

MECHANISMS AND SOLUTIONS TO PRODUCT DIVERSION

Product diversion is not a new problem – nor is it necessarily illegal under U.S. law. In broad terms, diversion occurs when products intended for specific markets are “diverted” and sold in alternative markets. In some cases, product diversion serves free market objectives – when there is an oversupply of goods in one geographic location and a paucity in another, diversion provides an equilibrium. More often, however, it is price, not availability, which drives the diversion market. This is the principle upon which arbitrageurs operate. Slight differences in pricing can yield substantial returns if there is sufficient volume to make the transactions worthwhile.

While diversion has notable benefits to the operation of the free market, a relatively obscure “underside” of this activity has attracted legions of sophisticated criminals, including money launderers, drug dealers, and international terrorists. Using mechanisms which are familiar to large-scale brokers in legitimate products, crooks have used diversion to transfer *billions* of dollars through phony transactions and have become a major funding source for organized crime and terrorist organizations.

Although diversion plots have dozens of permutations, the most common involve the purchase of goods from legitimate manufacturers of consumer products, allegedly destined for developing markets. These include such things as pharmaceuticals, prepared food, consumer electronics, auto parts, and even sporting goods. Generally, the perpetrators buy large quantities of product for cash equivalents at substantial discounts from the manufacturer. Rather than selling the goods in the stated destination, however, the products are “diverted” to high-priced markets, especially the U.S. and Europe. By using this mechanism, the scoundrels are not only able to score a modest profit, but succeed in laundering ill-gotten loot by passing it through an apparently legitimate transaction.

This scheme costs the U.S. producer millions of dollars in lost profits, and wrecks international marketing plans. Further, products intended for foreign markets often differ in quality or specifications from those intended for sale in the U.S. These variables can destroy consumer confidence in a product almost overnight. Some products such as pharmaceuticals are routinely mishandled during the diversion process and may lack efficacy by the time they reach consumers. Worse yet, the “diversion pipeline” which is established by “underground” diversion is a natural conduit for counterfeit products which “hitchhike” on “gray market” shipments of legitimate goods.

In the past three years, for example, the incidence of counterfeit drugs being sold in legitimate pharmacies in the U.S. has increased dramatically. *Without exception* these bogus drugs have gotten on pharmacists’ shelves by masquerading as “gray market” goods.

While the dangers to manufacturers of the “dark gray” market are manifest, it has been only recently that U.S. law enforcement has taken much of an interest.

Traditionally, these activities were regarded as “economic crimes” by state and federal authorities, and were routinely ignored. Many in the law enforcement community considered these activities to involve only such commercial matters as breach of contract, or at worst, an Intellectual Property (IP) problem.

That attitude changed after 9/11. Law enforcement looked at these activities and discovered that they were not “benign” commercial fraud. Diversion was being used to finance some really bad actors. The most obvious examples involved individuals who have been arrested in the past two years who were funding terrorist activities in the Middle East through their profits from cigarette smuggling in the U.S. Scores of arrests have been made in the past 18 months. Upon closer examination, it became evident that in many cases, smuggling was only one of the activities in which these crooks engaged. Surprise! They were also handling counterfeit perfumes, diverted pharmaceuticals and gray market food products. The proceeds were used to purchase military equipment for such groups as Hezbollah, the Islamic Jihad and Hamas. Al Qaeda operatives in the U.S. have also engaged in this sort of underground activity to fund their operations in this country.

Only a small number of diverters, however, are as ham-handed as the criminals who have been arrested with black market Marlboros. The brains behind the most successful diversion schemes often have no arrest records at all, and certainly are not driving trucks full of contraband tobacco across state lines. Often, they are well-educated, and are *always* intimately familiar with the legitimate mechanisms of international trade and finance. They are interested in moving *millions* of dollars in product on a weekly basis – not a few hundred dollars from butt-smuggling schemes.

What can be done to address this problem? The answers lie in more than one place:

Law Enforcement must become more educated about how these schemes work, and why product diversion constitutes a real threat to U.S. security. There are very few courses available to investigators to even *identify* a diversion scheme, much less crack a criminal conspiracy involving this activity.

Manufacturers must not only adopt anti-diversion policies, but implement them in an effective way. Many manufacturers have only a limited ability to even detect when their products *have* been diverted. Part of the solution is technology. There are dozens of vendors selling a bewildering array of high-tech marking solutions which would enable investigators not only to authenticate, but track and trace diverted goods. This technology, however, has been adopted by only a tiny percentage of companies. The bad guys know this, and tend to target the laggards. Another obvious tool is to check customers carefully. Standard credit checks rarely identify diversion schemes, but powerful databases are available which can target dubious purchasers.

Retailers should be encouraged not to purchase goods that they know, or have reason to believe are gray market products. Some retailers have learned to their chagrin

that some wholesalers of “gray market” goods were in fact selling inventory which had been stolen *from that same retailer*. Organized shoplifting gangs routinely sell their swag to “gray market” wholesalers who commingle the “hot” goods with diverted merchandise. Retailers must realize that dealing in the gray market is not a good business practice in the long run.

Consumers should be aware that buying goods at prices which are “too good to be true” is almost always an indicator that something is amiss. The ads which are saturating the airways about supporting drug barons when copping a joint applies with equal truth to buying diverted or counterfeit goods. Organized crime is behind almost all of the counterfeit goods sold in the U.S., and diversion is one of their favorite vehicles for dumping fakes on consumers.

Stopping *illegal* product diversion is in the interest of everyone except antisocial types. Were these villains only interested in making dirty buck, it would be bad enough, but all too often, they are using their ill-gotten gains to literally murder us.