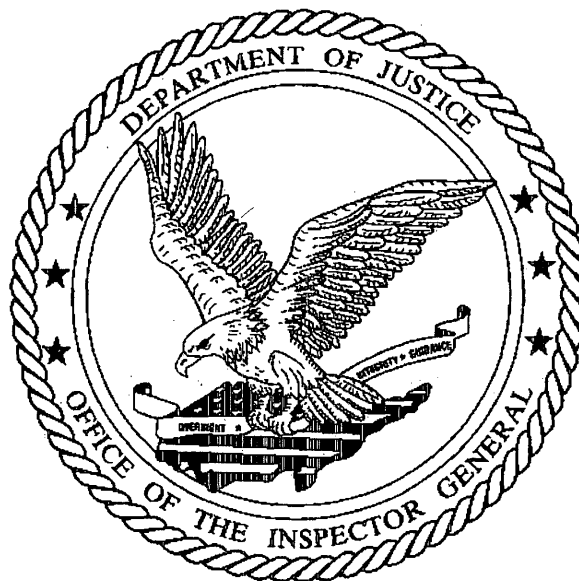


A Review of the FBI's Handling and Oversight of FBI Asset Katrina Leung. (U)



Unclassified Executive Summary

Office of the Inspector General
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EXECUTIVE SUMMARY

I. Introduction

In May 2000, the Federal Bureau of Investigation (FBI) received credible information that Katrina Leung, one of the FBI's most highly paid assets, was actively spying for the People's Republic of China (PRC) against the United States.¹ A year later, the FBI began an investigation that led to the discovery that Leung had been involved in an intimate romantic relationship with her handler of 18 years, Special Agent James J. Smith, who retired from the FBI in November 2000. The investigation also revealed that Leung had been involved in a sporadic affair with William Cleveland, another highly regarded FBI Special Agent, who retired from the FBI in 1993. The FBI's investigation further established that over the years, FBI officials had learned of several incidents indicating that Leung had provided classified U.S. government information to the PRC without FBI authorization. During the 18 years Leung was an asset, the FBI paid her over \$1.7 million in services and expenses.

In April 2003, Smith and Leung were arrested. FBI Director Robert Mueller asked the Office of the Inspector General (OIG) to review the FBI's handling of Leung and the performance and management issues relating to her case, and to recommend changes to improve FBI procedures and practices where necessary. The OIG's investigation revealed that the FBI did little or nothing to resolve the numerous counterintelligence concerns that arose during Smith's handling of Leung. This report describes the OIG's investigation and provides recommendations designed to address the flaws we identified, including the FBI's failure to consistently document concerns about Leung, its failure to follow up when concerns arose, and its willingness to exempt Smith from the rules governing asset handling.

II. Methodology and Scope of the Report

The OIG reviewed and analyzed more than 300,000 pages of material from the FBI and other Intelligence Community agencies. We conducted more than 100 interviews in Los Angeles, San Francisco, Northern Virginia, Southern Maryland, and the District of Columbia. The team interviewed Smith's former colleagues and supervisors at the FBI. We interviewed much of the hierarchy of the FBI's Counterintelligence Division. In addition, we interviewed DOJ and Intelligence Community personnel who had involvement with Smith, Leung, or the investigations of them. The team also interviewed Smith and Cleveland extensively.

¹ In this report, the terms 'China' and 'PRC' will be used interchangeably to refer to the People's Republic of China.

We provided copies of the report to the FBI for its comments concerning factual accuracy and classification. The 236-page report has been classified by the FBI at the Secret level because, according to the FBI, it contains sensitive classified information regarding intelligence sources and methods.²

The full report is divided into four chapters. Chapter One provides the backgrounds of Smith and Leung and an introduction regarding the FBI's Chinese Counterintelligence Program. Chapter Two addresses the 18-year period during which Smith operated Leung and is divided into four time periods. Chapter Three examines the FBI's investigations of Smith and Leung and describes the steps the FBI has taken to address the problems in the China program. Chapter Four contains the OIG's conclusions and recommendations. This unclassified summary of the report summarizes the findings, conclusions, and recommendations of the report.

III. The OIG Investigation

A. Background

The FBI's China program faced several significant challenges during the time Smith operated Leung. Field agents, supervisors, and program managers told us they were overwhelmed by the volume of work that required their attention. They said that during the years Leung served as an FBI asset, the FBI's China Program was understaffed, overworked, and experienced regular turnover in management. This report explores how, in this environment, the FBI failed to detect the activities of Smith and Leung and failed to address problems when they arose.

1. The FBI's Chinese Counterintelligence Program

After the United States and China normalized relations in 1979, the Chinese presence in the United States increased dramatically. By 1982, there were approximately 10,000 Chinese students in the United States and more were arriving at the rate of approximately 300 students per month. The number of Chinese visitors to the United States also increased to more than 15,000 per year and the number of Chinese immigrants exceeded 14,000. The FBI determined that the most effective means to counter the threat posed by this increased presence was to develop a large asset base. However, only a few FBI agents were available to investigate an increasing population of Chinese students, visitors, and government officials.

In the early 1980s, FBI Headquarters delegated a great deal of authority to the field to recruit, develop and handle assets. The devolution of authority from FBI Headquarters to the field had both positive and

² We have provided the full report to the FBI, DOJ officials and Congressional committees with oversight responsibility for FBI programs.

negative consequences: the field divisions had the flexibility to develop and implement creative operations to address counterintelligence concerns, but FBI Headquarters program managers told us it left Headquarters managers with the belief that they could not give orders to the field or interfere in field operations.

2. Smith's Background and FBI Career

Smith, a college graduate and Vietnam veteran, entered on duty with the FBI in October 1970 as a Special Agent. Following his first office assignment in Salt Lake City, Smith spent the remainder of his FBI career in Los Angeles. He specialized in FCI PRC matters from 1977 until his retirement in 2000. Smith received promotions and was frequently commended for his performance.

By 1982, when Smith opened Leung as an asset, the FBI considered him to be an agent who needed supervisory direction only in those instances where he clearly lacked the authority to act unilaterally on behalf of the FBI. Smith had achieved a level of trusted independence and his supervisors relied on his judgment and his recommendations regarding the squad's investigative responsibilities.

Smith was promoted to China Squad supervisor in Los Angeles in 1996, yet retained sole responsibility to handle Leung. By all accounts, Smith was knowledgeable of the China target, successful, well respected, and experienced in the work of the China squad.

3. Leung's Background

Leung's family background is unclear because her official immigration file contains substantial discrepancies between what official documents reveal and what Leung ultimately told Smith about her ancestry. Along with a woman who claimed to be Leung's mother but was probably her aunt, Leung emigrated to the United States in 1970, using a Taiwanese passport stating that she was born on May 1, 1954, in Canton, China. Eight days after their arrival in the United States, Leung's "mother" married a U.S. citizen. Leung enrolled at Washington Irving High School in New York City and graduated in June 1972. Leung became a permanent resident alien on August 7, 1972.

Leung obtained an undergraduate degree from Cornell University in 1976 and a Masters in Business Administration from the University of Chicago a few years later. In the 1970s while she was a student, Leung began to develop contacts with, and access to, persons of investigative interest to the FBI.

4. Leung Comes to the Attention of the FBI

In early 1980, Leung moved to Los Angeles, where she resided in an apartment building the FBI characterized as a "nest of spies" that was occupied by subjects of other FBI investigations. Upon her arrival in Los Angeles, Leung became the general manager of an import-export company suspected of engaging in the illegal transfer of technology from the United States to the PRC. In late 1980, the FBI began a full espionage investigation of that company.

The FBI authorized a full field counterintelligence investigation of Leung on February 10, 1981 predicated on her contacts with persons of investigative interest to the FBI. FBI documents stated that Leung was "believed to be engaged in clandestine intelligence gathering on behalf of the PRC and/or may be furnishing or about to furnish sensitive technological information to the PRC."

After the case agent originally assigned to investigate Leung transferred from Los Angeles, Leung's case was assigned to an inexperienced agent who was admittedly uninterested in FCI matters. One month later, in August 1981, the Los Angeles Division learned that Leung had a close relationship with a pro-PRC activist who was also a principal subject in an FBI technology transfer investigation conducted by the San Francisco Division. San Francisco agent William Cleveland was the lead case agent for the investigation, and Smith was assigned to be the case agent for the Los Angeles aspects of that investigation.

The Los Angeles Division took no immediate action after it learned about Leung's relationship with the subject of the San Francisco investigation. The FBI learned that Leung had left her job as general manager of the import-export company in early 1980, and in November 1981 the Los Angeles Division closed the Leung investigation. The closing communication contained no reference to Leung's relationship with the subject of the San Francisco technology transfer investigation and no resolution of the issue of Leung's other PRC contacts, the primary reason the FBI opened the investigation of Leung. Instead, the closing communication stated that Leung was unlikely to cooperate with the FBI. With the approval of her squad supervisor, the FBI agent to whom Leung's case had been reassigned closed the case without attempting to interview her, telling us that she believed she could not interview Leung because Leung was the subject of an investigation.

The case agent's rationale is incomprehensible. According to FBI documents, the standard objective of investigations such as the one opened on Leung was to determine whether the subject posed a threat to national security or had asset potential. FBI documents also state that the most logical way to resolve this objective is often through an interview of the subject. Further, neither the squad supervisor nor the case agent could

have known whether Leung would be cooperative without attempting an interview.

Based on our review, we concluded that the Los Angeles Division should not have treated the investigation of Leung as dismissively as it seems to have, especially in light of her connection to two ongoing technology transfer investigations. During the early 1980s, the FBI knew little about China's quest for technology. Once the FBI authorized a full foreign counterintelligence investigation of Leung, the Los Angeles Division should have given the case more attention. The FBI's failure to fully investigate Leung early on was a lost opportunity to obtain information concerning the PRC's attempts to acquire technology and her contacts with persons of investigative interest to the FBI.

B. Significant Time Periods

In 1982, Smith developed Leung as an FBI asset. He continued to operate her as an asset for 18 years, until he retired from the FBI in November 2000. The following sections summarize the OIG's findings from our review of Smith's 18-year operation of Leung as an FBI asset.

1. First Phase: 1982-1983

By 1982, the FBI knew about Leung's contacts with persons of investigative interest to the FBI, that she had been the general manager of an import-export company suspected of conducting illegal technology transfers to the PRC, and that she was linked to a pro-PRC activist and principal subject of the San Francisco technology transfer investigation, who had been arrested in the PRC. The San Francisco investigation had stalled.

In August 1982, Smith decided to re-open the investigation of Leung in the hope that she could provide information concerning the principal subject of the San Francisco technology transfer case and other matters. Smith first interviewed Leung in August 1982. According to Smith, Leung was very forthcoming with information concerning a number of matters of interest to the FBI. Smith interviewed Leung several times during the fall of 1982, and in December 1982 Leung was converted from the subject of an investigation to an FBI asset.

When Smith opened Leung as an asset, he was a 12-year veteran Special Agent with over six years' FCI experience, five of which involved the China program. The FBI recognized Smith's success in developing and handling other assets and trusted his judgment.

Smith obtained Leung's immigration records, conducted the requisite criminal checks, attempted unsuccessfully to obtain Leung's toll records (the local service provider refused to honor the letters), cross-referenced her information with information other assets provided about her, and asked FBI Headquarters for all the information contained in its indices about

Leung. We found no indication that Smith's background investigation and vetting of Leung prior to her conversion into an FBI asset was inadequate.

Consistent with her high profile in Los Angeles, Leung's access to Chinese diplomatic officials and prominent overseas Chinese in the United States enabled her to obtain and provide information of significance to the FBI.³

In August 1983, less than a year after Smith first interviewed Leung, they began their sexual relationship. Smith said he was confident that Leung would not disclose their relationship or try to blackmail him, reasoning that she had just as much to lose as he did.

The OIG found no indication that, at this time, anyone in the FBI suspected that Smith had begun an intimate relationship with Leung. When Smith began the affair with her, he was considered one of the top agents on the Los Angeles Division's China Squad.

2. Second Phase: 1984-1989

Throughout the 1980s, FBI Headquarters delegated a great deal of autonomy and authority to the field to conduct China program operations. Smith operated Leung with only a modicum of substantive input from his supervisors in Los Angeles and at FBI Headquarters.

With Smith's assistance in accelerating the process, Leung became a U.S. citizen on March 16, 1984. By then, the FBI's plan for Leung was to have the PRC intelligence services (PRCIS) recruit her as an agent of China. To facilitate this, the FBI encouraged Leung to flaunt her contact with the FBI and her high-profile status in the Chinese community in the United States.

In June 1984, Leung began traveling frequently between the United States and the PRC as a double agent working on behalf of the United States, gathering information from the PRCIS and reporting it back to the FBI. The PRC's Ministry for State Security (MSS), a counterintelligence agency of the PRC, recruited Leung. FBI documents indicate that the PRCIS believed that Leung was a low-level source of the FBI's Los Angeles office.

In August 1984, the FBI began providing monthly payments to Leung for services and expenses. In September 1984 and in January 1986, Leung passed FBI polygraph examinations regarding whether she had unreported contacts with Chinese intelligence services, whether she had deliberately provided the FBI with false information about her contacts with the Chinese, and whether she had told anyone she was cooperating with the FBI.

³ The PRC refers to individuals who were born in China but live elsewhere as "overseas Chinese."

In 1984, Smith became the lead case agent for the espionage investigation of former FBI Agent Richard Miller, who was suspected of unlawfully passing classified information to Svetlana Ogorodnikova, a Soviet agent with whom Miller was having an affair. At the same time, Smith continued the clandestine romantic relationship with Leung he had begun a year earlier, telling us he viewed the Miller case as merely a "cautionary tale." Smith's supervisor told us that one day during the Miller investigation, when Smith said he was going to meet Leung, the supervisor casually asked Smith whether he was involved in a Miller-Svetlana situation. The supervisor said he accepted Smith's denial because he trusted him. The supervisor said he never truly suspected that Smith was actually romantically involved with Leung.

Between the mid-1980s and 1990, Leung became more well known and well-connected in the West Coast Chinese community, entertaining PRC diplomatic officials and organizing huge banquets for high-level PRC government officials who visited Los Angeles. Through these activities, Leung met PRC President Yang Shangkun, who became her patron. Leung's connections to Yang and to the PRC's diplomatic community on the West Coast also put her in the position of advising the PRC concerning the location for a new PRC Consulate in Los Angeles in 1988. Leung's access to officials at the San Francisco Consulate also was useful to the San Francisco Division's China Squad, and she provided reporting concerning the activities of San Francisco Consulate officials who visited Los Angeles.

We found that the FBI vetted Leung and validated her information in the 1980s. However, we found one incident that should have caused the FBI concern about Leung during this period. In late 1987, Leung asked a PRC Consulate official in San Francisco to call her from a pay telephone, implying that she had something to tell him that she did not want others to hear. Although the FBI Los Angeles Division initiated an investigation into the matter, the investigation was closed when the case agent learned that Leung was an FBI asset. There is no documentation in the file to indicate whether Smith authorized Leung to contact the consulate official, and no follow-up from anyone at the FBI concerning why Leung made such a contact or what she discussed. Neither Smith nor his supervisors documented any resolution of the matter.

Other than that incident, the FBI had no reason to question Leung's reporting and access through the end of the 1980s. Leung passed two polygraph examinations, and an experienced San Francisco agent and an FBI Headquarters analyst gave Leung positive assessments regarding her access to information and her suitability as an FBI asset. A Chinese defector also confirmed much of Leung's reporting during this time. CIA officials, who received much of the information Leung reported concerning the PRC, also provided positive feedback on her reporting. By the end of 1989, Leung's prominent place in the FBI's China program was assured.

when she traveled to the PRC shortly after the Tiananmen Square incident and reported information to the FBI concerning political conditions in the PRC government, at a time when virtually no such information made its way out of China.

During the late 1980s, unbeknownst to Smith or anyone else in the FBI, Leung and San Francisco SSA William Cleveland also began a sporadic sexual affair, facilitated by Leung's travel to San Francisco for matters unrelated to the FBI. Smith had introduced Leung to Cleveland and to several other San Francisco agents because Leung was considered a resource for information concerning the San Francisco Division's technology transfer investigation and individuals at the PRC's San Francisco Consulate. Cleveland was described to us as a very religious man who was universally well regarded, dedicated to the FBI, and considered a mainstay in the FBI's China Program in the 1980s and early 1990s until his retirement in 1993.

According to Cleveland, Leung initiated their relationship. He told us that Leung did not try to elicit information from him and he did not discuss FBI matters with her when they were alone. Smith admitted to us that he shared operational information with Leung, but Cleveland steadfastly maintained that he provided no information to Leung, nor did she ask him for it. Cleveland was later interviewed extensively by the FBI in 2002 and described in detail his relationship with Leung. He passed a counterintelligence-focused polygraph examination during which he denied providing sensitive information to any representative of a non-U.S. intelligence service.

3. Third Phase: 1990-1996

We found that in the 1990s, several events should have led the FBI to question the extent of Leung's loyalty to the United States and the nature of Smith's relationship with her. Two of the most serious incidents in the early 1990s showed that Leung was providing classified information to the PRC without FBI authorization. However, the FBI failed to document the incidents in Leung's file, relied on Smith to resolve the concerns about Leung, and then failed to follow up further to ensure that he had done so. These incidents underscore the need for consistent documentation of red flags and negative reporting in an asset's file and an explanation of how concerns arising from such matters are resolved. The incidents also highlight the need for continuous objective assessment of an asset's bona fides and illustrate the dangers in allowing a single agent to handle an asset for such a long period of time.

a. Red Flag in 1990

In June 1990, the FBI received reporting indicating that Leung had disclosed to PRC officials the existence and location of a then-active sensitive technical operation that remains classified, as well as aspects of a

highly classified FBI counterintelligence program. This reporting raised serious questions concerning Leung's unauthorized activities on behalf of the PRC. However, we found that the FBI's response to this event was inadequate.

Although there were several communications between FBI Headquarters and Los Angeles concerning this matter, the communications were not consistently captioned, and as a result they were placed in different files. Almost no documentation of the incident was placed in Leung's file. The FBI Headquarters Unit Chief responsible for oversight of both the technical operation and counterintelligence program questioned Smith concerning the incident and accepted Smith's explanation that Leung could not have made the disclosure about the counterintelligence program because Smith had not known about it. The Unit Chief failed to ask further follow-up questions and did not question Smith concerning Leung's disclosures concerning the technical operation. We found no indication that the Unit Chief, who is now retired, ever attempted to resolve the concern that Leung not only knew about the technical operation but also disclosed it to the PRC. FBI documents show that another China Section Unit Chief, who was responsible for oversight of Leung at the time, was also aware of the matter and failed to take any action to ensure that it was resolved.

We concluded that FBI Headquarters made a significant mistake by failing to follow up on the concerns raised by Leung's disclosures. The reporting should also have exposed the FBI's lack of control over information Smith shared with her.

b. Red Flag in 1991

In April 1991, just ten months later, the FBI learned that Leung was using an alias to communicate with her PRC handler. During these conversations, Leung disclosed details concerning ongoing FBI operations and investigations. Again, the FBI did not adequately address the issue. Although FBI Headquarters held a meeting to discuss the matter, we found no documentation of the incident in Leung's file except for the communication arranging the meeting at FBI Headquarters.

Moreover, the full extent of Leung's disclosures was not provided to the participants at the meeting. A China analyst present at the meeting was unaware that Leung had actually provided to the PRC details of ongoing FBI operations and investigations. The analyst was also unaware of Leung's previous disclosures to the PRC concerning the sensitive technical operation and aspects of the classified FBI counterintelligence program. During the meeting, the analyst expressed no sense of alarm at those of Leung's disclosures of which he was aware. The analyst said he believed at the time that the FBI was gaining far more from Leung than it was giving away. Consequently, the analyst advised against terminating Leung as an asset and his recommendation was accepted.

We found that Smith's reputation at the time was such that he was treated as being above reproof. Participants at the meeting told us that there was a sense that Smith needed to assert stronger control over Leung, but FBI Headquarters managers decided to let Smith personally resolve the concerns about Leung. However, FBI Headquarters failed to follow up to ensure that he had done so. Incredibly, no one questioned how it was that Leung had obtained the information she supplied to the PRC. During our investigation, Smith conceded that he was the source of any information she supplied to the PRC. Had the FBI followed up and pursued the reliability concerns arising from this reporting about Leung's activities, the fundamental flaws in Smith's operation of her might have been revealed 10 years before the FBI actually began such an investigation.

c. FBI Management Failures

We concluded that the performance of both the Unit Chief and the Assistant Section Chief, who were responsible for oversight of Leung during both the 1990 and 1991 incidents, was deficient. FBI documents establish that they were aware of the two incidents. Yet, despite Leung's stature in the FBI's China program, neither drew a connection between the two matters that raised serious concerns about the extent of Leung's loyalty to the United States.

The FBI's Los Angeles Division also failed to provide adequate oversight of Smith at this time, enabling him to respond to the few concerns FBI Headquarters did express without input or follow up from his chain of command. The Los Angeles SSA who supervised the China Squad at the time of the 1990 reporting admitted to us that he readily deferred to Smith because he was very impressed with him and because Smith had been on the China Squad for so long.

At the time of the 1991 reporting, Smith was the acting supervisor of the squad and he did not inform the incoming SSA about the derogatory reporting. The Los Angeles ASAC who was responsible for FCI matters at the time claimed he had no recollection of either incident; however, FBI documents show that he was aware of sufficient information to have put him on notice that there was a problem with Leung.

When we asked Smith why he continued operating Leung despite his knowledge that she had disclosed classified information to the PRC without FBI authorization, he stated that he believed Leung was too important to be discontinued as an FBI asset. However, he admitted that he feared that exposing her disclosures would result in an inquiry that could have exposed his romantic relationship with her, ending both the case and his career.

According to Smith's contemporaneous notes, he confronted Leung about her alias and her disclosures. Leung responded that the PRC had discovered her relationship with the FBI in 1990 and had coerced her into cooperating with them. She told Smith that she had to give information to

the PRC in order to get information from it. Smith said he told Leung she would have to take a polygraph exam and she refused. According to Smith's notes, Leung confirmed that she disclosed what Smith knew was sensitive and classified material concerning FBI operations and investigations.

Smith told us that he did not consider ending his professional relationship with Leung because he truly believed he could regain Leung's loyalty to the United States. But Smith did not inform anyone at the FBI about the details of his confrontation with Leung. Instead, he merely asserted that the matter had been resolved. His FBI Headquarters managers accepted him at his word and failed to further question him. Smith's managers should have required him to re-assess Leung's reliability and bona fides and report back to FBI Headquarters, but they failed to do so. Smith said that for the next three or four months, he was more circumspect with Leung than usual, but eventually things went back to the way they had been before the issues arose and the entire matter appeared to be forgotten.

The FBI's failure to closely question Smith to resolve how it was that Leung learned the detailed information she supplied to the PRC was seriously deficient, because Leung's disclosures could have had serious adverse consequences for the United States' security interests. The lack of documentation in Leung's file concerning the two incidents also facilitated the FBI's failure to follow up. Had documentation of the two separate occurrences involving Leung been placed in her file, the FBI might have been able to minimize further damage resulting from her actions.

Smith continued to operate Leung largely unquestioned throughout the 1990s. Between 1990 and 1992, there were three different supervisors for the Los Angeles China Squad and two different ASACs. Smith's supervisors in Los Angeles continued to overly defer to him because he was perceived as an expert in the China Program. We found that Smith took advantage of FBI Headquarters' failure to follow up and intentionally kept his inexperienced supervisors in Los Angeles uninformed about the concerns about Leung. Although Smith's supervisors conducted the requisite reviews of Leung's file with him, they were not familiar with the incidents concerning Leung's disclosures to the PRC because they were not consistently documented in her file.

Throughout the 1990s, Smith continued to characterize Leung as "reliable" and "stable" in his communications to FBI Headquarters about her. In his semi-annual evaluations of Leung, Smith affirmatively misled his supervisors into believing that she had recently been polygraphed. In fact, she had not been polygraphed since 1986. By March 1993, the FBI had paid Leung over \$700,000. No one questioned Smith's characterization of Leung and his supervisors continued to approve the budget requests Smith submitted for her every six months.

d. Smith's Los Angeles Supervisor Encountered Smith and Leung Returning from an Overseas Flight and Failed to Alert Anyone in the FBI

Another egregious management failure occurred in March 1992, when Smith took five days of annual leave to take a sightseeing trip around the United Kingdom following a work-related trip to London. Unbeknownst to anyone in the FBI, Leung had flown to London to accompany Smith on his sightseeing trip.

Smith's supervisor, who transferred from FBI Headquarters to Los Angeles in late 1991, decided to surprise him by meeting him at the airport upon his return to Los Angeles. The supervisor, who was acquainted with Leung, saw Leung at the airport when she went to meet Smith, but told no one in the FBI about her observation. When interviewed as part of the FBI's investigation of Smith and Leung, the supervisor initially admitted that she saw them both in the Customs area of the airport after they disembarked from their flight. However, she later claimed to the FBI and to us that she did not see them together; rather, she said she went to the airport twice and saw Smith and Leung there on different days.

We found that the supervisor's version of events was not consistent with the evidence. Customs records establish that Smith and Leung were on the same flight and entered Customs processing at the same time. Further, Smith told us that he returned to the United States on the same flight as Leung and that his supervisor picked him up but did not mention Leung at all during the ride home. Smith said he was concerned that his supervisor had seen Leung and would then raise the issue with him or with FBI Headquarters, but the supervisor failed to do so.

Despite being confronted directly with evidence that Smith and Leung were engaged in an inappropriate relationship, Smith's supervisor did not question him, confront him, or report the situation to FBI Headquarters. We found that the supervisor was overly dependent on Smith, reluctant to confront him, and inappropriately deferential to him. Had she made her supervisors and FBI Headquarters aware of this issue, Leung's trip with Smith might have forced the FBI to examine their relationship.

e. Smith's Overt Relationship with Leung Results in Dismissal of Negative Reporting about her

Smith and Leung were frequently seen together at Chinese Consulate functions and banquets honoring Chinese dignitaries that Leung organized throughout the early 1990s. Smith and other agents on the China Squad attended such functions in accordance with the FBI's role in the protection of foreign officials. They also attended to make contacts within the Chinese community in order to obtain counterintelligence information. Smith and Leung's overt relationship at these events facilitated these contacts, but it

also functioned as a mechanism for Smith to easily deflect any negative reporting by other assets about Leung.

In 1992, the Los Angeles Division received credible reporting indicating that the PRC had a person "working in the FBI," a woman named "Katrina" who was a double agent. However, an inexperienced agent on Los Angeles's China Squad omitted Leung's name from the teletype transmitting this reporting to FBI Headquarters.

In an attempt to resolve the matter, FBI Headquarters directed Smith and an analyst to debrief the source of the reporting, unaware that the source had implicated Leung. Smith was the most experienced agent on the China Squad, and it would have been logical for Smith to have been involved in the debriefing had Leung not been the source of the problem. Smith's teletype to FBI Headquarters detailing the debriefing did not conceal that Leung was the subject of the negative reporting. However, Smith also was able to deflect any concerns this reporting raised by criticizing the source of the information as a liar and a misogynist and by rationalizing that the information was consistent with Smith's overt (and approved) relationship with Leung.

We found that Smith's supervisor in Los Angeles was too deferential to Smith to question his lack of objectivity in defending Leung to FBI Headquarters and took no further action to resolve the matter. At this time, the personnel at FBI Headquarters overseeing Leung were relatively new to the China program, were unaware of the earlier concerns about Leung, and thought so highly of Smith that they did not question his resolution of the matter. As a result, FBI Headquarters let the matter of the negative reporting about Leung drop, with no further follow up.

f. FBI Headquarters Managers Believed They Could not Interfere in Field Operations

During our review we found that many FBI Headquarters managers believed that they could not interfere in field office counterintelligence operations unless the field's actions contravened specific rules in the Foreign Counterintelligence Manual (FCIM). In a 1995 report, FBI Headquarters touted the success of the decentralized approach, noting that managers were instructed to take a "hands off" approach and to always say 'yes' to the field unless there were specific reasons to say 'no.' Several FBI Headquarters supervisors told us that as a result of this approach, they believed they were in no position to tell the field what to do, and they did not perceive their responsibility as truly supervising or exerting control over field operations. Rather, they functioned in a support role.

This attitude was demonstrated by one incident in which an FBI Headquarters SSA became suspicious that Leung had been "redoubled" against the United States. Instead of raising his concerns directly to Smith or to Smith's supervisor in Los Angeles, the SSA expressed them in an

administrative note attached only to the FBI Headquarters copy of a document responding to a Los Angeles communication. The SSA told us that the purpose of the note was an attempt to keep FBI Headquarters' executive management informed that there may have been an issue concerning Leung's loyalties. We found no reaction to the administrative note and the SSA did not follow up on his concerns.

Nevertheless, the SSA said he had become sufficiently concerned about Leung's reporting and the amount of money the FBI was paying her that he asked an analyst to do an in-depth review of Leung's file at the end of 1995. However, the SSA was transferred before the review was complete. The analyst discovered that Leung had not been polygraphed in ten years. The analyst drafted a teletype to Los Angeles directing that Leung be polygraphed within six months. Unfortunately, the incoming SSA, who is now retired, altered the teletype because he believed the language the analyst used was too strong. He told us that FBI Headquarters could not compel the field to take action not specifically required by the rules. The SSA changed the language in the teletype from an order that Leung be polygraphed to a suggestion that Los Angeles consider polygraphing Leung. Smith used the much softer language of the edited teletype as reason to ignore it, and Leung was not given a polygraph exam.

The numerous red flags that appeared between 1990 and 1996 should have placed the FBI on notice of serious concerns about Leung's true loyalties, as well as Smith's relationship with her. Several factors contributed to Smith and Leung's evasion of sustained supervision. One problem was constant turnover of management: there were four different FBI Headquarters first-line supervisors with oversight responsibility for Leung between 1990 and 1996, and three different China Squad first-line supervisors in Los Angeles. As a result, Smith was the only person in the FBI with a complete understanding of Leung's operation.

In addition, Smith's supervisors in both Los Angeles and at FBI Headquarters told us that they did not have time to read Leung's voluminous reporting in its entirety. Even if they had, documentation concerning the numerous red flags about Leung that surfaced during this time period was not consistently placed in Leung's file, and there was no centralized repository of derogatory information to warn Smith's supervisors about the problems with Leung.

Despite the problems that arose during this period, Smith operated Leung with little oversight based primarily on his status as a top agent in Los Angeles and Leung's status as a top asset. While there were strong indications that Leung was providing classified information to the PRC and that she had an unduly close relationship with Smith, the FBI failed to take action to address these concerns.

4. Fourth Phase: 1996-2000

In October 1996, Smith was promoted to SSA of the China Squad in Los Angeles. Until his retirement in November 2000, he continued to operate Leung as a source with little to no supervision or oversight. Smith also continued to treat Leung as though she was a member of his squad, sharing information and consulting with her about FBI operations and investigations.

Smith's ASAC, who transferred to Los Angeles in 1996, had no prior PRC FCI experience. He did not review Leung's file, did not conduct meaningful file reviews with Smith, and deferred to Smith, much like Smith's previous supervisors. The ASAC permitted Smith to sign out his own communications to FBI Headquarters concerning Leung. The ASAC approved Leung's asset payments but he did not examine the lists of itemized expenses Smith submitted, reasoning that Leung's budget was akin to a salary and that she would be paid the entire amount allotted for her budget for services and expenses every six months.

The ASAC did notice that in April 1990, Smith had received authorization from FBI Headquarters to pay Leung without a witness present but had not sought to renew his exemption from the rule throughout the 1990s.⁴ In 1999, the ASAC directed Smith to renew this request, but Smith was again granted a blanket exemption from the rule requiring that two agents must witness asset payments, without any questions concerning his need for the exemption. Although we found that Smith did occasionally have other agents witness payments to Leung, most of the time he met her alone when paying her.

In late September 1998, two years into Smith's tenure as supervisor of the China Squad, a source told the FBI that a Chinese American employee of a defense contractor met a PRC intelligence officer and exchanged information for cash. In mid-October 1998, the Los Angeles Division opened an espionage investigation into the matter, which Smith supervised. Smith told us that the source's reporting did not make any sense and he was frustrated by the investigation. Unbeknownst to anyone, he briefed Leung and consulted with her concerning all aspects of the investigation.

To complicate matters, another FBI agent in Los Angeles, who had a covert role in the espionage investigation, was a childhood friend of the main subject's spouse. The agent allegedly accessed information about the investigation without authorization and told the subject he was under investigation. The agent was placed on administrative leave and was eventually fired. She was subsequently charged with a criminal offense and her case is pending.

⁴ In 1992, the FBI amended the rule to require SACs to authorize such exemptions.

During the late 1990s, the FBI also learned that certain of its operations had been compromised and that several of its assets had been detained and interrogated in China. A task force was formed to address these counterintelligence issues. Among its endeavors, the task force undertook a review of other sources' files and slated Leung's file for review because she was one of the FBI's top PRC assets.

In spring 2000, FBI Headquarters received reporting from the source whose information had predicated the espionage investigation of the employee of the defense contractor, stating that Leung was an agent of a PRC intelligence service and had an internal source in the FBI. This new reporting indicated that Leung had disclosed to the PRC the source's relationship with the FBI as well as details concerning the espionage investigation. Incredibly, given that the information potentially implicated Smith as Leung's internal source, the Section Chief at FBI Headquarters, who had been Smith's former ASAC in Los Angeles, immediately informed Smith about the reporting.

FBI Headquarters decided to use the task force to investigate the allegations about Leung and her internal source, but the FBI found at the time that the issue of the technical compromises was potentially far more damaging. The task force worked extremely slowly, did not identify the information necessary to resolve the compromise issues, lost the confidence of the Section Chief, and was eventually dissolved before reaching any conclusions.

In mid-2000, the FBI received another report from the same source as the spring report indicating that Leung was "in bed with" the Los Angeles Division of the FBI. Once again, Smith was kept informed about this reporting. The Section Chief, who is now retired, told the OIG that he did not suspect Smith and it was unclear whether the source meant the "in bed with" comment literally. We concluded that by providing Smith with the source information that possibly implicated Smith, the Section Chief abdicated his responsibility to ensure an untainted investigation.

In August 2000, the Assistant Director for the Counterintelligence Division, who is now retired, decided that no investigation should be conducted based solely on the allegations against Leung. He told us that he concluded that the reporting consisted of "sources pointing fingers at each other," and he maintained that the issue was "not as clear as the written reports would indicate." We found his argument was unconvincing because the source had made a specific allegation against Leung but she had made no such allegation against the source. Further, while it was appropriate to question the credibility of the information, the Assistant Director did not to take the necessary steps to validate or disprove it. Finally, the allegation pointed specifically to the origin of the problem and we believe the FBI should have at least investigated the allegation.

Smith retired from the FBI in November 2000. He was never required to take a polygraph examination, as was initially suggested by his Los Angeles supervisors during the summer of 2000. FBI Headquarters officials told us that they did not want Smith alerted that he might be the subject of an investigation by asking him to take a polygraph exam. We found this rationale puzzling because FBI Headquarters officials knew that Smith had been fully informed about the initial allegation that Leung was a PRC spy with an internal source in the Los Angeles Division of the FBI and of the later allegation that Leung was "in bed with" the Los Angeles Division of the FBI. Further, Smith told us that he assumed he would be investigated. Smith claimed to us that out of loyalty to the FBI, he did not tell Leung about the reporting even though he knew it was likely they would both be investigated.

The FBI compounded the mistake it had made in keeping Smith informed of the source reporting by then failing to take steps to resolve the matter expeditiously. Once Smith retired, the FBI no longer could compel him to take a polygraph exam. Moreover, as discussed below, a formal investigation of Smith was not opened until January 2002, some 14 months after he retired from the FBI.

We recognized that during the late 1990s through 2000, FBI Headquarters China program officials were consumed with other high-profile matters such as the campaign finance investigation codenamed CAMPCON and the Wen Ho Lee investigation, which involved allegations that a Chinese-American scientist employed at the Los Alamos National Laboratory in New Mexico stole computer hard drives containing nuclear secrets in order to turn them over to the PRC. However, we believe the FBI still should have prioritized the investigation of an allegation that the PRC had an internal source in the Los Angeles Division of the FBI.

5. The Investigations of Smith and Leung

Late in 2000, management officials in the FBI Headquarters China Section uncovered the reporting from 1990 indicating that Leung had disclosed to the PRC the existence and location of the sensitive technical operation and aspects of the classified FBI counterintelligence program. These officials told us that they believed the 1990 reporting constituted independent "pristine" evidence that Leung had been providing unauthorized information to the PRC.

On January 30, 2001, the FBI's China Section prepared a briefing paper for the FBI's Assistant Director for the Counterintelligence Division encapsulating the 1990 reporting along with the more recent allegations that Leung was a spy for the PRC. The report recommended that the FBI open a full counterintelligence investigation on Leung. In response, FBI Headquarters authorized a full investigation of Leung. A special squad in the Los Angeles Division was assigned to conduct the investigation, and all

personnel assigned to the matter were required to pass a polygraph examination before the investigation began. The investigation did not actually begin until May 2001, a year after the FBI received credible information that Leung was spying for the PRC.

We found no reasonable explanation for the long delay in fully investigating the allegation that Leung had an internal source in the Los Angeles FBI office. The responsibility for this delay was mainly attributable to the Assistant Director of the Counterintelligence Division as the ultimate decision maker concerning this matter at FBI Headquarters, who decided that the source's reporting that Leung had an internal source in the Los Angeles Division did not provide a sufficient basis to investigate her. It is particularly puzzling that the Assistant Director did not suspect Smith because the Assistant Director was overseeing the Robert Hanssen espionage investigation at the time. Even after the FBI authorized the full investigation in early 2001, it took several more months for the investigation to actually begin because of the need to polygraph the individuals assigned to it.

At the end of August 2001, the Los Angeles team investigating Leung issued a preliminary report to FBI Headquarters presenting its view that "an espionage relationship between an FBI employee and Leung is unlikely."⁵ In early July 2001, the Los Angeles Division requested that FBI Headquarters obtain approval to use special techniques to investigate Leung. Several factors, including the closely compartmented nature of the investigation and the events of September 11, 2001, delayed FBI Headquarters' response to Los Angeles's request. In December 2001, the FBI obtained the authority to use special techniques for the investigation. Shortly thereafter, the FBI discovered that the relationship between Smith and Leung was more than friendship. FBI surveillance also witnessed numerous meetings between Smith and Leung at Leung's house when Leung's family was not at home.

In January 2002, members of the Los Angeles investigative team traveled to FBI Headquarters to brief the Acting Assistant Director for the Counterintelligence Division on the investigation. The Acting Assistant Director briefed the FBI Director, who expressed concern about the pace and scope of the investigation. FBI Headquarters and Los Angeles personnel pointed to each other for the lack of progress in the investigation. Following a meeting with Los Angeles and FBI Headquarters representatives, the Director directed that a full field investigation be opened on Smith. The Director also appointed Randy Bellows, a prosecutor experienced in FCI matters, to review the Los Angeles-based investigations and suggest a course of action.

⁵ This conclusion was not unique. The Assistant Director, who retired in November 2001, told us that even at that time he believed Leung was the problem, rather than Smith and Leung.

As a result of his review, Bellows recommended that an independent task force headed by an Inspector-in-Charge be appointed to take control of the investigations of Leung and Smith and other counterintelligence issues. Based on this recommendation, the Director created the task force in February 2002 to investigate the numerous counterintelligence issues that had surfaced in Los Angeles. The investigation confirmed that Smith and Leung were engaged in a sexual relationship.

Smith and Leung were arrested on April 9, 2003. Smith was charged with Gross Negligence in Handling Documents Relating to the National Defense in violation of Title 18, U.S.C. § 793(f). He agreed to cooperate with the government and on May 12, 2004, he pleaded guilty to one count of making false statements to the FBI during the Personnel Security Interview as part of his background reinvestigation, in violation of 18 U.S.C. § 1001.⁶ In July 2005, Smith was sentenced to three years' probation and a \$10,000 fine.

Leung was charged with Unauthorized Copying of National Defense Information with Intent to Injure the United States or Benefit a Foreign Nation in violation of 18 U.S.C. § 793(b). Leung spent three months in jail and 18 months in home detention following her arrest. In early January 2005, U.S. District Judge Florence Marie Cooper dismissed the case against Leung for prosecutorial misconduct based on language in Smith's plea agreement that specified that Smith could not share further information relating to the case with Leung or her counsel. Judge Cooper found that this language denied Leung's constitutional right to a fair trial because it obstructed Leung's access to a witness necessary to her defense. The U.S. Attorney's office appealed Judge Cooper's dismissal of Leung's case to the Court of Appeals for the Ninth Circuit.

While the appeal was pending, plea negotiations between Leung and the U.S. Attorney's office continued concerning income tax issues that had surfaced during the investigation. On December 16, 2005, Leung pleaded guilty to one count of lying to the FBI in violation of 18 U.S.C. § 1001 and one count of filing a false federal tax return in violation of 26 U.S.C. § 7206(1).⁷ That same day, Leung was sentenced pursuant to the terms of

⁶ On the 5-year background reinvestigation questionnaire form, Smith asserted that he was not aware of any current or past circumstances bearing on his suitability for continued federal employment or his access to classified information. He told the investigating agent that he was not concealing anything that could be used to pressure or coerce him or that could have an adverse impact on his character, judgment, trustworthiness, or responsibility. This was a false statement because he did not disclose his ongoing sexual relationship with Leung.

⁷ As part of the initial espionage investigation, the FBI had interviewed Leung on December 11, 2002. During that interview, Leung lied to the FBI about her relationship with Smith, describing herself as nothing more than a good family friend of Smith's, and

her plea agreement, which provided that Leung must cooperate in debriefings and prosecutors would recommend that a sentence of three years' probation, 100 hours of community service, and a \$10,000 fine.

C. Aftermath

Following the discovery of Smith's relationship with Leung, the FBI has taken steps to identify and correct deficiencies in the China Program and to improve asset handling and vetting procedures. One of the most significant changes to the FBI's asset vetting and validation efforts since the uncovering of Smith and Leung's relationship has been the FBI's creation of specialized units which have implemented a three-part validation review process that consists of a case agent assessment, an analytical production evaluation, and a counterintelligence review. In the China program, the longest-running and most problematic assets were given high priority and reviewed first. By December 2005, the FBI had completed several dozen comprehensive counterintelligence reviews of PRC assets. Fewer than 10 percent of those assets reviewed were recommended for closure for control and reliability issues.

The FBI's Directorate of Intelligence has also become involved in the area of asset vetting and validation. It has begun an initiative to simplify the administrative handling of the FBI's human sources and to ensure that their bona fides are continuously validated. As of March 2006 the FBI was making efforts to insure its validation review process and the Directorate of Intelligence administrative handling project are compatible.

IV. Conclusion

The FBI's discovery that a highly regarded veteran FBI agent like Smith was involved in a long-term, intimate relationship with his asset raised critical issues regarding the FBI's overall management of its agents and its counterintelligence assets. During our review, the OIG examined more than 300,000 pages of documents and conducted over 100 interviews to determine how Smith and Leung were able to deceive the FBI for nearly 20 years. Our investigation established that while Smith himself bears much of the responsibility for the FBI's failure to detect that Leung was actively working for the PRC to a greater extent than the FBI realized, Smith's managers in Los Angeles and at FBI Headquarters failed to aggressively question him or to follow up when red flags arose. We concluded that the FBI's inattention to oversight of Smith and Leung, its willingness to waive and exempt Smith from complying with the rules, and supervisory mismanagement allowed Smith to continue his affair with Leung unimpeded until his retirement. Unfortunately, through Smith,

denying having traveled to the United Kingdom with him in 1992. Leung also failed to report to the IRS several payments the FBI made to her in 2000.

Leung's access to sensitive FBI investigations and information also continued until that time.

In the early 1980s, at the beginning of Leung's years as an FBI asset, Smith performed the routine vetting and validation procedures in place at the time for assets and their information. Further, Leung passed two polygraph examinations, one in 1984 and one in 1986. Throughout the 1980s, the FBI valued the information Leung supplied and received positive feedback about her information from other agencies. As Leung's status grew in the Chinese community in Los Angeles during the 1980s, so did Smith's stature as a perceived expert in the FBI's China Program. As a result, Smith's managers in Los Angeles readily deferred to him and failed to adequately address concerns about Leung that began to surface.

Major problems in FBI oversight that we uncovered during our review included the lack of consistent documentation concerning the many red flags evident throughout Leung's tenure as an FBI asset, and a failure to follow up to ensure that red flags were resolved. For example, as early as 1987 the FBI learned that Leung told a Chinese official to call her from a public telephone because she had something urgent to convey that she did not want anyone to hear. Despite an initial routine investigation reflected in Leung's file, neither Smith nor his supervisors documented any resolution of the matter. Two of the most serious incidents took place in the early 1990s, just 10 months apart, and indicated that Leung was providing classified information to the PRC without FBI authorization. Again, the FBI failed to document the incidents in Leung's file, relied on Smith to resolve the concerns about Leung, and failed to follow up further to ensure that he had done so. Out of an overabundance of trust in him, Smith's managers relied on Smith to address the concerns raised about Leung's activities and failed to determine how it was that Leung had obtained the classified information she disclosed to the PRC. While the FBI had procedures in place, such as periodic case file reviews and analytic reviews, which could have helped detect not only Leung's duplicity but also Smith's improper disclosures to her, the procedures were not followed.

Smith also exploited the inexperience of his supervisors, sometimes intentionally deceived them, and circumvented or ignored FBI rules with impunity. Smith took advantage of the substantial deference he was afforded because of his stature in the FBI's China program. Many of Smith's managers disregarded or exempted Smith from the FBI's asset handling rules, policies, and procedures during his operation of Leung. For example, Smith's managers in Los Angeles did not question his failure to consistently bring an alternate agent to Leung's debriefings. Further, in 1990 Smith received what amounted to a blanket exemption from the rule requiring that two agents witness all payments to an asset. Smith's managers failed to question his need for the continued exemption and the practice continued until his retirement. Smith continued to handle Leung

in 1996 when he became a supervisor, an atypical practice in the FBI. His immediate supervisor failed to conduct the periodic asset file reviews the FBI requires that supervisors undertake with their subordinates. Taken together, these exemptions from usual asset handling practices removed mechanisms that could have allowed the FBI to more closely monitor the asset-handler relationship between Leung and Smith.

By 2000, the FBI had identified compromises within the China program and in spring 2000 the FBI received reporting that unquestionably implicated Smith as the source of information Leung passed to the PRC. Inexplicably, an FBI Headquarters Section Chief immediately informed Smith about the reporting. Moreover, the FBI did not undertake a full investigation into the matter for nearly a year. Instead, the FBI allowed Smith to retire without being interviewed and polygraphed. Despite the specificity of the allegations, it took a year for the FBI to begin investigating Leung, and a year and half to begin investigating Smith.

Prior to the investigations of Leung and Smith, the FBI had undergone espionage investigations and prosecutions of two of its Special Agents, R. W. Miller (who had also been assigned to Los Angeles) and Earl Pitts. Additionally, by 2000 the FBI was conducting a major espionage investigation soon to result in the arrest of another Special Agent, Robert Hanssen. Against that backdrop, the failure of the FBI immediately to act on the potential significance of allegations that pointed directly to Smith is even more troubling.

We found that the performance of several of the supervisors with oversight for Smith and Leung was deficient. Nearly all of them are now retired. We therefore make no disciplinary recommendations concerning them. However, the FBI Headquarters Unit Chief responsible for oversight of Smith and Leung in 1990 and 1991, when two of the most serious anomalies occurred indicating Leung was providing sensitive information to the PRC without FBI authorization, is still working for the FBI. FBI documents establish that he was aware of the two incidents that occurred just 10 months apart and failed to address the significant concerns raised by them. Although we do not believe his actions constitute intentional misconduct, they raise performance concerns that we believe the FBI should address.

Finally, in this report we offer 11 recommendations designed to help address the systemic issues that enabled Smith and Leung to escape detection and avoid accountability for so long. We recognize that the FBI has developed and implemented many of its own changes to asset handling and validation since 2002 when Leung and Smith's relationship was discovered. The FBI has undertaken several initiatives to identify and correct deficiencies in the China program. As one example, the FBI made significant progress towards validating its PRC assets since it established an asset validation review process.

However, our recommendations go beyond the steps the FBI has implemented since 2002. Our recommendations include continuing the new FBI asset validation review process and devoting sufficient resources to these reviews; creating a new subsection in the asset file for red flags, derogatory reporting, anomalies and analyses; requiring a more thorough periodic background reinvestigation for long-term assets; maintaining a record of all documents passed to or topics discussed with assets; requiring alternate case agents to meet with assets on a frequent basis; limiting the time an agent can handle an asset; fully implementing its policy regarding counterintelligence polygraph examinations; and prohibiting blanket exemptions to the asset handling rules. We believe that our recommendations, if implemented, will help the FBI improve further to avoid in the future the serious problems that occurred in this case.