# FINANCIAL HARDBALL: CORRALLING TERRORISTS AND PROLIFERATORS

## HEARING

BEFORE THE

SUBCOMMITTEE ON TERRORISM, NONPROLIFERATION, AND TRADE

OF THE

COMMITTEE ON FOREIGN AFFAIRS
HOUSE OF REPRESENTATIVES

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# FINANCIAL HARDBALL: CORRALLING TERRORISTS AND PROLIFERATORS

**WEDNESDAY, APRIL 6, 2011**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TERRORISM,
NONPROLIFERATION, AND TRADE,
COMMITTEE ON FOREIGN AFFAIRS,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 3:04 p.m., in room 2172, Rayburn House Office Building, Hon. Edward R. Royce (chairman of the subcommittee) presiding.

Mr. ROYCE. This hearing of the Subcommittee on Terrorism, Nonproliferation, and Trade today will look at corralling terrorists and proliferators—financial hardball, in other words.

Economic sanctions have long been a key diplomatic tool. Athens imposed a trade boycott on Sparta's ally Megara. And, of course, it is a long history, but in recent years the United States has increasingly relied upon reputational financial sanctions, particularly against North Korea and Iran. These sanctions target financial institutions employed by rogue states for illicit transactions. To preserve their reputation and protect their businesses, other banks shun the targeted institution, restricting the rogue's ability to finance proliferation or terrorist activities.

This model was effectively used in 2005 with Banco Delta Asia hitting North Korea. Once BDA was identified as complicit in North Korea's money laundering and WMD activities, banks throughout the region shunned Banco Delta Asia and other North Korean transactions, effectively shutting the regime out of the international system. As Dr. David Asher, a key architect of this policy, will testify, this was a "financial shot heard around the world."

The key to this action was Section 311 of the PATRIOT Act, which allows the Treasury Department to designate a particular financial entity as a "primary money laundering concern," barring it from the U.S. financial system. One witness, Juan Zarate, pioneered the use of this sanction against "bad banks" during his tenure at Treasury.

After being used against North Korea and BDA, this "unprecedented power" took a 5-year vacation. That is until this year, when the Beirut-based Lebanese Canadian bank was sanctioned. Treasury found that as much as $200 million per month in drug money was laundered through this bank to the benefit of Hezbollah, financing weapons, financing logistics, financing training.

The "market-based financial isolation" that was used against North Korea set the stage for Treasury's campaign against Iran. Beginning in 2006, senior U.S. officials visited some five dozen banks, seeking to persuade them to reconsider their business with Iranian financial institutions. Dubious transactions by Iranian banks, like the $50 million transmitted by Iran's bank Saderat through a London subsidiary to Hezbollah, were spotlighted. In this "whisper campaign," Treasury officials revealed the high cost foreign institutions could bear if found to be facilitating illicit Iranian transactions.

This has caused economic hassle and even pain for the regime in Iran, but it is yet to alter its nuclear weapons drive.

But neither has our financial pressure been turned to the max. Treasury has yet to designate a single bank under Section 311 of the PATRIOT Act for Iran-related sanctions. Nor has Treasury imposed any sanctions against Iran's Central Bank, which has reportedly assisted Iranian banks to sidestep U.S. financial pressure.

Nor have new financial sanctions that were included in the Comprehensive Iran Sanctions, Accountability, and Divestment Act been fully implemented. Nine months after the bill was signed, Treasury is yet to issue regulations to bar foreign banks from doing business with designated Iranian entities from the U.S. financial market. If fully implemented, this would transform Treasury's whispers into a loud bark and a bite.

Successive administrations have shown little interest in sanctioning firms investing in Iranian's energy sector. Last week's sanctioning of an already sanctioned and largely insignificant Belarusian energy firm was embarrassing for the Obama administration. It was just a gesture.

Our witnesses today suggest that financial sanctions, if made a cornerstone of a coordinated campaign, could tip the playing field. In North Korea's case, one suggests they could have proven "decisive" had naive diplomats not demanded that they be dismantled.

Lastly, I should note that our hearing comes as the Treasury Department is in transition. Under Secretary Stuart Levey left his post just days ago. He was innovative and aggressive. The administration insists his departure won't affect policy. Let's hope that is the case.

I will now introduce our witnesses.

Mr. Juan Zarate is a senior adviser at the Center for Strategic and International Studies. Mr. Zarate previously served as Deputy Assistant to the President and Deputy National Security Adviser for Combating Terrorism from 2005 to 2009. Prior to that, Juan served as the first Assistant Secretary for Terrorist Financing and Financial Crimes. He is actually from my county, Orange County, California.

I am going to mention the ranking member after I go through the witnesses and then go to you for your opening statement, if that is all right.

Mr. SHERMAN. Very good.

Mr. ROYCE. Dr. David Asher is a non-resident senior fellow at the Center for a New American Security. Previously, Dr. Asher served as a Senior Asia Adviser at the State Department and was the Coordinator for the North Korea Working Group that attacked

Kim Jong Il's illicit activities and finances. He is a coauthor of a new report, "Pressure," in which he documents those efforts.

Professor Orde Kittrie is professor of law at Arizona State University's Sandra Day O'Connor College of Law. He focuses on legal and policy issues relating to the proliferation of weapons of mass destruction. Prior to academia, Mr. Kittrie served for 11 years at the State Department as an attorney.

I would like to turn now to our ranking member, Mr. Brad Sherman from California, for his opening statement; and then we will go to Mr. Zarate, Dr. Asher, and Mr. Kittrie, in that order, for their statements.

Mr. Sherman.

[The prepared statement of Mr. Royce follows:]

**Statement of Chairman Ed Royce**
**Subcommittee on Terrorism, Nonproliferation and Trade**
***Financial Hardball: Corralling Terrorists and Proliferators***
**April 6, 2011**

Economic sanctions have long been a key diplomatic tool. In recent years, the United States has increasingly relied upon "reputational" financial sanctions, particularly against North Korea and Iran. These sanctions target financial institutions employed by rogue states for illicit transactions. To preserve their reputation, and protect their business, other banks shun the targeted institution, restricting the rogue's ability to finance proliferation or terrorist activities.

This model was effectively used in 2005 with Banco Delta Asia, hitting North Korea. Once BDA was identified as complicit in North Korea's money laundering and WMD activities, banks throughout the region shunned BDA and other North Korean transactions, effectively shutting the regime out of the international financial system. As Dr. David Asher, a key architect of this policy, will testify, this was a "financial shot heard around the world."

Key to this action was Section 311 of the Patriot Act, which allows the Treasury Department to designate a particular financial entity as a "primary money laundering concern," barring it from the U.S. financial system. One witness, Juan Zarate, pioneered the use of this sanction against "bad banks" during his tenure at Treasury.

After being used against North Korea and BDA, this "unprecedented power" took a five-year vacation. That is, until earlier this year, when the Beirut-based Lebanese Canadian Bank was sanctioned. Treasury found that as much as $200 million per month in drug money was laundered through this bank to the benefit of Hezbollah: financing weapons, logistics and training.

The "market-based financial isolation" that was used against North Korea set the stage for Treasury's campaign against Iran. Beginning in 2006, senior U.S. officials visited some five-dozen banks, seeking to persuade them to reconsider their business with Iranian financial institutions. Dubious transactions by Iranian banks, like $50 million transmitted by Iran's Bank Saderat through a London subsidiary to Hezbollah, were spotlighted. In this "whisper campaign," Treasury officials revealed the high cost foreign institutions could bear if found to be facilitating illicit Iranian transactions.

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signed into law, Treasury has yet to issue regulations to bar foreign banks doing business with designated Iranian entities from the U.S. financial market. If fully implemented, this would transform Treasury's whispers into a loud bark and bite.

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Lastly, I should note that our hearing comes as the Treasury Department is in transition. Undersecretary Stuart Levey left his post just days ago. He was innovative and aggressive. The Administration insists his departure won't affect policy. This hearing should help Members hold them to that.

###

Mr. SHERMAN. American national security depends upon our nonproliferation efforts, particularly against Iran. The issue is raised, can sanctions work? The answer is, obviously, of course, definitely, but only if you are willing to make our international businesses and trading partners angry. We have been absolutely unwilling to do that to any degree whatsoever, and our sanctions program has manifestly failed to slow the times centrifuges.

Let me give an extreme example that demonstrates what I am saying. Imagine if the United States had a rule that you could not trade with the United States, not one paperclip, if you conducted any trade with Iran—a single paperclip, perhaps excluding medicine and food. The result would be an immediate shutdown of the Iranian economy, as it couldn't get spare parts for oil field equipment, elevators, et cetera. Iran would have to discontinue its program within weeks.

And, of course, this would make all of our trading partners angry, not the least of which would be the Chinese. We would see our ports locked to their exports until such time as they bend to our nonproliferation strategy, which I think they would do within hours.

Wall Street is simply too powerful, the business community is too powerful, the State Department is too deferential for us to do anything close to what I am talking about. So, instead, we have a policy of sanctions to the full extent that can be implemented without making anybody upset, except the Iranians. And within that range we have at least been able to annoy the North Koreans and the Iranians with our very limited efforts.

Financial measures play an important role in applying this level of pressure, and financial institutions seem particularly concerned about their reputations and susceptible to things that pose reputational risks. You can demonstrate tactical results. A bank quits doing business for Iran, for example. But what does that mean? That just means they have got to go to another bank. Iran is not going to abandon its nuclear program just because they have to go to the bank with the high ATM fees.

Big Western banks do tend to be wary institutions. They respond to pressure, to whisper campaigns. Stuart Levey did an outstanding job within the constraint that he couldn't make anybody angry. He accomplished all that could be.

Financial institutions, in an effort to protect their reputation, often go well beyond letter of the law. At least initially the Bush administration designated Banco Delta Asia under the PATRIOT Act in September, 2005. The order only affected that one bank. Yet almost all reputable institutions stayed away from North Korea and its banking institutions, causing a cash crunch for the North Korean Government that led to a little bit of more reasonable negotiating from them for a while.

We have to play financial hardball and will learn about that at these hearings. But we also have to impose trade as well as financial pressures.

The fact that we are doing the exact opposite was illustrated a couple weeks ago when, on March 16th, the State Department sent notice to Congress saying that it was going to give a license to GE to repair the jet engines of supposedly civilian Iranian aircraft. Well, how civilian are these aircraft? We know that they are used to take weapons to Hezbollah. We know that they were used in intelligence operations involving Iranian dissidents and assassinations and assassination attempts. And we know that they were used, as shown on page 240, 241 of the 9/11 Commission Report, to ferry 9/11 highjackers in and out of Afghanistan prior to the 9/11 incident.

These are their civilian aircraft. We are going to license their repair.

What we should have the guts to do is simply tell Iran, ground your airplanes until you ground your nuclear program. Unfortunately, while many of us, including, I believe, the chairman, the chairwoman of the full committee, the ranking member of this full committee, are urging the State Department to do just that, I suspect that the administration will bow to corporate pressure and license this, while at the same time telling the American people that we are using all the economic power of the United States to try to prevent the Iranians from developing a nuclear weapon.

We can and should go way beyond CISADA. Last Congress, joined by our chairman, I introduced the Stop Iran's Nuclear Weapons Program Act. That would, among other things, sanction those who would buy bonds from the Iranian Government. Recent news reports suggest that some $4.2 billion in bonds will soon be issued by an agency of that government, the Power Oil and Gas Company. I will be reintroducing that legislation next week, and I want to urge all our colleagues to cosponsor that legislation.

Finally, I want to mention that some $33 billion was seized and frozen by Treasury because those assets were owned by Libya and the Qadhafi family. It is time that those assets be used to pay the costs of Operation Odyssey Dawn. That is an operation designed to protect the Libyan people.

The fact that we have not even asked the Benghazi government—I don't think we need to ask, but we haven't even bothered to ask—for a clear declaration that those funds should be used to

support our efforts shows a real lack of respect to the American taxpayers.

I would point out that Libya produces more oil per capita than any country that you can find on the map without a magnifying glass.

So there is still much to be done. I want to commend our Treasury Department for what they have been able to do under the political constraints they face, and I yield back.

Mr. ROYCE. Thank you, Mr. Sherman.

Mr. Zarate.

**STATEMENT OF MR. JUAN C. ZARATE, SENIOR ADVISER, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES (FORMER DEPUTY ASSISTANT TO THE PRESIDENT AND DEPUTY NATIONAL SECURITY ADVISOR FOR COMBATING TERRORISM, AND FORMER ASSISTANT SECRETARY FOR TERRORIST FINANCING AND FINANCIAL CRIMES, U.S. DEPARTMENT OF THE TREASURY)**

Mr. ZARATE. Thank you Chairman Royce, Ranking Member Sherman. It is an honor to be here with you today. Thank you for the invitation, always an honor to be with southern Californians.

I submitted written testimony and ask that it be entered in the record, Mr. Chairman.

Mr. Chairman, I was privileged to serve at the Treasury Department and the National Security Council after 9/11 with a team of remarkably dedicated public servants like Dr. David Asher sitting to my right, who are dedicated to deploying these innovative financial tools to promote and defend the national security of our Nation.

David, in particular, was critical as the State Department's point man in devising new ways of integrating law enforcement, financial, and diplomatic tracks to squeeze the regime in Pyongyang.

Mr. Chairman, I would also like to thank you for your consistent support on these issues, especially as we deploy targeted financial sanctions against international scofflaws like Viktor Bout and his international business empire.

Mr. Chairman, between diplomacy and war lies the realm of economic influence and financial power. Over the past decade, we have developed a new brand of financial suasion used to constrict the budgets and global reach of terrorist networks and to isolate and diminish the international financial and commercial access of rogue regimes like North Korea and Iran. This new paradigm leverages the integration of complementary financial and national security objectives to protect the integrity of the international financial system and isolate rogue financial activity.

What makes this approach so powerful is that it relies more on the risk-based calculus of global financial and commercial institutions than the policy decisions of governments. This is why we have seen banks and insurance companies end their dealings with North Korea and Iran, even absent government decrees or U.N. sanctions.

Enabling this new power is the suspect or illicit behavior of rogue actors themselves. With sensitivities embedded in the financial system to illicit financial behavior, such activities become the Achilles' heel of rogue actors. This is why the Iranian Revolu-

tionary Guard forces growing control of the Iranian economy is a central vulnerability.

This system of financial suasion relies on a virtuous cycle where rogue behavior is exposed or targeted by governments and shunned by the private sector, reinforcing financial isolation. This then puts a premium on government exposure of masked financial transactions.

Importantly, this new paradigm has done away with the old orthodoxy that defines sanctions as being either unilateral or multilateral. This new brand of financial power is multilateral by nature. This explains why a domestic proposed administrative rule under Section 311 of the PATRIOT Act can lead to the global financial isolation of the North Korean regime.

Financial suasion is now central to our national security approach. It can cut off funding for rogue regimes, heighten scrutiny of suspect international activity, amplify the financial pressure and political fissures within regimes and societies, and anchor the international isolation of the rogue regime and its leadership.

These financial campaigns also alter the strategic environment, and so we need to be aware of the trends that could dull the sharp edge of this new power.

Criminal and terrorist networks and sanction states will continue to need access to the international financial system. This will breed innovation in circumventing sanctions and the creation of shadow banking networks. We then need to continue to shine a light on those actors engaged in illicit and suspect conduct, especially the financial facilitators.

Governments need to remain acutely aware of the reliance on the private sector and maintain focus on conduct-based sanctions that have direct relevance to the integrity of the financial system. It is critical as well that we tend to the economic and enforcement environment that makes this power possible. In the first instance, it requires maintaining and using the tools and authorities we already have in place, drawing the sharp distinction between legitimate and illegitimate financial activity. It also requires strengthening the United States as a central financial and commercial center to ensure that what the United States says and does has global impact.

And we can't remain static in our application of financial pressure against rogues. We need to integrate law enforcement and other tools to amplify the effects of these powers and launch new campaigns to address plutocracy and human rights to underscore the illegitimacy of rogue actors in the international financial arena.

The recent steps taken to expose Hezbollah's international drug trafficking and money laundering activity is a welcome strategic move. We may also need to think more creatively about positive finance incentives, both to reward the right behavior by the financial community and punish illicit financial actors. It is important as well as not to view these powers as a magic bullet for all our hard transnational problems. This power needs to be an enabler for our broader national security strategies.

Finally, Congress plays an important role in this realm. Congress should hold the executive's feet to the fire in implementing existing authorities to isolate rogue behavior. As it has done with CISADA,

Congress can affect the international environment and pressure on foreign governments, the private sector nongovernmental organizations to ensure there is a clear dividing line between legitimate financial activity and activities that serve to circumvent controls on illicit behavior.

As the world faces challenges from rogue states' networks and actors, there now exists a well-developed international system to use financial information, power, and suasion to isolate rogues from the legitimate financial system. If maintained properly and used aggressively, this new paradigm of smart financial power will remain an effective cornerstone of our national security approach, keeping both the financial system and our citizens safe.

Thank you very much, and I look forward to your questions.

[The prepared statement of Mr. Zarate follows:]

**Statement before the House Foreign Affairs Committee, Subcommittee on Terrorism, Nonproliferation, and Trade,**

# *"FINANCIAL HARDBALL: CORRALLING TERRORISTS AND PROLIFERATORS"*

A Statement by

**Juan Zarate**

Senior Adviser,
Center for Strategic and International Studies (CSIS)

**April 6, 2011**

**2172 Rayburn House Office Building**

**Testimony of Juan C. Zarate**
**Senior Adviser, Center for Strategic and International Studies**
**Before the House Committee on Foreign Affairs**
**Subcommittee on Terrorism, Nonproliferation, and Trade**
**"Financial Hardball: Corralling Terrorists and Proliferators"**
**April 6, 2011**

Chairman Royce, Ranking Member Sherman, and distinguished members of the Subcommittee on Terrorism, Nonproliferation, and Trade. I am honored to be with you today to talk about the important evolution of the use of financial power and influence as an essential element of our national security strategy. I was privileged to serve at the Treasury Department and the National Security Council after 9/11 with a team of dedicated public servants dedicated to deploying these innovative financial tools to promote and defend the national security of our nation. Thank you for this opportunity.

Between diplomacy and war lies the realm of economic influence and financial power. Over the past decade, we have developed and used a new brand of financial suasion that has proven critical to isolating rogue behavior around the world. This new strategy relies on leveraging the interests and gate-keeping function of the legitimate financial system. This power has been used to constrict the budgets and global reach of terrorists and their supporters and to isolate and diminish the international financial and commercial access of rogue regimes like North Korea. In situations where the United States has limited reach or influence, such financial campaigns – enabled by the international financial system -- are often seen as the only effective means of gaining leverage and influencing rogue behavior.

This financial suasion is now central to our national security strategies and need to be understood and nurtured to ensure they remain viable and are used effectively. Policymakers need to understand though that these tools and related effects are not a magic bullet that can solve the hardest problems. It is often the cornerstone of a more sophisticated approach, where financial suasion cuts off funding for rogue budgets, heightens scrutiny of suspect international activity, amplifies the financial pressure and political fissures within regimes and societies, and anchors the international isolation of the rogue regime and its leadership from the legitimate financial world.

These financial campaigns also alter the strategic environment – including how our enemies operate – and are impacted by global economic conditions. This means we need to adapt our strategic use of financial power, reinforcing the core dynamics of this powerful new tool without doing damage to its effectiveness.

This testimony lays out the nature of this new financial power, how it has been used to great effect, the ongoing challenges to its effectiveness, and some new ideas to consider in an evolving geopolitical and economic environment.

**Nature of this New Financial Power**

Over the past decade, a new paradigm of smart financial power has emerged which has made a particular brand of financial suasion more targeted, effective, and central to critical issues of national security import. At the heart of this paradigm has been the integration of complementary financial and national security objectives to protect the integrity of the international financial system and isolate rogue financial activity. This evolution from classic, state-based sanctions has depended on a deeper involvement of the private sector in arenas previously confined to the halls of governments, with a commensurate and widening appreciation within governments of the power of markets and the private sector to influence international security.

There has been growing recognition and reliance on this form of financial pressure as part of coercive diplomacy campaigns – especially when addressing threats from rogue regimes whose leadership seem immune or distant from the reach of classic American power or deterrence. Enabling this new power is the behavior of rogue actors themselves – often engaged in recognized illicit activity with related suspect financial dealings and masking of their operations globally. With sensitivities embedded in the international financial system to illicit financial behavior, such activities become the Aquilles' Heel of these rogue actors.

What makes this approach so powerful is that it relies more on the risk-based compliance calculus of global financial institutions than the policy decisions of governments. For legitimate financial institutions, there are no benefits to the risk of facilitating illicit transactions that could bring high regulatory and reputational costs if uncovered. This means that rogue actors who try to use the financial system to launder money, finance terrorism, underwrite proliferation networks, and evade sanctions can be exposed and denied access by the financial community itself. It also means that the sanctions are based on the conduct of the rogues themselves, relying on the illicit or suspicious behavior of the actors trying to access the international financial system to trigger their isolation, and not on the political decisions of governments.

This new paradigm has done away with the old orthodoxy that defined sanctions as being either unilateral or multilateral. In essence, this new brand of financial power is multilateral by nature, given that the international financial community is the key protagonist in isolating rogue actors from the financial system. The United Nations and government actions are important and make financial pressure more effective, but those are not the essential components of this power. If financial entities act according to their own commercial interests, targeted actors and their fronts will be denied access to the facilities of the international financial system such as bank

accounts, cross- border money transfers, and letters of credit. If some banks decide to provide these services, they themselves run the risk of becoming financial pariahs, even before they become objects of sanctions themselves. In a system such as this, financial institutions act as the guardians at the gates of the financial system.

This new use of financial power was spawned by design and necessity, harnessed from the dramatic steps taken by governments around the world to build and adapt legislative, regulatory, and financial enforcement tools to prevent terrorist financing since the September 11, 2001 attacks. The international community has begun to expand these tools to address other transnational security threats that rely on, or touch, the international financial system, from narco-trafficking to kleptocracy and state-sponsored illicit financial activity.

The emergence of this new brand of financial power can be explained by understanding three primary developments since September 11: the expansion of the international anti-money laundering regime; the development of financial tools geared specifically to affect issues of broad national security; and the centrality of the international financial system as well as the private sector to transnational threats and issues of primary national security concern.

*Expanding the International Anti-Money Laundering Regime*

In the wake of September 11, governments, in concert with the private sector, sought to leverage the existing global anti-money laundering system to prevent the financial system from being abused by al Qaeda and other terrorist organizations to perpetrate another attack or sustain their organizations. In this context, global anti-money laundering regulations and practices based on principles of financial transparency, information sharing, and due diligence were expanded and aggressively implemented. Regulations and obligations were applied to new sectors of the domestic and international financial community, such as insurance companies, brokers and dealers in precious metals and stones, and to methods of moving money such as hawala (a trust-based money transfer mechanism) and money service businesses.

In the United States, Title III of the USA PATRIOT Act ushered in this expansion, representing the most wide-sweeping expansion of the U.S. anti-money laundering regime since the inception of the 1970 Bank Secrecy Act. The PATRIOT Act provided the legislative mandate to extend anti-money laundering requirements to a range of commercial and financial actors, to expand financial information sharing between the government and the private sector, as well as between financial institutions, and to develop more powerful tools to enforce the expanded policies and regulations.

Internationally, relevant multilateral fora became venues to address the issue of terrorist financing and to reiterate or define international obligations. In October 2001, the Financial Action Task Force (FATF), the world's anti-money laundering

and counterterrorist financing standard setting body established in 1989, developed the Eight Special Recommendations (a ninth was added in 2005) for countering terrorist financing, and amplified and updated the FATF "40 Recommendations on Money Laundering" (originally adopted in 1990, revised in 1996 and 2003), all with the effect of creating the expectation of greater financial transparency, accounting, and regulatory oversight around the world. The World Bank, the International Monetary Fund, and the UN later adopted these standards.

At the same time, international associations such as the Egmont Group of Financial Intelligence Units (FIUs) (an international network of units in countries around the world devoted to collecting, analyzing, and sharing financial information to prevent financial crimes such as money laundering and terrorist financing) committed to develop counterterrorist financing tools and to expand its membership to ensure broader access to suspicious financial information, required to be submitted by most banks around the world. Nongovernmental organizations, such as the Better Business Bureau's Wise Giving Alliance, also engaged with regulators and governments as concern over terrorists' abuse of charities became central to the international community's campaign against terrorist financing.

There was also a newfound focus on these issues in corners of the world that had been relatively detached from the global anti-money laundering system, with China and Russia eventually joining the FATF and new FATF-style regional style bodies created in Eurasia (e.g., the Eurasia Group on Combating Money Laundering and the Financing of Terrorism [EAG] founded in 2004), as well as in the Middle East and North Africa (e.g., Middle East and North Africa Financial Action Task Force [MENAFATF] founded in 2004). Countries around the world followed suit, passing new anti-money laundering laws, creating new units to apply sanctions and develop and share financial information, and committing politically to protecting their financial systems from illicit financial activity.

Increasingly vigilant regulatory bodies and prosecutors around the world have enforced this expansion of the international regulatory regime. As a result, multinational banks and local institutions were hit with significant investigations and penalties for anti-money laundering and sanctions violations. In the United States, investigations and multimillion dollar fines against well- established institutions such as Riggs Bank, UBS, and ABN Amro, among others, served to further sensitize the private sector to the reputational and financial risks of failing to observe the letter and spirit of these expanding anti-money laundering obligations. In the post-September 11 environment, financial institutions did not want to find themselves caught in the headlines of counterterrorist financing or anti-money laundering investigations.

This expansion was not without controversy, cost, or difficulty. Applying anti-money laundering tools built largely to address classic drug-based and bulk money laundering to the problem of terrorist financing (whose sourcing may not be criminal in nature) and to more informal sectors dealing with smaller and more

opaque transactions frustrated both the private sector and government authorities. Questions about the relevant costs and usefulness of enhanced enforcement continue to top the list of private sector concerns. These concerns have been exacerbated by an increased reliance on the private sector to serve as "gatekeepers" for the financial system and the need for greater communication between governments and regulated entities.

Despite these concerns, the expanded global anti-money laundering regime stands as an embedded and lasting framework for the protection of the international financial system and is now understood as an essential part of a "safe and sound" financial system. Indeed, this framework has been the baseline from which the international community has expanded its focus and concern from money laundering and terrorist financing to proliferation finance, illicit use of front companies, sanctions evasion, and kleptocracy.

*Applying Financial Tools to National Security Issues of Concern*

After September 11, the United States and the international community also developed new and amplified tools to isolate rogue actors from the financial system. The campaign against terrorist financing was defined early through the use of targeted financial sanctions against terrorist-supporting individuals and entities. The "smart" sanctions of the late 1990s that targeted rogue leaders and entities they controlled were put on steroids.

In the United States, then-President George W. Bush signed executive order 13224 on September 22, 2001, allowing for the broader use of U.S. authorities to freeze assets and transactions of designated terrorist supporters and facilitators, including financial institutions, and restricting commercial interactions between such designated parties and U.S. persons. This order launched U.S. efforts to identify and sanction more than four hundred individuals and entities, with the express purpose of corralling assets and transactions to prevent terrorist financing. At the UN, the pre-September 11 al Qaeda and Taliban sanctions regime (as reflected in UN Security Council resolution 1267) was ramped up and served as the international community's primary method of identifying those al Qaeda and Taliban-supporting entities subject to global financial sanctions and travel and arms bans.4 The European Union has applied targeted sanctions in a similar manner through what is known as the EU Clearinghouse process.

The uses of such administrative, preventative sanctions since September 11 have served to stop suspicious money flows and isolate those identified with such activities from the legitimate financial system. Unlike criminal arrests and procedures, these asset freezes are often administrative actions designed to disable entire networks of businesses or related entities when tied to the funding of terrorism. Unlike civil or criminal forfeiture proceedings, this means that there are no trials, hearings, or notices before orders are issued to financial institutions to freeze bank accounts and transactions owned or controlled by the designated

parties. These sanctions have also served as diplomatic tools to raise the consciousness of the international community to issues of immediate concern such as al Qaeda's abuse of charities and its presence in Iran. The use of such aggressive sanctions, however, has come under direct attack by those arguing for ex ante due process (e.g., advanced notice of designation or a judicial hearing to allow for rebuttal of evidence presented) for those individuals and entities, especially in Europe.

The United States supplemented these tools by implementing Section 311 of the PATRIOT Act, which allowed the Secretary of Treasury to apply regulatory measures to financial entities, jurisdictions, and classes of transactions identified as "primary money laundering concerns." The U.S. Department of Treasury used this authority aggressively between 2003 and 2005 as part of a "bad bank initiative" to isolate those financial institutions around the world facilitating an assortment of illicit financial activity. The use of this regulatory tool in 2005 against Banco Delta Asia, a private bank in Macau that was facilitating money laundering, proliferation, and counterfeiting on behalf of the North Korean regime, served as a way to notify the international financial community of the ongoing practices of concern by this financial entity and Pyongyang.

The use of targeted financial sanctions and related international focus has also expanded to issues such as proliferation finance and high-level or regime corruption, often referred to as "kleptocracy." In the United States, the president's signing of executive order 13382 on June 29, 2005, provided the domestic legal and regulatory framework to expand this paradigm to proliferation financing, which has been used to identify front companies from China, North Korea, and Russia engaged in suspect proliferation activities.

As seen in the Iran-related sanctions at the UN and by Europe and the United States, there is a growing reliance on targeted sanctions and broader financial warnings to help pressure the Iranian regime by isolating those entities and activities possibly engaged in the development of a nuclear weapons program. The use of such tools against autocratic regimes and leadership in countries such as Burma, Belarus, Liberia, Sudan, Syria, and Zimbabwe has also served to expand ongoing efforts in the EU and the United States to deter and prevent large-scale corruption. The most recent actions to freeze the assets of deposed leaders from the Middle East is also a demonstration of the international system responding quickly to the challenges of suspect leadership assets nested in financial institutions.

The increasing use of these tools has spawned a new line of business within governments and the private sector focused on developing, analyzing, and using financial data and information to understand vulnerabilities and to prevent their exploitation by illicit networks of concern. In the United States, the Office of Terrorism and Financial Intelligence was established within the Department of Treasury in 2004, with a dedicated intelligence office charged with developing financial information and analysis within the intelligence community for potential

use by policymakers and the private sector.

The effects of these sanctions were amplified by private lawsuits from victims of terrorism, which served as de facto sanctions on those individuals, companies, and financial institutions implicated in the lawsuits. The deterrent power of such lawsuits was seen most vividly in the case of victims of Hamas terror, whose threats of suits against institutions willing to provide financial services to Hamas entities effectively shut down Hamas' access to banks such as Arab Bank PLC and Cairo Amman Bank, especially after Hamas took over the Gaza strip.

The reliance on financial information and targeted financial sanctions to identify and isolate rogue actors from the financial system is a hallmark of the last eight years, with a broadening expansion of these powers. Though there are limitations and challenges to the use of such power and the information that can be used or shared, there is no question that such sanctions and related regulatory and prosecutorial actions remain a cornerstone of the international community's approach to using financial power and influence to affect a wide range of national security concerns.

*Integrating the International Financial Community and Private Sector*

A key dimension of this new paradigm is the central role and influence of the private sector for issues of international security import. There has been an enormous anti-money laundering/counterterrorist financing regulatory burden placed on financial and commercial actors since September 11. Governments have relied more and more on the ability of financial institutions to act as protective gatekeepers to the financial system by identifying, reporting, and preventing the use of financial facilities by transnational actors and criminals of concern.
The international banking community has grown acutely sensitive to the business risks attached to illicit financial activity and has taken steps to avoid the taint of such activities being facilitated through their institutions. Sensitivity by this community, the primary gatekeepers to international commerce and capital, has been the amplifying element that has motivated private sector actors to cease problematic or suspect business relationships, even absent government mandate or requirements. The legitimate international financial community will ultimately act based on its own business interests, which is aligned with the interests of governments desiring to isolate rogue financial actors. In this post-September 11 environment, there is a natural convergence between the interests of responsible governments and the financial community to protect the integrity of the international financial system.

This sensitivity to both commercial and reputational risks has been shaped in large part by increased anti-money laundering regulatory scrutiny at a global level, well-publicized enforcement actions by national governments, lawsuits brought on by victims of terror, and the explosion of available information sources on terrorist financing and transnational threats of concern (credible or otherwise) that form

part of the required review and due diligence by compliance officers around the world. These factors have amplified the perceived risks of illicit financial activity assessed by financial institutions as worth avoiding at all costs. This has led to some distortions and unintended consequences such as diminishing access to the international financial system by smaller, yet legitimate, entities unable to prove their bona fides or ability to vet customers to larger financial institutions.

There is no better example of this dynamic than the efforts by the United States and other governments over the past four years to identify and isolate the illicit and dangerous financial activity of the regimes in North Korea and Iran. Government actions have spurred banks to make independent cost-benefit determinations leading to closing accounts and ending banking relationships with North Korean as well as Iranian organizations and front companies, shipping lines, and pass-through and shell account holders. In this field and in others related to issues of international security import, the financial community, for better or for worse, has become the frontline actor in the quest to protect the integrity of the financial system and to isolate rogue and illicit financial activity.

**Financial Campaigns against Rogue Regimes**

With few concrete levers to influence rogue regimes in Pyongyang, Tehran, and elsewhere, the United States will continue to rely heavily on this new brand of financial suasion to isolate those engaged in activities that threaten both national security and the integrity of the financial system. In this new paradigm, actors bring this financial isolation on themselves given the nature of their illicit or suspect activities and the manner by which they try to hide or mask the ultimate purposes of their financial dealings.

*North Korea*

The power of this market-based financial isolation was made evident in 2005 against North Korea. As part of a strategic pressure campaign, the U.S. Department of Treasury issued a domestic regulation in September 2005, under Section 311 of the PATRIOT Act, ordering U.S. financial institutions to close any correspondent accounts for Banco Delta Asia, a small private bank in Macau. This bank was facilitating money-laundering, proliferation, and counterfeiting on behalf of the North Korean regime. The regulation cut the bank off from the U.S. financial system. More importantly, what appeared to be a simple unilateral regulation against a private bank unleashed the market-based financial furies against North Korea.

Banks in Asia and Europe stopped doing business with Pyongyang, ultimately denying North Korea access to the international financial system. North Korean bank accounts were closed, their transnational commercial transactions were cancelled, and their officials' financial activities were carefully scrutinized. Without further prompting from governments or the UN, the private sector reacted in this manner based on their own commercial interests. No bank wanted to be seen as the

North Korean regime's bank of choice when the regime was engaged in both illicit and dangerous commercial activity, which would then put the financial institution's own access to the U.S. and international financial systems in jeopardy.

The pressure hurt the North Korean regime. Pyongyang scrambled to regain access to their money and accounts around the world while trying to undo the official damage done to its reputation in the international financial community. The key state actors, including China, had no incentive to block the full effect of the market reaction. On the contrary, they did not want their banks or financial reputation caught up in the taint of North Korean illicit financial activity. This pressure became the primary leverage for the United States to press North Korea's return to the Six-Party negotiating table, which it eventually did in late 2006. With the Six-Party Talks reassembled, the international financial squeeze was gently loosened, though a direct link was never officially acknowledged.

In the face of North Korean recalcitrance and belligerence, this type of financial smart power is being leveraged again, with the elements of a financial pressure campaign emerging. The UN adopted Security Council resolution 1874 on June 12, 2009, serving as a rejuvenated international baseline to ramp up financial pressure, along with an amplified arms ban and a new system for inspection of North Korean cargo. This was quickly followed on June 18, 2009, by the U.S. Department of Treasury advising the financial community of the dangers of doing business with North Korea and the threat to the integrity of the financial system, given the likelihood of continued deceptive and criminal activities. That advisory also listed 17 North Korean banks whose commercial connections and financial activity should be viewed with great suspicion, given the use of such institutions by the regime to evade sanctions, engage in proliferation activities, and in broader illicit activity. Late in June and July 2009, the Departments of State and Treasury designated three North Korean commercial entities tied to the regime's missile proliferation and nuclear weapons programs. This pressure campaign continues with continued designations.

North Korea's suspect activities proliferation, sanctions evasion, counterfeiting, drug trafficking, and smuggling provide the continued seeds of their own isolation. These revelations and sanctions will be the heart of this new pressure campaign against Pyongyang. Along with Japan and South Korea, the United States will use North Korea's recalcitrance and illicit behavior to drive public and private sector efforts to stop North Korea's international commercial activity critical to the development of their weapons program, financing, and potential proliferation.

Over time, this will include public and private threats of sanctions, regulatory actions, or public revelations against those financial institutions that continue to do business with suspect North Korean entities and officials. If fully realized, it will also include a more aggressive use of targeted financial sanctions and regulatory actions, including an aggressive campaign to uncover and freeze leadership assets. As leadership assets are critical to regime loyalty, an international campaign to

freeze those assets would build tension and suspicion within the leadership's ranks.

*Iran*

The financial pressure campaign against Iran using this same paradigm and playbook has been a slower, yet more consistent effort, relying on sanctioning Iranian banks and companies at the UN and by the United States for proliferation violations and support for terrorism. The private sector has reacted to Iran's activities by reducing, and in some cases ceasing, business with Iranian banks and companies. The decisions by Swiss banking giants UBS and Credit Suisse Group along with energy companies, such as BP PLC of London and Conoco Phillips, to curtail if not cease business ties and relations in Iran and with Iranian entities were emblematic of this trend. Meanwhile, governments, led by the U.S. Department of Treasury, have been reaching out more frequently to the private sector to provide them with briefings and information about the nature of Iran's illicit activity and use of the international financial system.

The revelations of the secret nuclear facility at Qom along with consistent reports from the International Atomic Energy Agency (IAEA) expressing concerns about Iranian obfuscation have created additional questions and concerns about Iranian nuclear activity.

Critical to the effectiveness of these measures has been the public and private revelations of the growing reach of the Iranian Revolutionary Guard Corps (IRGC) in the Iranian economy and its control of major overseas companies and operations including in the oil, defense production, and construction industries. The IRGC serves as the parallel military and intelligence arm of the Iranian clerical regime committed to defending the regime. This includes supplying organizations like Hezbollah, Hamas, and Iraqi militants with weapons, training, and funding, and in developing the Iranian ballistic missile system.

The IRGC's deep involvement in commercial ventures proves problematic for the international financial community because financial institutions are not able to discern legitimate activity from what may be illegal or suspect transactions furthering the IRGC's mission. Thus, no bank or company wants to find itself in the position of unwittingly assisting or facilitating activities that are viewed as dangerous, if not illegal, by the international community. The risks of doing business with Iranian entities that may be acting as direct agents of the regime to assist in proliferation, terrorist financing, or sanctions evasion represent major international and financial security concerns for both governments and banks.

On October 25, 2007, the U.S. Departments of State and Treasury took a series of important steps to drive this narrative and the related international pressure campaign by designating the IRGC, nine IRGC front companies, five of its leaders, the Ministry of Defense and Armed Forces Logistics (MODAFL), and Bank Melli and Bank Mellat of Iran as proliferators of weapons of mass destruction. At the same

time, the United States also designated the IRGC-Qods Force (the external arm of the IRGC) and Bank Saderat of Iran as supporters of terrorism. These actions were intended to encapsulate the dangers of doing business with Iran and solidify the financial isolation that had already begun to take hold in the international financial system.

These actions have been buttressed by multilateral measures, including UN sanctions against the IRGC, Iranian officials, Iranian banks and companies, and multiple calls by the world's anti-money laundering body, the FATF, for members to take necessary actions to protect their respective financial systems against the inherent dangers of the Iranian financial system. All of these measures create a deepening sense for the private sector of an inhospitable, if not dangerous, business environment in which legitimate financial and commercial ventures cannot ensure that they are doing business with credible business entities. As a result of almost three years of these efforts, most major financial institutions and numerous commercial entities, including energy companies, have stopped doing business with Iranian banks and entities. All of this makes it costlier and more complicated for Iran to conduct business internationally.

Unlike North Korea, Iran has the advantage of being a major oil producer and having deeper financial and trading ties with countries in Europe and Asia. To a certain extent, this tempers and complicates the willingness of commercial entities and banks to cleave all business relations with Iran. Yet, it has been the Iranian regime's continuous involvement with illicit activities and unwillingness to adhere to international law that has proven to be the driver of their own isolation. In addition, statements by President Mahmoud Ahmadinejad denying the Holocaust and threatening Israel have added to the sense of political tension and turmoil in Iran. All of this weighs in the minds of chief executive officers and boards of directors calculating whether to drop investments or opportunities in and with Iran. Decisions by some of the major non-U.S. financial institutions in the world and European companies to withdraw their presence and exposure in Iran, when there are clear economic benefits to be had from such engagement, demonstrate the importance of these risks and factors to the legitimate financial and commercial world.

To be sure, the latest escalation of sanctions and financial isolation is hurting the regime. Legitimate banks, insurance and shipping companies, and energy firms are abandoning business with Iran for fear of sanctions and risk to their reputations. The most recent round of sanctions — those set in motion by the United States, along with the European Union's most severe measures against Iran since the passage of U.N. Security Council Resolution 1929 — increased the pressure on Iran's economy by targeting its dependence on refined-petroleum imports and closing correspondent relationships between Iranian banks and those in other countries. And more nations are adding their voices to this chorus. Significantly, Japan and South Korea, two of Iran's largest trading partners, announced that they would impose harsh sanctions and target designated Iranian entities.

The U.S. Congress' passage of the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA), has been significant – creating a fear of secondary sanctions against non-American companies still doing business with Iran. Lloyd's of London has announced it will stop insuring or reinsuring refined-petroleum shipments into Iran. European insurance giants Allianz, Munich Re, and Hannover Re have committed to ending business ties with Iran. Multinational firms including Total, Repsol, Royal Dutch Shell, BP, Eni, Petronas, Reliance, Glencore, Trafigura, and Vitol have all ended their refined-petroleum trade or energy investments in Iran. In July, Iran's gasoline imports were down 50 percent from May, according to the International Energy Agency, and according to Reuters they were down 90 percent in August from the previous year. The State Department estimates that $50 to $60 billion in upstream energy-development projects (i.e., exploration and production) have been terminated or put on hold over the last several years.

These sanctions work because they are triggered by Iranian activity, which is growing less transparent and more suspicious, thus causing further reluctance by the private sector to do business with Iran. As Iran's financial isolation grows, Iranian ventures — especially those controlled directly by the regime — will seek to hide their activities in order to evade scrutiny and sanctions, causing the private sector to worry further about business with Iranian entities. In June 2010, the Treasury Department issued a financial advisory for precisely this reason.

Another factor is the growing and visible role of the harsh and repressive Islamic Revolutionary Guard Corps (IRGC) in Iran's economy. The sanctions target IRGC leaders and front companies, which may account for the withdrawal from the South Pars gas-field development (the world's largest, and shared between Iran and Qatar) of Khatam al-Anbia, the IRGC's engineering company. All this fuels the suspicion of the legitimate financial and commercial worlds and is amplified by the Iranian regime's electoral illegitimacy and human-rights violations, along with the growing evidence of duplicity regarding its nuclear program. This pressure will increase stress on an Iranian economy already battered by profound mismanagement, years of growing isolation, and the global economic downturn. It also appears to be exacerbating tensions within the regime, which were already serious enough to threaten its stability.

Unfortunately, the sanctions campaign alone will not be enough to stop Iran's march toward nuclear-weapons capability. Though Defense Secretary Robert Gates and Secretary of State Hillary Clinton have described sanctions as a tool to change the Iranian regime's thinking about its weapons program, CIA director Leon Panetta has admitted that they will not achieve this goal, and that the emergence of a nuclear-weapons-capable Iran is possible within two years. Karim Sadjadpour, an Iran expert from the Carnegie Endowment, has emphasized this point, noting that Tehran's hardliners are hard-wired to oppose the United States and to resist compromise in the face of direct pressure.

We often hamstring ourselves by talking about the utility of sanctions in maximalist terms. Secretary Gates explained that the point of sanctions is to "persuade the Iranians that they . . . will undermine their security by pursuit of nuclear weapons, not enhance it." Biting sanctions can achieve important objectives, though those objectives may sometimes be peripheral to the Iranian regime's nuclear calculus. As stated above, they can exacerbate internal regime fissures and increase the isolation of the regime; they can also buy time by delaying supplies Iran needs for its nuclear program, interrupt flows of funds sent to terrorist proxies, and serve as a diplomatic chip if the regime ever comes to the table. But we need to use this pressure as a starting point, and use multiple lines of pressure at once against Tehran.

The Obama administration has framed its engagement with Iran as a step-by-step diplomatic dance, with an ascending scale of confrontation. Sanctions and financial pressure come in the middle of that dance — after engagement and before other options (presumably military). Aside from giving Iran more time by dismissing the diplomatic engagement that occurred before January 2009, this framework constrains the administration's ability to think about financial pressure as one part of a much broader campaign, with multiple approaches pursued simultaneously, to build leverage against the regime.

Such leverage could help at the negotiating table or could lead to regime change. But the mullahs know the steps to this dance, and their diplomatic maneuvers (such as making insincere offers of negotiations, with unrealistic conditions attached, that the administration will have to follow up on) can buy them more time. The strategic ambiguity of "all options on the table" is undermined by the tactical predictability of the Obama administration's strategy. Most troubling, the administration has seen a potential dialogue with the regime as a goal in and of itself. This way of thinking has foreclosed opportunities to build multiple sources of leverage, as with our muted response to the Green Movement in December 2009, which could have been viewed as a strategic opportunity to pressure the regime based on human rights concerns.

We should therefore pursue our Iran policy on three separate tracks simultaneously. Our approach should attempt to (a) slow the Iranian nuclear clock, (b) create and exacerbate fissures within the Iranian regime and Iranian society, and (c) build other forms of leverage that could affect the regime's decision-making and enhance our credibility with allies. This would include the following steps:

- *Continue Financial Pressure Momentum.* Build on the momentum of our financial-pressure campaign, highlighting Iran's deceptive business practices, and anything the IRGC does to control the Iranian economy, by all available means, including Treasury advisories suggesting caution when dealing with certain entities, designations of firms as terrorist-affiliated, public hearings in Congress or other bodies, and private meetings with commercial actors still doing business with Iran. The Treasury should threaten and enforce sanctions on any entity doing business with the IRGC or designated Iranian

banks and should be pressed to apply CISADA aggressively against banks continuing to facilitate Iranian activity.

- *Use of Section 311 against Iran.* This pressure could be followed by the designation of Iran and its central bank as "primary money laundering concerns" under section 311 of the Patriot Act, signaling to the international financial community not to trust any Iranian commercial activity. The United States does not need the U.N. to do this. Indeed, the U.S. Treasury added the German-based European-Iranian Trade Bank AG to its blacklist last year and can continue to do so. The continued disengagement by international companies, the growing role of the IRGC in Iran's economy, and growing dread of potential military conflict will feed private-sector flight from Iran. A similar approach was quite effective in choking off North Korea's illicit global business activities in 2005.

- *Human Rights Campaign.* We need to continue to highlight Iranian human rights abused, and recent steps to begin designations of Iranian officials on this basis and to name a Special Rapporteur for Human Rights Abuses in Iran is a good step. This will also include bolstering the flagging Green Movement with a full-throated human-rights campaign against the Iranian regime — ideally led by human-rights NGOs. Such a campaign could be a means to protect and empower dissidents. Perhaps with breathing space enabled by international scrutiny, the movement can regain its footing, thus forcing the regime to defend itself on another front.

- *Digital Dissidents.* A human rights effort should be buttressed by a digital dissident and Internet freedom campaign. The State Department has announced efforts to promote digital dissidence, but more should be done in Iran and other rogue regimes to provide dissidents the technology necessary to circumvent those regimes' Internet controls. In this regard, we need a more active campaign — a 21st-century Berlin airlift to facilitate the movement of information in both directions across Iran's borders. This would involve the creative enlistment and participation of the Iranian-American community. This would give real meaning to Secretary Clinton's Internet-freedom agenda and momentum to the democracy activists in and outside of Iran.

- *Leadership Asset Hunt.* In concert with interested international partners, threaten the mullahs and the IRGC with an international hunt for assets owned by regime leaders, as a complement to existing sanctions on those leaders. The Iranian regime and security establishment have made fortunes off the people of Iran. A focus on assets held outside of Iran by the regime's key leaders, and the accompanying exposure of corruption and kleptocracy, would threaten both those leaders' legitimacy and their finances. It could also influence decisions internally in the direction of de-escalation and make

certain regime members more willing to cut deals with us. The timing of this works well internationally, on the heels of the asset freezes of the following leaders -- Ben-Ali, Qaddafi, Mubarrak, and Gbabgo – and legitimate questions as to why leadership assets of corrupt regimes are not frozen before a crisis emerges.

- *Focus on Iranian Support for Terror.* Promote international scrutiny on Iran's support for terrorist proxies and militias, despite international disagreement about labeling groups like Hezbollah and Hamas terrorists. The United States should request that the U.N. committees responsible for dealing with terrorism — in particular the U.N. Security Council Resolution 1267 al-Qaeda and Taliban Sanctions Committee — report on Iranian support for the Taliban and explain what the Iranians are doing with senior al-Qaeda leadership in Iran. Highlighting Iran's terrorist sponsorship will make it harder for the regime to continue that support and will underscore the danger of nuclear terrorism and proliferation should Iran acquire atomic weapons.

- *Military Option.* Maintain a credible military option, as the Bipartisan Policy Center has recommended. This will keep the possibility of force in the mind of the Iranian regime and reassure our allies. Credible demonstrations of U.S. military reach, such as naval exercises, become important as we push the international community to take more difficult steps — and perhaps ask the Israelis not to attack Iranian nuclear sites.

Engagement with Iran works only when we are dealing from a position of strength. The financial-pressure campaign is a strong cornerstone for our efforts to influence and isolate Iran, but it's only one part of what needs to be a multi-dimensional strategy. To stop Iran from building nuclear weapons, we must use every weapon at our disposal.

The effects of this smart financial power against Iran, North Korea, or other rogue actors are important. In the first instance, this market-based financial isolation has the ability to complicate, make more costly, and even impede the international commercial activity that facilitates and finances the activities of greatest concern such as ballistic missile system development, nuclear arms programs, support to terrorist and non-state networks of concern, and proliferation of knowledge and materiel. Just as important, this tool may provide the United States and its allies the best source of diplomatic leverage to affect regimes' behavior and calculus.

**Limitations and Key Considerations**

Though effective, these new financial tools and approach are vulnerable to direct attempts to blunt its reach, overuse, complications in implementation, and changes in the balance of global economic power. The U.S. government is now disposed to

leverage this new brand of financial power to give teeth to its diplomacy and to pressure regimes around the world when the reach of the United States is otherwise limited. To maintain the sharp edge of this smart power, it is important to understand the challenges that lie ahead.

- *Unholy Alliances of Financial Rogues.* The initial challenge comes from rogue actors themselves. Criminal and terrorist networks and organizations, along with sanctioned states, will continue to need access to the international financial system. This need will breed innovation in circumventing sanctions ranging from recreating targeted companies to hiding the nature of suspect transactions with creative fronts or corrupted banking officials and regulators. This may create a market with incentives for organized criminal actors, such as high-end money launderers, and poorly regulated institutions to provide a full suite of banking and commercial services to the isolated actors. The key then is to continue to shine the light on those actors engaged in illicit and suspicious conduct through regulatory and enforcement actions, with the private sector and regulatory maintaining diligence of those transactions that may be subject to manipulation.

  The need to counter or neuter the reach of smart financial power will also create incentives for those isolated states and entities to forge new business or banking relationships as a means of creating alternate shadow networks to fund and facilitate commercial transactions across borders. For example, Belarussian, Burmese, Iranian, North Korean, and Syrian banks or entities would have incentives to create business relationships of convenience providing access to the international financial system while also facilitating cooperation between the state actors. These unholy alliances already exist in some cases. On June 30, 2009, the U.S. Department of Treasury designated Hong Kong Electronics, a North Korean company that formed part of North Korea's nuclear weapons proliferation and ballistic missiles and weapons program. This company was based on Kish Island, Iran and had been transferring money from Iran to North Korea.

  Such networks would be amplified by banks or countries willing to flout, for economic or political reasons, the legitimate financial system's isolation of these actors or states. This makes alternate banking outlets in places such as China, Malaysia, Russia, Qatar, and Venezuela all the more important and potentially problematic, given the potential for lax enforcement of anti-money laundering rules and principles as well as the penchant of those countries' governments to oppose Western policies and interests, especially those that directly concern the United States. These countries could then serve as international financial outlets for rogue regimes not because they overtly approve of the activity being financed or facilitated but simply as a way of countering the influence of the Western banking system. In this regard, such countries and some financial institutions backed by governments may be willing to assume the risk of potential taint by labeling the international community's use of financial

sanctions and power as being purely politically motivated. An important issue then is to create incentives, as well as potential punishment, with the international financial community that encourage such states to act in line with the legitimate financial system and to preserve the sense that the use of such measures is driven by suspect conduct and not solely by politics.

- *Regulatory Burden and Overuse.* The regulatory burden and related costs on the private sector have increased over the last decade. Governments need to remain acutely aware of the importance, burdens, and reliance on those private actors. As noted above, the United States needs to ensure that it maintains a focus on conduct-based sanctions that have direct relevance to the private sector and the integrity of the financial system. Renewed financial pressure campaigns against countries such as North Korea and Iran focused on their illicit conduct in the international financial system such as counterfeiting, sanctions evasion, and money laundering can help. Though such campaigns would be undertaken to address international security problems, rejuvenating such a focus on illicit financial activity would restore confidence in the U.S. Department of Treasury's tools, which should not be seen as being arbitrarily driven by political and diplomatic factors alone.

  At the same time, there will be a tendency to overuse these financial tools for all national security issues for which there is not a ready solution. In some cases, as with the problem of piracy in East Africa, these tools will prove less relevant and effective because certain money flows and economies do not link as directly or neatly into the international or regional financial systems that can be affected. The attempts to overuse them, especially if unsuccessful, could dull their broader utility and strain relations with the private sector.

  In addition, governments should increase collaboration and useful information sharing so as to enlist, as opposed to alienate, financial institutions. Information sharing and transparency will continue to be the engine that drives the effective protection of the financial system from illicit financial activity. Governments around the world need to find better ways of leveraging data already available, such as in the data sharing agreement of the Egmont Group of financial intelligence units (FIUs), and more frequent sharing of specific information or intelligence with the financial community. Banks and other financial institutions also need to take advantage of provisions, as found in Section 314 of the PATRIOT Act, to share information between respective institutions to build common awareness of those threatening the financial system. All of this needs to be done within the framework of consistent multinational practices that protect privacy and individual civil liberties.

  This also means that governments need to check their regulatory practices and to work closely to build consistent regulatory requirements and regimes across borders to assist international financial institutions to operate effectively and efficiently. This challenge will be exacerbated as governments create new

regulatory structures and requirements in the wake of the current financial crisis.

- *Implementation Challenges.* There are also some critical challenges emerging to the tools that undergird the ability of the United States and its allies to use this financial suasion effectively, especially in Europe. The European Court of Justice has called at least part of this system into question, noting that the EU's automatic listing of individuals based on UN action and without prior notice or opportunity to challenge lacks requisite due process to protect human rights. Yet, this system is built on the chapter VII obligations of the UN charter and forms part of the broader targeted financial sanctions regime used by the international community across the board. If the system of judicious use of targeted financial sanctions used by the UN and member nations to pressure rogue international actors is dismantled in Europe, then the system of targeted financial sanctions might potentially collapse. These tools need to be preserved while governments and the UN continue to refine and adjust how they are used. These tools should include allowances to redress grievances and encourage U.S.-style delisting processes.

- *The Important Role of the U.S. Financial System and the Dollar.* More fundamentally, the current financial crisis and attendant questions of the global capitalist system, along with the challenges to the predominance of the U.S. dollar, potentially threaten the effectiveness of this new tool. As the effects of the financial crisis continue to ripple throughout the international financial and economic systems, banks in dire need of capital and liquidity may alter their business risk calculus, making them more willing to take on suspect clients or facilitate activities with less focus on anti-money laundering compliance and reputational risk.

  In addition, much of the power behind this new paradigm stems from the ability of the United States to use its sanction powers with global effect. This, in turn derives from the centrality and stability of New York as a global financial center, the importance of dollar-clearing transactions, and the demonstration effects of any regulatory or other steps taken by the United States or major U.S. financial institutions in the broader international system. Countries such as Russia will continue to challenge the predominance of the U.S.-led international system and the dollar itself. If such attacks succeed fundamentally, they could potentially weaken the ability of the United States to affect or move private sector decision-making in line with national security interests regardless of what other governments do.

  What buttresses this tool, though, is the broad agreement in the international community, especially the private sector, about the types of activities that are threatening and bad for business such as front companies or sanctions evasion. Thus, business risk and reputational calculus, not the economic dominance of

the United States, will ultimately determine how effective these measures will be. In addition, current discussions about global regulatory reform in the G-20 and elsewhere provide an opportunity to clarify and enhance the international community's responsibilities to protect the financial system against the risks attendant to illicit financial transactions, regardless of the U.S. share of global gross domestic product.

**Some New Plays for the Financial Playbook**

When we developed this new brand of financial power, our enemies (as well as most in the national security establishment) were surprised at the power and reach of these efforts. The ability of the U.S. government to use domestic, unilateral regulatory or administrative actions to trigger a global response that isolated rogue financial behavior has shocked most observers. That shock is wearing off, and our enemies are adapting to the use of this new strategy and the hoped-for diminution of American economic influence. This then puts a premium on innovating new methods to reinforce and apply these financial tools.

- *Use Existing Authorities Strategically.* The first and most important lesson is for the U.S. government to use its existing authorities – under legislation like CISADA or with Executive powers, like relevant Executive Orders and others provided by Congress like Section 311 of the USA PATRIOT Act. There is often a desire to create new authorities to build on the momentum of our past successes in this field, when the most important next step is effective application of existing authorities. Importantly, the existing authorities should be used judiciously to target strategic illicit financial nodes (like rogue banks or notorious money launderers), which provide connectivity for rogue actors in the international financial system. Such targets do not need to be seen as relevant only to country-specific programs or strategies, but instead as all-purpose enablers of illicit financial activity that need to be isolated and disabled. This approach will ensure that actions taken by the U.S. government, our allies, and the legitimate financial system will have strategic impact and a demonstration effect to deter other bad actors seeking to misuse the financial system.

- *Develop International Authorities and Capabilities.* A major deficit internationally is the inability of foreign governments – to include law enforcement and regulatory bodies – to manage effectively their financial systems and sanctions policies. I have advocated for a more aggressive international network and system for sanctions enforcement, which does not rely so heavily on Treasury's Office of Foreign Assets Control to administer sanctions for the international financial community, the UN sanctions monitoring committees, or the international banks themselves. Foreign governments and bodies have a role to play in ensuring that existing sanctions are implemented and that new holes in the international financial system are plugged via enforcement, regulation, and consistent administration of sanctions.

- *Kleptocracy as a Key Tool and Campaign.* With much attention on the wealth of autocratic regimes and their families, this is the time to rejuvenate a campaign to isolate and scrutinize the assets of regime leadership. This will add another tool in our financial toolbox, and will further sensitize the international financial system to the dangers of handling high-end, potentially corrupt assets.

  In 2006, the Bush Administration launched the Kleptocracy Initiative, which was an attempt to scrutinize, prevent, and deter high-scale corruption by enlisting the international community, to include the banking community, before leadership crises emerged. From the lessons of the Saddam Hussein asset hunt, where finding billions of stolen assets proved difficult and frustrating, we crafted a strategy to get ahead of these problems and to leverage the interests of the international financial system to avoid past leadership asset scandals that have plagued banking systems like Switzerland's.

  Now is the time to rejuvenate those efforts on a global scale while the revolutions in the Middle East unfold – with a focus on identifying, investigating, and freezing suspect assets of illegitimate regime leaders. This has already been done with deposed leaders, and there is no reason this should not be done before regimes fall – especially with respect to regimes engaged in promotion of terror, proliferation, and human rights abuses like Iran, Syria, and North Korea. Such an effort provides another point of leverage for our diplomacy and reinforces the importance of transparency and anti-corruption efforts in the international financial system.

- *System of Positive Financial Incentives.* We have been very good at designing a system of financial pressure built on principles of disincentives and sanctions. In adapting our financial strategies, we may need to think more aggressively and creatively about positive financial incentives simultaneously to reward the right behavior by the financial community and punishing illicit financial actors. For example, we should be considering how to advantage those banks in the Middle East and Europe that have decided to cease doing business with Iran (often painfully to their bottom line) while punishing those banks that continue to do business with rogue actors (like Lebanese banks servicing Hizballah accounts). Could the international financial community create incentives for positive transfers of assets by good actors that do not want their assets commingled in banks servicing terrorists or proliferators? There should be an exploration of this idea as a way of building financial incentives to reinforce the right decisions in isolating rogue behavior.

- *Human Rights Campaign.* As noted above with respect to Iran, we are at a point in history where human rights and the aspirations of people are central to the ongoing geopolitical debate. In most cases, the regimes we are most concerned about from a terrorism and proliferation perspective are also the worst human

rights abusers – often brutally suppressing the rights and aspirations of their own people. Such repression adds to the loss of legitimacy of those regimes and should be seen as a thematic that reinforces the financial isolation of rogue regimes and actors. Thus, we should build our financial isolation campaigns with human rights squarely in mind. The U.S. government has begun to do this in the context of Iran with some human rights designations, but this can be expanded to apply a more systemic and global approach to these issues. This will allow the U.S. government to enlist new actors like human rights groups and certain European countries to engage in scrutiny over the financial assets and illicit activity of repressive regimes.

- *Role of Congress*. Congress plays an important role in this financial campaign. In the first instance, Congress can and should hold the Executive's feet to the fire in effectively implementing existing authorities to isolate rogue behavior. It can also fills gaps of authorities as those become apparent. More importantly, Congress can affect the international environment and pressure on foreign governments, the private sector, and non-governmental organizations to ensure there is a clear dividing line between legitimate financial activity and activities that serve to circumvent controls on illicit behavior. Oversight hearings and informational sessions on who is doing what internationally becomes very important, especially as enforcement of sanctions grows lax internationally, countries like China and Russia attempt to provide an alternative platform for international financial activity, and some banks or even banking centers attempt to fill the void of financial services left by legitimate banks ending their business relationships Iranian, North Korean, or other suspect actors. Congress should see itself as an actor in this financial battle space and an asset to the Executive in deploying effective financial pressure campaigns.

**Conclusion**

As the world faces challenges from rogue states, networks, and actors, there now exists a well developed international system to use financial information, power, and suasion to isolate rogues from the legitimate financial system. Though this alone cannot solve the issues of deepest national security concern, this private sector-based paradigm gives the U.S. government and its allies the tools and leverage to affect rogue actors and their interests, which historically would have been considered out of reach. If maintained properly, this new paradigm of smart financial power will remain an effective cornerstone of the international community's efforts to keep both the financial system and global citizens safe.

Thank you again for the opportunity to testify.

Mr. DUNCAN [presiding]. Dr. Asher.

**STATEMENT OF DAVID ASHER, PH.D., NON-RESIDENT SENIOR FELLOW, CENTER FOR A NEW AMERICAN SECURITY (FORMER SENIOR ADVISER, EAST ASIAN AND PACIFIC AFFAIRS, AND COORDINATOR, NORTH KOREA WORKING GROUP, U.S. DEPARTMENT OF STATE)**

Mr. ASHER. Chairman Royce, Ranking Member Sherman, and members of the committee, thank you very much for the opportunity to testify here today.

I had the great pleasure, as a colleague and counterpart of Juan Zarate during the Bush administration, to go to work on the North Korea problem set in particular but also to help develop the use of finance as a fulcrum element in applying nonkinetic pressure against some of our most difficult adversaries and most defiant regimes and networks.

Recently, I had the pleasure of being a coauthor of this report from the Center for New American Security called Pressure, which reviews the history not only of the Bush administration's North Korea Illicit Activities Initiative but also the Clinton administration's path-breaking initiative to put financial pressure on Slobodan Milosevic, something which I encourage people to pay attention to.

And with your permission, sirs, I would like to submit for the record at least the text as well as my written statement today. I would like to highlight five points briefly from this report.

The first is essentially covering what Juan just mentioned. In the last decade, the Treasury Department has pioneered a new era of financial operations other than war and created what I would say is a revolution in financial affairs equivalent to the revolution in military affairs engendered by the use of precision-guided munitions and sort of smart warfare capabilities.

We have the ability today, given the interconnectivity of the global financial system to apply nonkinetic pressure coercively against nations by combining economic sanctions, precision-guided financial measures using Treasury authorities and, really importantly, law enforcement, in my mind, in a way that you can essentially intimidate, deter, deny, coerce, and I think even defeat, in some cases, adversaries who may otherwise be difficult to have any effect on. And I think on the Iran problems set we would have to look at nonkinetic ways and means as the primary.

The effectiveness, of course, of economic statecraft, a second point, really depends on the clarity of the desired end state. That is why, Ranking Member Sherman, I totally understand your point. I mean, the administration has to decide what it wants to achieve and what it is willing to do to achieve it.

Because the stakes on the Iran problem set are so incredibly high they go well beyond just Iran's nuclear threat, which is considerable looking ahead, but also the threat of proliferation throughout the Middle East triggered by the Iranian regime's development, especially in the wake of this revolutionary sea change in the political environment in the entire Middle East.

The third point, which I already sort of touched on, is I believe law enforcement remains the most neglected element of national

power. One of the most important things we did together, working with the Department of Justice during the Bush administration, was launch global undercover investigations against the North Korean networks which were engaged in weapons proliferation and illicit procurement as well as the funding of the regime of Kim Jong Il.

Law enforcement evidence is much more compelling than intelligence in convincing foreign governments to act; and by providing an evidentiary basis that is acceptable under national legal rules, as well as the rules of foreign partner countries, I think we can find we can freeze much more money than we can simply through Treasury designations or even the United Nations sanctions.

But what is one very important point is that the financial actors that are complicit within the world of weapons proliferation, for example, have to be held accountable. The Department of Justice apparently has investigated maybe as many as a dozen banks for complicity and falsifying wire transfers on behalf of the Iranian regime, billions and billions of dollars. None of those bankers has been essentially taken away in handcuffs or with his head on a stick, in effect, as a criminal. Instead, they have been given fines. I don't believe that policy is a sound policy in the long haul.

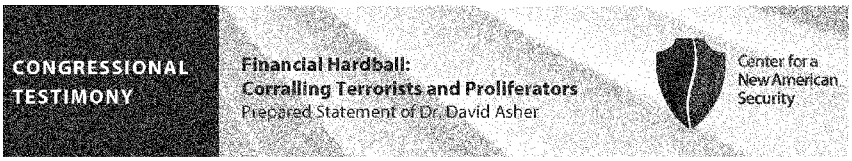
The fourth is the economic course of diplomacy has a very important role within the military context, and I think that these threat finance cells within Afghanistan and within Iraq are playing an important role and continue to play an important role within the military complex. It is not just a shaping mechanism. Denying the means of sustainment to our adversaries has been a fundamental principle of warfare since time immemorial. After all, Marcus Tullius Cicero wrote, I think in 44 B.C., that endless money forms the sinews of war; and its insight remains very significant today.

We can be doing a much better job I believe going after, for example, the financing of the Taliban, but the problem is we would have to look at Pakistan, and this is the problem set we are going to have to face.

Finally, the power of economic and financial coercive diplomacy which we found in reviewing the history in this report can be underestimated. Had we known how successful our sanctions had been against Saddam Hussein there would never have been a need to invade that country. Not underestimating ourselves and having an accurate measure of the actual effects of our policies is critical.

On that note, I turn over to you. Thank you, sir.

[The prepared statement of Mr. Asher follows:]




Wednesday, April 6, 2011

**Testimony before the Committee on Foreign Affairs**
**Subcommittee on Terrorism, Nonproliferation, and Trade**

*Prepared Statement of Dr. David Asher*
*Non-Resident Senior Fellow, Center for a New American Security*

Chairman Royce, Ranking Member Sherman, and members of the committee, thank you for the opportunity to testify today on the subject of using financial pressure as an element in national security strategy.

I had the honor of serving as the coordinator from 2001-2005 of the Bush administration's strategy against the Kim Jong Il regime's illicit activities and finances. I am pleased to be testifying today with my key Treasury Department counterpart at the time, Juan Zarate. Juan pioneered the use of the USA Patriot Act Section 311 against bad banks that were involved in supporting terrorism, organized crime, and WMD proliferation, including the designation of North Korea-linked Banco Delta in Macau as a primary money laundering concern in 2005. This single action served as a financial shot heard around the world and compelled banks globally to cut off or severely curtail North Korea's financial access.

Today I am a Non-Resident Senior Fellow at the Center for New American Security (CNAS), where I specialize in economic and security issues. Recently, CNAS published a report where two co-authors and I reviewed the history of coercive economic pressure strategies. This report includes detailed case studies on both the North Korea Illicit Activities Initiative and the path-breaking sanctions effort mounted against the Slobodan Milosevic regime in the Balkans during the 1990s. With your permission I would like to submit this report, *Pressure: Coercive Economic Statecraft and U.S. National Security*, in its entirety for the record.

In addition to our historical review, CNAS convened a series of expert working groups to review lessons learned from previous experiences in coercive statecraft. From these discussions, a series of recommendations and key conclusions emerged. Let me briefly highlight five of them:

1. In the last decade the Treasury Department has pioneered a new era of financial *operations other than war* and created a "revolution in financial affairs" (RFA) – akin to the revolution in military affairs (RMA) engendered by the employment of precision guided munitions and high tech networked systems.

   > In an inter-connected and globalized world, finance can serve as a fulcrum for making coercive diplomacy considerably more powerful and effective than in the past. The use of a carefully planned international campaign of targeted and coordinated financial measures, economic sanctions, and law enforcement actions can abet and in some circumstances even supplant the use of military force in intimidating, deterring, denying, coercing, and even defeating adversaries who may otherwise seem difficult to effect.

2. The effectiveness of a campaign of coercive economic statecraft depends on the clarity of the desired end state; the backing of senior leaders, the sophistication of planning and integration of domestic and international capabilities and authorities; and the quality of intelligence support for planning, execution and monitoring. The U.S. government is not well organized for any of these tasks and in each case, the appointment of a high level interagency coordinator and the development of a true whole of government campaign plan was essential. None of this comes naturally in the U.S. government.

3. Law enforcement remains perhaps the most neglected tool of national power. We found that enforcing the law against state directed illicit activities and finances was a highly effective, non-sanctions based way of pressuring North Korean leaders. The strategy remains relevant today.

   Law enforcement also can be used to enhance Treasury's effort to pressure financial and business leaders to comply with executive orders and sanctions. Banks and bankers that break the law in support of adversaries should be held legally accountable. In the case of money laundering for the Iranian government, for example, the Justice Department and the Treasury Department have investigated and fined numerous banks for falsifying billions of dollars in wire transfers and "stripping" data from financial accounts corresponding with banks in the United States. Rather than just levying fines, there should be serious prosecutions of these banks and bankers for illicit conduct. Arrests and prosecutions would send a stronger, more credible and effective message to financial institutions that earn billions of dollars per year and see fines as merely "the cost of doing illicit business." Finally, the use of the USA Patriot Act Section 311 remains a potent regulatory enforcement tool as was shown last month against the Lebanese Canadian Bank, which laundered hundreds of millions of dollars for drug trafficking organizations linked to Hezbollah.

4. Economic coercive diplomacy is a matter of national security and national defense and the DoD needs to get smart about how to use it. Economic coercive diplomacy constitutes what the DOD calls an "economy of force" - a way of fighting and defending at relatively low expense - or avoiding the conventional fight altogether. It is being employed to considerable effect in a military context in interagency counter threat finance cells in Iraq and Afghanistan. However, there is much more that can be done to use economic and financial lines of operation within and outside of war zones and conflict areas. Attacking an enemy's economic depth, lines of communication, and its leaders' finances proved viable and important in the Balkans, in Iraq, and in North Korea. It should be a larger part of current military campaigns. Around 44 BC Roman Philosopher-statesman Marcus Tullius Cicero wrote, "Endless money forms the sinew of war." Cicero's insight remains relevant today.

5. The power of economic and financial coercive diplomacy can be underestimated. The Iraq case in particular is an instance where the pressure strategy succeeded but, ironically, was perceived to have been a failure. Had policymakers known how well they had defanged Saddam's regime there would have been no need for an invasion of Iraq in 2003. Likewise, in 2005-2006 we had the Kim Jong Il regime's finances in a vice. Had this leverage been amplified I have little doubt that the ground would have started to weaken under Kim Jong Il's feet and he would have been compelled to make a strategic choice. But, had he not reacted positively we had the credible means prepared and planned to bring decisive forces of change to bear against him – without firing a shot.

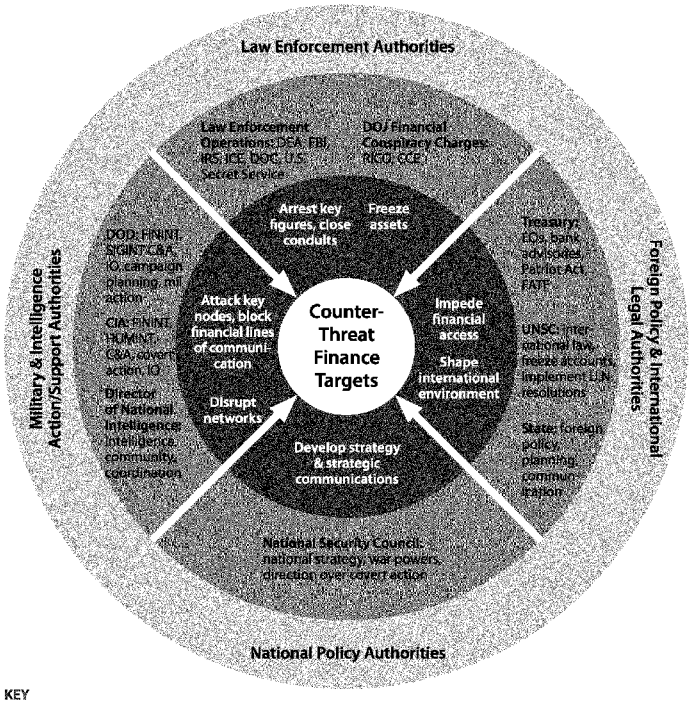
> Given the increasing danger that North Korea will use its growing stockpile of enriched uranium to provide Iran the materiel that successful denial, interdiction and systemic sabotage appear to have forestalled, North Korea's continued proliferation is clearly a geo-strategic disaster in the making. There is an obvious need to re-launch the Illicit Activities Initiative – focused both on applying active pressure against the regime in Pyongyang and it proliferation activities and related finances. We proposed taking down North Korea's WMD networks repeatedly between 2003-2005, in concert with action against the AQ Khan network, and today the imperative is far greater than before. U.N. Sanctions and Treasury designations have complicated, but certainly not eliminated, these networks and today they simply cannot be allowed to exist.

Our CNAS report concludes that effectively applying pressure on a network, an organization, or a state requires a stratified, sequenced, and blended approach, incorporating a mix of national and international legal authorities and capabilities in a well-planned campaign strategy. True interagency planning and execution remain the biggest challenges today for the U.S. government. Even toward critical threats like Iran and North Korea, or in support of national security objectives in Afghanistan or Libya, many aspects of national and international financial and economic power are underutilized or not applied effectively. The National Security Council needs to be more imaginative and operational in coordinating the development and use of financial pressure strategies. I believe a special assistant for counter-threat finance position should be established to oversee whole-of-government planning and coordinate interagency activities. Especially in this resource-constrained era, we need to be prepared to financially go to war with our enemies as an alternative to dropping bombs and deploying troops.

I ask the Committee to consider the following graphic from our report that attempts to illuminate what a true whole of government approach entails and use it as a metric to measure past, current, and future efforts.

I look forward to your questions, comments, and opinions.

COUNTER-THREAT FINANCE: BALANCING NATIONAL SECURITY RESOURCES




KEY

**C&A:** Collection and Analysis

**CCE:** Continuing Criminal Enterprise

**DEA:** Drug Enforcement Administration

**DOC:** Department of Commerce

**DOJ:** Department of Justice

**EO:** Executive Order

**FATF:** Financial Action Task Force

**FININT:** financial intelligence

**HUMINT:** human intelligence

**ICE:** U.S. Immigration and Customs Enforcement

**IO:** Information Operations

**RICO:** Racketeer Influenced and Corrupt Organizations Act

**SIGINT:** signals intelligence

**UNSC:** United Nations Security Council

## Background on the North Korea Illicit Activities Initiative, 2001-2005

Between 2002-2006 the U.S. government organized a multi-agency and multinational initiative to restrict the illicit activities and finances of the Kim Jong Il regime in North Korea. The Illicit Activities Initiative (IAI) sought to pressure Kim Jong Il to back away from his nuclear development and proliferation programs. It aimed to undercut the Kim regime's ability to profit from illicit activities. By impeding the regime's misuse of the international financial and trading system and threatening its accumulated fortune deposited in overseas banks, the initiative sought to create leverage over Pyongyang, without resorting to conventional coercive strategies – such as large-scale threats of military attack – or employing broader economic sanctions (for which it would be difficult to garner international support, let alone effectively enforce).

As a senior advisor to former Assistant Secretary of State for East Asian and Pacific Affairs James Kelly, I led this initiative under Kelly's direction. I also served as the North Korea working group coordinator, reporting directly to former Deputy Secretary of State Richard Armitage, and in 2004-2005, co-chaired a special policy coordinating commit- tee at the National Security Council called the North Korean activities group (NORKAG).

The Illicit Activities Initiative (IAI) ultimately involved 14 different U.S. government departments and agencies, 15 foreign government partners and more than 200 policy officials, intelligence analysts and law enforcement officers around the world. In addition to wide ranging and sensitive diplomatic efforts to curtail North Korea's illicit financing and weapons proliferation, the IAI featured multiple international law enforcement investigations, including two of the largest undercover Asian organized crime cases in U.S. history, and the innovative use of Treasury Department authorities in conjunction with those investigations.

The IAI drove North Korea out of a range of criminal businesses and cut the nation's illicit trading companies and leadership off from bank accounts around the world. Through the IAI, the U.S. government generated significant diplomatic leverage over North Korea, a point made clear by the regime's reaction to the imposition in September 2005 of the Patriot Act's section 311 against Banco Delta Asia, a Macau bank accused of laundering money for the Kim regime and other North Korea entities. I believe that if this leverage been sustained and used effectively, North Korea's ability to defy international rules and norms could have been crippled, compelling Kim Jong Il to make a strategic choice toward denuclearization.

CONGRESSIONAL TESTIMONY

**Financial Hardball: Corralling Terrorists and Proliferators**
Prepared Statement of Dr. David Asher

Center for a New American Security

Biography

**David Asher**
**Non-Resident Senior Fellow, Center for a New American Security**

Dr. David Asher is a Non-Resident Senior Fellow at CNAS, where he specializes in issues related to Asia, economics and security.
Dr. Asher has worked extensively as a subject matter expert on countering illicit financial networks and trans-national threats for the U.S. government, including advising OSD Policy, U.S Special Operations Command, Central Command, and the Drug Enforcement Administration. From 2001-2005, Dr. Asher served as Senior Adviser for East Asian and Pacific Affairs and coordinator of the North Korea Working Group at the State Department, where he helped plan and participated in the Six Party Talks. He also directed the North Korea Activities Group at the National Security Council, overseeing the Bush administration's strategy against the Kim Jong Il regime's illicit activities and finances.

Dr. Asher has a deep background in Asian economic and security relations and is fluent in Japanese. From 1999-2001, he was a resident fellow and Associate Director of the Asian Studies Program at the American Enterprise Institute and from 1998-99 he was a fellow with the Center for International Studies and the Japan Program at the Massachusetts Institute of Technology. From 1994-95 he was assigned to the East Asian Affairs office in the Pentagon, supporting the development of the U.S.-Japan "Nye Initiative" to update the bilateral security alliance. From 1990-1993, he ran a congressional task force on U.S.-Japan economic relations. Over the last 20 years, David also has worked as a principal, strategist, and management consultant in the financial services and asset management industries, focused on Asia.

He graduated from Cornell University and received his doctorate in International Relations from the University of Oxford. His doctoral dissertation examined the failure of economic reform in interwar Japan and the rise of military nationalism.

Mr. DUNCAN. Thank you.
Professor Kittrie is recognized for 5 minutes.

## STATEMENT OF PROFESSOR ORDE F. KITTRIE, SANDRA DAY O'CONNOR COLLEGE OF LAW, ARIZONA STATE UNIVERSITY

Mr. KITTRIE. Thank you, Mr. Duncan, Ranking Member Sherman. Thank you for the invitation.

It is a pleasure to be here today. Since you have such great experts alongside me on North Korea and terrorism finance in David Asher and Juan Zarate, who literally have those topics covered from A to Z, and I primarily follow Iran issues, I will focus my remarks on the application of sanctions to Iran.

U.S. Government officials have stated that the current sanctions on Iran are designed to both coerce and constrain Iran. How is the international community, led by the U.S., doing in achieving those goals?

With regard to coercion, while sanctions on Iran have undoubtedly increased the costs to Iran of its illegal behavior, they have

clearly not raised the costs sufficiently to outweigh the benefits to the Iranian regime of proceeding with its nuclear program and state sponsorship of terrorism. We know that because Iran is clearly still choosing to proceed with both.

The bottom line with regard to the efforts to constrain Iran is that, while Iran's capacity to pursue its illicit behavior is undoubtedly being hindered, it is clearly still making progress, albeit somewhat more slowly, toward its illicit goals.

What more needs to be done if we are to tip the balance and succeed in both coercing Iran and halting its capacity to conduct illicit activities? I have detailed in my written testimony several ideas for tipping that balance. The following are some highlights, which I would be happy to discuss in more detail during Q&A.

In light of the hearing's title, I will start with some financial measures.

Number one, sanctioning the Central Bank of Iran. In light of the key role played by the Central Bank of Iran in financing Iran's illicit state sponsorship of terrorism and illicit proliferation activities, the imposition of sanctions on the Central Bank, ideally in conjunction with key allies, is looking like an increasingly smart option.

Number two, curtail Iran's ability to issue bonds. With most major international banks and energy companies having stopped doing business with Iran, it is harder for Iran to attract the investment it needs to develop its energy sector. In response, as Ranking Minority Member Sherman mentioned, Iran recently announced the issuance of billions of dollars in bonds to support development of its South Pars natural gas field.

The Stop Iran's Nuclear Weapons Program Act, H.R. 6296, which was introduced in the last Congress by the chair and ranking member of this subcommittee, would address this by making sanctionable the buying or facilitating of Iranian bonds. I am glad to hear that excellent bill is going to be reintroduced soon, and I hope it gains the widespread support it deserves.

Number three, probably the most important steps to be taken to ratchet up the pressure on Iran involve China. Only some of the steps involve financial sanctions, but I will mention them all because they are so important.

China is reportedly failing to comply with the several U.N. Security Council resolutions which prohibit the transfer to Iran of proliferation-sensitive equipment and materials.

Robert Einhorn, the State Department's Special Advisor for Nonproliferation and Arms Control, last month stated that, "We continue to have concerns about the transfer of proliferation-sensitive equipment and materials to Iran by Chinese companies."

Such transactions are crucially important to the Iranian nuclear program, which reportedly is still dependent on the import of high-strength maraging steel, vacuum pumps, and other critical items.

In light of the continued contributions by some Chinese companies to Iran's proliferation activities, it may be wise to sanction those companies, for example, under the Iran, Syria, North Korea Nonproliferation Act and/or Executive Order 13382.

It may also be worth considering a more systemic response, such as assessing whether China meets the criteria set forth in CISADA for designation as a destination of diversion concern.

Chinese banks are also reportedly involved in violating sanctions on Iran, including by facilitating the provision to Iran of restricted technology and materials.

A failure to take decisive action in response to Chinese violations and backfilling provides Iran with an important loophole in the sanctions regime. It also risks undercutting the more helpful compliance records of other companies and countries.

A fourth and final idea I would highlight involves hindering Iran's ability to benefit from crude oil sales. Doing to Iran's crude oil exports what CISADA did to Iran's refined petroleum imports could have an enormous impact on Iran. Crude oil exports are the lifeblood of the Iranian regime, reportedly accounting for 80 percent of Iran's export earnings and a quarter of its GDP.

In light of the current worldwide price of crude, I don't see much support out there for a blanket sanctioning of all companies that are involved with Iran's crude oil exports. However, there are measures short of such blanket sanctions that might be able to hinder the Iranian regime's ability to benefit from its crude oil sales without depriving the world market of so much Iranian crude.

These measures include Treasury publicly identifying IRGC subsidiaries which are involved in Iran's crude oil export chain and enactment of the provision in H.R. 6296, introduced by the chair and ranking member that would sanction entities that pay in advance for oil deliveries or sign long-term contracts to purchase oil and gas from Iran. If members of the international community have to buy Iranian crude oil and natural gas, they should at least do so on a cash basis, without long-term commitment, lest they provide the Iranian Government with a financial lifeline it doesn't deserve.

There is plenty of work to be done if we are to tip the balance and succeed in our efforts to peacefully coerce and constrain the Iranian regime and achieve a halt to its illicit nuclear weapons program and support for terrorism.

Thank you.

[The prepared statement of Mr. Kittrie follows:]

**Written Testimony**

**Orde F. Kittrie, Esq.**

**Professor, Sandra Day O'Connor College of Law, Arizona State University**

**Before the United States House of Representatives**
**Committee on Foreign Affairs**
**Subcommittee on Terrorism, Nonproliferation & Trade**

**At a Hearing titled**

**"Financial Hardball: Corralling Terrorists and Proliferators"**

**April 6, 2011**

Chairman Royce, Ranking Member Sherman, and distinguished members of the Subcommittee, thank you for the opportunity to speak with you about financial sanctions. It's a pleasure to be here today, especially alongside such distinguished colleagues. I follow Iran issues far more closely than I do North Korea, so I will focus in my remarks on the application of sanctions to Iran. I will open with an overview of U.S. sanctions on Iran and their impact. The financial sanctions on Iran are one piece of a broader set of sanctions on Iran, and can only be understood in that broader context, so I will address that broader context as well as the specifics of the financial sanctions on Iran. I will then turn to making a series of recommendations for next steps with regard to U.S. sanctions on Iran, with an emphasis on financial sanctions. The standard caveat applies that this presentation is in my personal capacity and doesn't necessarily represent the views of any of my employers, past or present.

## I. The Current U.S. Sanctions on Iran: Goals and Progress

What are the goals of the current U.S. sanctions on Iran, and what kind of progress is being made towards achieving those goals?

The U.S. government's current sanctions on Iran are designed to both coerce and constrain Iran.[1] Sanctions can coerce a target (in this case Iran) into halting its illegal behavior,

[1] *See, e.g.*, Press Release, *U.S. Dep't of the Treasury, Remarks at the Center for Strategic and International Studies by Treasury Under Secretary for Terrorism and Financial Intelligence Stuart Levey* (Sept. 20, 2010), available at http://www.ustreas.gov/press/releases/tg862.htm (Levey emphasizes two desired impacts of the Obama Administration's tightening sanctions on Iran. One is "to sharpen the choice for Iran's leaders between integration with the international community, predicated on fulfilling their international obligations, and the hardship of further isolation." Levey explains that "[b]y dramatically isolating Iran financially and commercially and by capitalizing on Iran's existing vulnerabilities, we can impact Iran's calculations" so as to "create crucial leverage for our

if the costs of the behavior (in this case proceeding with its nuclear program or supporting terrorism) are increased sufficiently to outweigh the benefits to the regime of proceeding with the behavior. Sanctions can constrain a target from engaging in illegal behavior, if the sanctions materially reduce the target's supply of assets necessary to engage in the behavior.[2]

How are we doing in achieving those goals?

The bottom line with regard to the efforts to coerce Iran is that while sanctions on Iran have undoubtedly increased the cost to Iran of its illegal behavior, they have clearly not raised the costs sufficiently to outweigh the benefits to the Iranian regime of proceeding with its nuclear program and state sponsorship of terrorism. We know that because Iran is clearly still choosing to proceed with both its nuclear program and its state sponsorship of terrorism.

The bottom line with regard to the efforts to constrain Iran is that while Iran's capacity to pursue its illicit behavior has undoubtedly been hindered it is clearly still making progress, albeit somewhat more slowly, towards its illicit goals.

So, how are financial sanctions on Iran *contributing* to raising the cost to Iran and constraining Iran, and what more needs to be done if we are to tip the balance and succeed in both coercing Iran and halting its capacity?

The U.S. Department of the Treasury has convinced more than eighty banks around the world, including most of the world's top financial institutions,[3] to cease some or all of their business with Iran.[4] The tactics Treasury is using were designed and first implemented under the George W. Bush administration.[5] However, the Obama Administration cast a strong vote of confidence in them, including by taking the extraordinary decision to retain in place Stuart Levey, the Bush-appointed Under Secretary of the Treasury, principally known as the leading architect of these financial sanctions, who returned to the private sector just a few weeks ago.[6]

What is Treasury's rationale for pressuring foreign banks to curtail their business dealings with Iran?[7] Iran utilizes the international financial system to advance both its nuclear program

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diplomacy." Another desired impact is to "make it harder for Iran to pursue international procurement for its nuclear and military programs.").

[2] Readers interested in a more detailed discussion of the goals potentially served by the imposition of sanctions in the international arena may wish to refer to Orde F. Kittrie, *Averting Catastrophe: Why the Nuclear Nonproliferation Treaty is Losing its Deterrence Capacity and How to Restore It*, 28 MICH. J. INT'L L. 337, 354–61 (2007), **http://ssrn.com/abstract=996953** .

[3] Orde F. Kittrie, *New Sanctions for a New Century: Treasury's Innovative use of Financial Sanctions*, 30 U. PA. J. INT'L L. 789–822 (2009), http://ssrn.com/abstract=1402265.

[4] *See* Robin Wright, Stuart Levy's War, N.Y. TIMES MAG., Nov. 2. 2008, at 31.

[5] *See, e.g., id.,* Kittrie *supra* note 3.

[6] Paul Richter, *Obama Administration Keeps Bush Official Involved with Iran Sanctions*, L.A. TIMES (Feb. 3, 2009), http://articles.latimes.com/2009/feb/03/world/fg-usiran3 ("The Obama administration has decided to retain the official who led the Bush administration's effort to squeeze Iran with economic sanctions, providing an important clue on how it intends to approach the Islamic Republic.").

[7] Readers interested in a more detailed discussion of the U.S. Treasury Department's innovative campaign to persuade banks to curtail their business with Iran may wish to refer to Orde F. Kittrie, *New Sanctions for a New*

and its state sponsorship of terrorism. In order to avoid suspicion and minimize the risk of detection, Iran's state-owned banks and other entities use an array of deceptive practices when using their global financial ties to advance Iran's nuclear program and sponsorship of terrorism. For example, Iran uses front companies and intermediaries to surreptitiously obtain technology and materials for its nuclear and missile programs from countries that would prohibit such exports to Iran.[8] In addition, Iranian banks ask other financial institutions to remove the Iranian banks' names when processing their transactions through the international financial system.[9] The goal is to allow Iranian banks to remain undetected as they move money through the international financial system to pay for the Iranian government's nuclear and missile related purchases and to fund terrorism.[10]

What accounts for Treasury's considerable success in persuading foreign banks to stop doing business with Iran? Treasury's principal innovation can be described as follows: Rather than asking, e.g., the Swiss government to order its banks to stop doing business with Iran, the Treasury has gone directly to the Swiss banks. Treasury has found that its unprecedented direct outreach to a country's key private financial institutions can yield results much more quickly than does outreach to that same country's government, which can lack political will or the necessary authority, or may face cumbersome bureaucratic procedures for exercising whatever relevant authorities it does have.[11] Once some foreign private financial institutions decide to halt business with entities or individuals of concern, the reputational risk for others not to follow is increased, and those who have halted business with Iran often cooperate with the U.S. in putting pressure on those who have not yet done so.[12] Other banks within the jurisdiction soon follow.[13] Such private sector decisions can in turn make it more politically feasible for foreign governments to impose restrictions because some or all of the major relevant companies in their jurisdiction have already forgone the business.[14]

What does the Treasury Department say to the foreign banks to get them to stop doing business with Iran? Treasury officials remind the foreign banks of the risks of doing even prima facie legal business with Iran.[15] The banks with which the Treasury Department communicates are already aware of the prosecutions the Treasury has brought against other banks. For example, in May 2004, the Federal Reserve fined UBS, Switzerland's largest bank, $100 million for sending U.S. dollars to Cuba, Iran, Libya, and Yugoslavia, and intentionally hiding the

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*Century: Treasury's Innovative use of Financial Sanctions*, 30 U. PA. J. INT'L L. 789–822 (2009), http://ssrn.com/abstract=1402265, from which this discussion is adapted.

[8] *See Between Feckless and Reckless: U.S. Policy Options to Prevent a Nuclear Iran: Joint Hearing Before the Subcomm. on the Middle East and South Asia, and the Subcomm. on Terrorism, Nonproliferation and Trade of the House Committee on Foreign Affairs*, 110th Cong. 28 (2008) (statement of Daniel Glaser, Deputy Assistant Secretary for Terrorist Financing and Financial Crimes, U.S. Dep't of Treasury), http://foreignaffairs.house.gov/110/41849.pdf .

[9] *Id.*

[10] *Id.*

[11] PRESS RELEASE, U.S. DEP'T OF TREASURY, REMARKS BY TREASURY SECRETARY PAULSON ON TARGETED FINANCIAL MEASURES TO PROTECT OUR NATIONAL SECURITY (June 14, 2007).

[12] *See id.*

[13] *See id.*

[14] Glaser statement, *supra* note 8.

[15] *Id.*

transactions by submitting false monthly reports to the Federal Reserve.[16] In December 2005, ABN Amro Bank NV, a Dutch firm, was fined $80 million by U.S. federal and state financial regulators for actions including modification by its branch in Dubai of payment instructions on wire transfers, letters of credit, and checks issued by Iran's Bank Melli and a Libyan bank in order to hide their involvement in the transactions and enable access to the U.S. banking system.[17] As one former Treasury official put it in 2008, the Treasury Department's success in persuading foreign banks to curtail transactions with Iran was due in part to those banks' eagerness "to avoid being the 'next ABN AMRO.'"[18]

Such prosecutions have continued under the Obama Administration. In January 2009, Lloyds TSB Bank had to pay the U.S. government $350 million in fines and forfeiture as a result of a scheme in which Lloyds altered or "stripped" wire-transfer information to hide the identities of Iranian and Sudanese clients in order to deceive American financial institutions and enable the clients to access the U.S. banking system.[19] The stripping of wire-transfer information "made it appear that the transactions originated at Lloyds TSB Bank" in the U.K. rather than in the sanctioned countries.[20] Most recently, in August 2010, Barclays PLC agreed to a $298 million settlement with U.S. prosecutors in connection with allegations that it violated U.S. financial sanctions against countries including Iran.[21]

What has been the impact on Iran of the pressure on foreign banks doing business with Iran? According to former Under Secretary of the Treasury Stuart Levey, Iran is "effectively unable to access financial services from reputable banks and is finding it increasingly difficult to conduct major transactions in dollars or euros."[22] The challenges of doing business with Iran are "leading major companies across the range of industry, finance, engineering, energy, manufacturing, automobile, insurance, accounting firms" to announce that they are curtailing their business dealings with Iran.[23] Levey noted that "Iran's reduced access to international financial system has also made it very difficult for Iran to make payments on loans and maintain insurance coverage on IRISL ships" and this is having an impact on IRISL's ability to continue operations and even led to the seizure of some IRISL ships by its creditors.[24] With most leading foreign banks curtailing their business with Iran, Iranian companies and their business partners

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[16] *See UBS Fined $100 Million Over Trading of Dollars*, N.Y. TIMES, May 11, 2004, at C17.

[17] Paul Blustein, *Dutch Bank Fined for Iran, Libya Transactions: $80 Million Levied for Foreign Dealings, Money Laundering*, WASH. POST (Dec. 20, 2005, 5:09 PM), http://www.washingtonpost.com/wp-dyn/content/article/2005/12/19/AR2005121901804.html . Between December 2001 and April 2004, ABN AMRO's overseas branches removed or revised references to entities in which the governments of Libya and Iran had an interest before forwarding wire transfers, letters of credit and U.S. dollar checks to ABN AMRO branches in New York, NY and Chicago, IL. OFFICE OF FOREIGN ASSETS CONTROL, DEP'T OF TREASURY, ENFORCEMENT INFORMATION (Jan. 3, 2006).

[18] Michael Jacobson, *Sanctions Against Iran: A Promising Struggle*, 31 WASH. Q. 69, 73 (2008).

[19] Chad Bray, *Lloyds TSB Settles with U.S. Officials*, WALL ST. J., Jan 10, 2009, at B8.

[20] *Id.*

[21] *Barclays Deal with U.S. Over Trade Sanctions is Approved*, N.Y. TIMES, Aug. 19, 2010, at B9.

[22] *Hearing on Iran Sanctions, House Committee on Foreign Affairs*, December 1, 2010 (testimony of Under Secretary Stuart Levey).

[23] *Id.*

[24] *Id.*

are finding it difficult to arrange letters of credit, a central requirement for conducting trade.[25] Many companies doing business in or with Iran have been forced to use smaller banks or go through intermediaries to arrange new letters of credit, adding twenty to thirty percent to their costs.[26]

So the financial sanctions currently in place on Iran have clearly increased the cost to Iran of its illegal behavior, and undoubtedly have hindered that behavior by costing Iran money and complicating its economic transactions. The other sanctions on Iran have had a similarly significant but non-dispositive impact. These include the U.N. and other international sanctions aimed at hindering Iran's proliferation as well as the U.S. sanctions -- set forth principally in the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010 (CISADA) – which are aimed at leveraging Iran's dependence on imported refined petroleum. All of these sanctions, combined, have clearly not raised Iran's costs sufficiently to outweigh the benefits to the Iranian regime of proceeding with its nuclear program and state sponsorship of terrorism. Nor have they succeeded in so constraining Iran's illicit programs that progress has become impossible. We know that because Iran is clearly still choosing to proceed with both its nuclear program and its state sponsorship of terrorism, and is still making progress, albeit somewhat more slowly, towards its illicit goals.[27]

What more needs to be done if we are to tip the balance and succeed in both coercing Iran and halting its capacity?

President Obama's National Security Advisor, Tom Donilon, in his March 29 speech to the Carnegie International Nuclear Policy Conference, stated as follows: "Unless and until Iran complies with its obligations under the NPT and all relevant UN Security Council resolutions, we will continue to ratchet up the pressure."[28]

I don't know what alternatives the NSC is considering for ratcheting up that pressure, and I certainly don't speak for anybody but myself here today. However, I have read closely the options being suggested in Congressional bills, and by my colleagues in the academic and think tank communities. The following are some of the most interesting ideas I have seen for tipping the balance towards succeeding in both coercing Iran and halting its capacity to pursue proliferation and state sponsorship of terrorism. In my personal opinion, these are options well worth considering.

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[25] *See, e.g.*, Mark Trevelyan, *More Companies Suspend Business with Iran*, INT'L HERALD TRIB., Jan. 17, 2008, at 15 (quoting a senior German banking and finance consultant as stating that "[i]t is today impossible more or less in Europe, with a couple of exceptions, to get a letter of credit" for trade with Iran); *No Letters of Credit, No Steel for Iranian Importers, say Traders*, METAL BULLETIN WEEKLY, Sept. 13, 2010, http://www.metalbulletin.co.uk/Article/2675316/No-letters-of-credit-no-steel-for-Iranian-importers-say-traders.html.

[26] Michael Jacobson, *Putting the Squeeze on Iran*, THE GUARDIAN ONLINE, July 22, 2008, http://www.guardian.co.uk/commentisfree/2008/jul/22/iran.usforeignpolicy.

[27] *See, e.g.*, Arms Control Association, *The Impact of Sanctions on Iran's Nuclear Program*, March 9, 2011 (transcript of a presentation by Robert J. Einhorn, Special Advisor for Nonproliferation and Arms Control, U.S. Department of State), http://www.armscontrol.org/events/RoleSanctionsIranNuclear .

[28] http://iipdigital.usembassy.gov/st/english/texttrans/2011/03/20110330120145su5.553401e-02.html .

## II. Options for Ramping Up the Pressure on Iran

### A. Respond Vigorously to Chinese Violations and Backfilling

China is reportedly failing to comply with the several UN Security Council Resolutions which prohibit the transfer to Iran of proliferation-sensitive equipment and materials. Robert Einhorn, the State Department's Special Advisor for Nonproliferation and Arms Control, last month stated that "we continue to have concerns about the transfer of proliferation-sensitive equipment and materials to Iran by Chinese companies."[29] On a visit to Beijing last September, Einhorn reportedly discussed with Chinese officials the concern that various Chinese companies were violating UN sanctions against Iran[30] and handed them a "significant list" of Chinese firms that the Obama Administration thinks are violating the UN sanctions on Iran.[31] In January, David Albright, a leading expert on Iran's nuclear program, stated that the Chinese government's lax oversight enables Iran to purchase from Chinese companies "a large amount" of proliferation-sensitive equipment and material.[32] Such transactions are crucially important to the Iranian nuclear program, which reportedly is still dependent on the import of high-strength maraging steel, vacuum pumps, and other critical items.[33]

Some of the equipment and material making its way to Iran by way of China reportedly originates with European companies who are duped into selling it to Chinese companies that are fronting for Iranian smugglers.[34] U.S. officials reportedly believe that at least some of the transfers to Iran may be taking place without the knowledge of the Chinese government, and thus are the result of lax oversight and weak enforcement rather than a Chinese government desire to help Iran.[35] Over the last twenty years, the U.S. government has sanctioned dozens of Chinese

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[29] *See, e.g.*, Arms Control Association, *The Impact of Sanctions on Iran's Nuclear Program*, March 9, 2011 (transcript of a presentation by Robert J. Einhorn, Special Advisor for Nonproliferation and Arms Control, U.S. Department of State), http://www.armscontrol.org/events/RoleSanctionsIranNuclear .

[30] *See, e.g.*, Indira Lakshmanan, *U.S. Concerned Chinese Companies May be Aiding Iran's Nuclear Weapon Effort*, BLOOMBERG, March 10, 2011, http://www.bloomberg.com/news/2011-03-10/u-s-concerned-chinese-companies-may-be-aiding-iran-nuclear-weapon-effort.html .

[31] John Pomfret, *U.S. Says Chinese Businesses and Banks Are Bypassing U.N. Sanctions Against Iran*, WASHINGTON POST, October 18, 2010, at http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703364_pf.html .

[32] Indira Lakshmanan, *China Failing to Enforce Nuclear-Weapon Sanctions on Iran, Expert Says*, BLOOMBERG, January 14, 2011, http://www.bloomberg.com/news/print/2011-01-14/china-failing-to-enforce-sanctions-on-iran-s-nuclear-program-expert-says.html .

[33] *Id.*

[34] *Id.*

[35] *See, e.g.*, Indira Lakshmanan, *U.S. Concerned Chinese Companies May be Aiding Iran's Nuclear Weapon Effort*, BLOOMBERG, March 10, 2011, http://www.bloomberg.com/news/2011-03-10/u-s-concerned-chinese-companies-may-be-aiding-iran-nuclear-weapon-effort.html; John Pomfret, *U.S. Says Chinese Businesses and Banks Are Bypassing U.N. Sanctions Against Iran*, WASHINGTON POST, October 18, 2010, at http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703364_pf.html .

companies for Iran-related proliferation activities.[36] **In light of the continued contributions by some Chinese companies to Iran's proliferation activities, it may be wise to strongly consider sanctioning additional Chinese companies, for example under the Iran-Syria-North Korea Nonproliferation Act and/or Executive Order 13382. It may also be worth considering a more systemic response, such as assessing whether China meets the criteria set forth in CISADA for designation as a Destination of Diversion Concern.**

Chinese *banks* are also reportedly involved in violating sanctions on Iran, including by facilitating the provision to Iran of restricted technology and materials.[37] In addition, while Einhorn on March 9 expressed less concern about Chinese energy cooperation with Iran, stating that Beijing appears to have taken a "cautious, go-slow approach,"[38] on March 10 ten U.S. Senators wrote to Secretary Clinton to express concern that "Chinese firms in the energy and banking sectors have conducted significant activity in violation of U.S. law."[39] **If Chinese banks are either directly facilitating Iranian proliferation or backfilling behind other countries' banks that have responsibly exited the Iranian market, they could be subject to the requisite sanctions. Similarly, if Chinese energy companies are persisting in doing business with Iran's energy sector in a manner inconsistent with the Iran Sanctions Act, as amended by CISADA, they too could be sanctioned.** A failure to take decisive action in response to Chinese violations and backfilling risks undermining the more helpful sanctions compliance records of Europe and the governments of such countries as Japan, Canada, and Australia, as well as the scores of individual companies that have curtailed their business ties with Iran.

### B. Hinder Iran's Ability to Benefit from Crude Oil Sales

With world crude oil prices already sky high as a result of the turmoil in the Middle East, this is obviously a very sensitive topic. Doing to Iran's crude oil exports what CISADA did to Iran's refined petroleum imports could have an enormous impact on Iran. Crude oil exports are the lifeblood of the Iranian regime, reportedly accounting for 80 percent of Iran's export earnings and a quarter of its GDP.[40] However, in light of the current worldwide price of crude, I don't see much support out there for a blanket sanctioning of all companies that are involved with Iran's crude oil exports.

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[36] *See, e.g.*, John Pomfret, *U.S. Says Chinese Businesses and Banks Are Bypassing U.N. Sanctions Against Iran*, WASHINGTON POST, October 18, 2010, at http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703364_pf.html ; Mark Dubowitz & Laura Grossman, IRAN'S CHINESE ENERGY PARTNERS (2010), http://www.iranenergyproject.org/documents/1674.pdf (Annex A).

[37] John Pomfret, *U.S. Says Chinese Businesses and Banks Are Bypassing U.N. Sanctions Against Iran*, WASHINGTON POST, October 18, 2010, at http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703364_pf.html .

[38] Arms Control Association, *The Impact of Sanctions on Iran's Nuclear Program*, March 9, 2011 (transcript of a presentation by Robert J. Einhorn, Special Advisor for Nonproliferation and Arms Control, U.S. Department of State), http://www.armscontrol.org/events/RoleSanctionsIranNuclear .

[39] http://menendez.senate.gov/download/?id=f2fd53f6-d75f-4d16-b7d7-6d497c14617c .

[40] Mark Dubowitz, *Killing Iran's Energy Industry*, WALL STREET JOURNAL, January 2, 2011.

However, there are measures short of such blanket sanctions that might be able to hinder the Iranian regime's ability to benefit from its crude oil sales without depriving the world market of so much Iranian crude. The best work I have seen on this is being done by Mark Dubowitz at the Foundation for Defense of Democracies (FDD). Here are two of what I find to be the most intriguing ideas along these lines:

- Subsidiaries of the Iranian Revolutionary Guard Corps (IRGC), which is the backbone of the regime and its crackdown on dissidents, are reportedly involved in Iran's crude oil export chain and thus benefiting directly from Iran's crude oil profits.[41] Many of these subsidiaries may not yet have been specifically designated or listed by Treasury. It takes time and resources for Treasury to go through the process of publicly identifying IRGC subsidiaries. It may make sense to focus some of those resources on **publicly identifying IRGC subsidiaries which are involved in Iran's crude oil export chain**. If Iran as a whole is going to continue to benefit from its crude oil export revenues, we should at least make it as difficult as possible for the IRGC to receive those benefits. As Dubowitz points out, this would have the additional benefit of greatly intensifying the "hassle factor" in buying Iranian crude.[42]

- H.R. 6296, The Stop Iran's Nuclear Weapons Program Act, which was introduced in the last Congress by the chair and ranking member of this subcommittee, Congressmen Ed Royce and Brad Sherman, would **sanction entities that pay in advance for oil deliveries or sign long-term contracts to purchase oil and gas from Iran**. In 2003, Japan reportedly paid several billion dollars in cash for Iranian crude oil to be delivered over the course of several years.[43] EGL, a Swiss firm, reportedly signed a contract worth nearly $20 billion for future purchases of Iranian natural gas.[44] When the international community buys Iranian crude oil and natural gas, they should do so on a cash basis without long term commitment, lest they provide the Iranian government with a financial lifeline it doesn't deserve.

### C. Crack Down on the Central Bank of Iran

**In light of the key role played by the Central Bank of Iran (Bank Markazi) in financing Iran's illicit state sponsorship of terrorism and illicit proliferation activities, the imposition of sanctions on the Central Bank, ideally in conjunction with key allies, is looking like an increasingly good option.** Members of Congress have for years been calling

[41] *Id.*
[42] *Id.*
[43] *Summary of the Stop Iran's Nuclear Weapons Program Act.*
[44] *Id.*

for sanctions on the Central Bank of Iran. For example, in a "Sense of Congress" recommendation, CISADA "urges the President, in the strongest terms, to consider immediately using the authority of the President to impose sanctions on the Central Bank of Iran and any other Iranian financial institution engaged in proliferation activities or support of terrorist groups." In 2008, 26 Senators, led by Senator Chuck Schumer, called for Bank Markazi to be sanctioned because it is "heavily involved in the funding of terrorism and the financing of Iran's proliferation activities," and because of its role helping Iranian banks that have already been blacklisted to circumvent U.S. financial sanctions.[45]

Senior U.S. Treasury officials have also publicly identified Bank Markazi as engaged in money laundering activities.[46] In addition, in last year's Resolution 1929, the UN Security Council singled out the Central Bank of Iran, noting "the need to exercise vigilance over transactions involving Iranian banks, including the Central Bank of Iran, so as to prevent such transactions contributing to proliferation-sensitive nuclear activities, or to the development of nuclear weapon delivery systems." However, several European countries reportedly oppose sanctions against Iran's Central Bank as an extreme step that would prevent Iran from keeping its currency stable.[47]

Central banks should be sanctioned only in extraordinary circumstances.[48] However, this is such a circumstance. The Central Bank of Iran operates as an arm of the regime,[49] and its leadership has publicly admitted that the Central Bank is used to help other Iranian banks evade sanctions.[50] So long as the Central Bank of Iran is not included in U.S. sanctions, and has accounts with major European banks, it is able to utilize those banks' services on behalf of Iranian banks that have been sanctioned.[51] Iran is aggressively destabilizing its neighbors, including through state sponsorship of terrorism, and pursuing nuclear weapons contrary to international law. It should not be allowed to continue to use its Central Bank to pursue these aims.

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[45] Glenn R. Simpson, *Democrats Urge Sanctions on Iran's Central Bank*, WALL STREET JOURNAL, March 5, 2008, at A4.
[46] *See, e.g.*, Glenn R. Simpson, *U.S. Weighs Sanctions on Iran's Central Bank*, WALL STREET JOURNAL, February 25, 2008, at A1.
[47] *See, e.g.*, Kenneth Katzman, *Iran Sanctions*, February 3, 2011, at 34.
[48] Such a move would not be unprecedented, as the U.S. reportedly included the central bank of Iraq in its sanctions on that country during the 1990s. Glenn R. Simpson, *U.S. Weighs Sanctions on Iran's Central Bank*, WALL STREET JOURNAL, February 25, 2008, at A1.
[49] Glenn R. Simpson, *U.S. Weighs Sanctions on Iran's Central Bank*, WALL STREET JOURNAL, February 25, 2008, at A1.
[50] *Id.*
[51] *Id.*

**D. Fully Implement CISADA Section 104**

The principal CISADA provision addressing financial measures is section 104, which includes specific changes to U.S. law, as well as the previously referenced "Sense of Congress" recommendation regarding the Central Bank of Iran. According to the conference report on CISADA, these changes to U.S. law were "designed to impose considerable additional pressure on Iran by mandating a new financial sanction that, if implemented appropriately, will substantially reduce Iran's access to major segments of the global financial system." Nine months after enactment of CISADA Section 104, it is well worth asking whether Section 104 has been implemented fully and what its impact has been.

Section 104(c) requires Treasury to, within 90 days, issue regulations to prohibit, or impose strict conditions on, the opening or maintaining in the United States of a correspondent account or a payable-through account by a foreign financial institution that the Secretary finds knowingly engages in various types of activities facilitating specified Iran-related transactions. Section 104(d) requires Treasury to, within 90 days, issue regulations to prohibit any person owned or controlled by a domestic financial institution from knowingly engaging in a transaction or transactions with or benefitting Iran's Revolutionary Guard Corps or any of its agents or affiliates whose property or interests in property are blocked pursuant to the International Emergency Economic Powers Act. This expands the reach of the Iranian Transactions Regulations (ITR) to prohibit certain activities undertaken by entities that are not "U.S. persons" under the ITR but are owned or controlled by a domestic financial institution.

The Section 104(c) and 104(d) regulations were issued in a timely manner. My understanding is that no financial institutions have yet been penalized for violation of either. However, that doesn't mean that these provisions have yet to have an impact. We know from other examples of Treasury's Iran sanctions work that Treasury can often achieve the desired goal – getting a company to stop doing proscribed business with Iran – by going to that company directly, informing it of the risk, and thereby securing an agreement that it will stop the proscribed business with Iran. My understanding is that this is being done with regard to CISADA section 104(c) in particular and that it is having a dramatic impact, with more and more banks all over the world making the decision to curtail their business with Iran.

Section 104(e) requires Treasury to issue regulations to require a domestic financial institution maintaining a correspondent account or payable-through account in the United States for a foreign financial institution to take steps to guard against the foreign financial institution being engaged in activities facilitating Iran-related financial transactions of the type listed in Section 104(c). Unlike with Sections 104(c) and 104(d), CISADA did not specify a deadline by which the Section 104(e) regulations must be issued. **However, it is now 9 months after enactment of CISADA and the regulations required by Section 104(e) have yet to be issued.**

**E. Curtail Iran's Ability to Issue Bonds**

With most major international banks and many major international energy companies having stopped doing business with Iran, it has become harder for Iran to attract the investment it needs to develop its energy sector. In response, Iran recently announced the issuance of billions of dollars in bonds to support development of the South Pars natural gas field.[52] **The Stop Iran's Nuclear Weapons Program Act, H.R. 6296, which was introduced in the last Congress by the chair and ranking member of this subcommittee, Congressmen Ed Royce and Brad Sherman, would address this by making sanctionable the buying or facilitating of sovereign debt of the Government of Iran, including Iranian governmental bonds, or debt, including bonds, of any entity owned or controlled by the Iranian government.**

**F. Require Disclosure to the SEC of Sanctionable Activities**

Several foreign companies which reportedly may be engaged in sanctionable business with Iran are listed on the New York Stock Exchange.[53] **The Iran Transparency and Accountability Act of 2010, H.R. 740, sponsored by Congressman Ted Deutch, would help deter such behavior by requiring companies to publicly disclose such sanctionable activity in their quarterly and annual reports to the Securities and Exchange Commission.**

**G. Confirm the New Leadership of Treasury's Office of Terrorism and Financial Intelligence**

The departure of Under Secretary Stuart Levey is a big loss for Treasury's Office of Terrorism and Financial Intelligence. However, the Obama Administration has nominated two exceptionally capable, knowledgeable, and experienced successors in David Cohen, the nominee for the Under Secretary position Levey vacated, and Daniel Glaser, the nominee to be Assistant Secretary for Terrorist Financing. They should be confirmed as soon as possible. This is no time to leave in limbo the leadership of Treasury's Office of Terrorism and Financial Intelligence.

There is plenty of work to be done if we are to tip the balance and succeed in our efforts to peacefully coerce and constrain the Iranian regime and achieve a halt to its illicit nuclear weapons program and support for terrorism. Thank you.

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[52] *See, e.g.*, Avi Jorisch and Lee Prisament, *Iran's Merry-Go-Bonds*, JERUSALEM POST, April 4, 2011, http://www.jpost.com/Opinion/Op-EdContributors/Article.aspx?id=215158 ; Michael Lynch, *Iran's bond sales for South Pars should be a stunning success*, Gerson-Lehrman Group, March 13, 2011, http://www.glgroup.com/News/Irans-bond-sales-for-South-Pars-should-be-a-stunning-success-52920.html.

[53] *See, e.g.*, Mark Dubowitz & Laura Grossman, IRAN'S CHINESE ENERGY PARTNERS (2010), http://www.iranenergyproject.org/documents/1674.pdf .

Mr. DUNCAN. Thank you, gentlemen, for a very timely testimony today.

And Mr. Zarate—have I pronounced that correctly? I wasn't here during the opening of that—you have written that China, Malaysia, Russia, Qatar, and Venezuela may serve as potential alternate banking outlets that would be willing to file U.S. pressure for economic or political reasons. And I know that was a few years ago, but the question I have for you is, have you changed your view, and if you could elaborate on your perspective there.

Mr. ZARATE. I have not. I think my diagnosis is that you have very real potential of the creation of alternate banking networks, what I call shadow banking networks or alliance of financial rogues, that are intended to circumvent existing legitimate financial controls on rogue behavior. And so could you very well have—and we have seen in the past—a merger of those rogues who are outside the legitimate financial system beginning to cooperate to provide each other the financial facilities to not only trade but then to reenter the financial system in a layered way, that is, to hide their activities but ultimately to gain access to the international financial system. That I think is a fundamental challenge to this very power that we developed.

And as Professor Kittrie mentioned, a major dimension of that is the challenge of China, which is a major economy now, the second-largest economy the world, which has a thriving banking sector and which is playing both sides of the fence in many ways, both wanting to be a legitimate financial power and wanting to play by the rules but also then facilitating activity that skates the line in terms of its international obligations. It is not just with respect to Iran but it is also North Korea, with some of the mining contracts and deals that have been made recently.

And so I think this is a major concern, and I think we need to not only shine the light on the individual entities that exist that are providing the services but also the regimes that provide the legitimacy for that kind of activity. That is why I think countries like Venezuela deserve greater scrutiny.

Mr. DUNCAN. As a follow-up, other than the countries mentioned, would you identify any other countries that may act in that same capacity?

Mr. ZARATE. Well, the first thing I would do in looking at the strategy is look at where there are legitimate alternate banking centers around the world and where are there potential outlets or safety valves for illegitimate financial actors who are trying to avoid the scrutiny in New York or London or Frankfort but may find financial institutions in places like Kuala Lumpur, Beijing, or in other capitals. So the first thing I would do in this context is map the world in terms of where there are outlets. And then I would start to look at where the particular institutions are being used or misused for purposes of illicit financial behavior.

We have seen some very good actions by the Treasury Department, for example, with joint ventures between Iran and Venezuela. I think that is helpful.

So I would continue to look for those points in the system that are the manifestations of that vulnerability, and I would shine a light on it. And you can do it in a variety of ways. As David men-

tioned, you can use not only Treasury tools but State Department tools, law enforcement tools. And there is a real sort of all-of-government approach that can be applied to this problem.

Mr. DUNCAN. I thank you for that.

The chair will now recognize the ranking member, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you.

For the record, I mentioned the importance of this proposed license to GE to repair the supposedly civilian aircraft. That would be bad enough. It certainly undercuts our argument that others should sanction Iran. But I should point out that four of the planes that will be the subject of this inspection and possible repair are owned by Mahan Air, which has already been designated by the U.S. Department of Commerce as a company of proliferation concern. It has already been designated similarly by the U.K. Government, and most in the field view it as an IRGC front company.

So if American companies can make a buck providing jet aircraft engine repair to an entity so deeply involved in the terrorist activities and proliferation activities of Iran, then it makes a mockery of everything we are discussing here today.

What I would like each of the witnesses to do is to submit by Friday, if at all possible, a list in as close to statutory language as possible of everything that should be added to the Stop Iran's Nuclear Weapons Program Act. Include mandatory designations of certain entities in Iran instead of leaving it to the administration to designate this or that bank or this or that company or this or that airline. Let's put them in by name.

I think you know me well enough to know that you should not be shy in your draftsmanship, and I look forward to getting your comments, and hopefully this will just add to the enthusiasm of our cosponsors.

One thing I want to focus on here are those sanctions that have an immediate affect. You know, the original idea of the Iran Sanctions Act, once known as the Iran-Libya Sanctions Act, was to deter investment in oil fields. Well, that affects revenue maybe a decade later, maybe a little less; and then the lack of revenue begins to pinch when you burn through your currency reserves. That is a long time.

What acts much more quickly is when Iran cannot get replacement parts for every elevator, for every oil pump, for every aircraft, et cetera.

I don't know which of the witnesses want to comment, but what can we do to have an immediate effect on whether things in Iran work or fail to work?

Mr. KITTRIE. Thanks, and thank you for the invitation to submit.

My own sense is that with regard to Iran the two things that can be done most quickly would be, one, to respond vigorously to Chinese violations and backfilling, as I mentioned. Iran still needs to purchase parts——

Mr. SHERMAN. Now, what would you tell the Chinese? You are going to be sending them a really strong letter or would we have to, say, find a day or a week when this or that boat filled with tennis shoes couldn't be inspected or unloaded in the L.A. Harbor.

What do you do to China, other than point your finger and look stern?

Mr. KITTRIE. I think probably the first thing to do would be to consider sanctioning those Chinese companies, for example, under the Iran, Syria, North Korea Nonproliferation Act or Executive Order 13382, that are involved in this activity.

Mr. SHERMAN. That would be a good first step. Although it is easy for companies to come up with aliases, even easier if their host governments cooperate. So that might work, depending upon how agile the company is.

Mr. KITTRIE. Well, it has been reported that at least some of the transfers to Iran may be taking place without the knowledge of the Chinese Government and are the result of a kind of lax oversight and weak enforcement. To the degree that that is true, it may help to encourage the Chinese to crack down. For instance, as I mentioned earlier it may be worth considering a more systemic response, such as assessing whether China meets the criteria set forth in CISADA for designation as a destination of diversion concern.

It has been reported that it has not just been parts and components manufactured in China that have ended up in Iran, but also some of these parts and components apparently originate with European companies who are duped into selling it to Chinese companies that are fronting for Iranian smugglers. To the degree that that may be happening also—and I have no information on that—to the degree that that may be happening also with U.S. origin parts and components, that would certainly bring China—or might bring China within the criteria for designation as a destination of diversion concern.

Mr. SHERMAN. Or maybe that should be specified by statute, which is more likely to occur than a State Department designation. I look forward to you including that on your list, even if you list it as nonrecommended.

Mr. Zarate.

Mr. ZARATE. Ranking Member Sherman, I would take the approach of picking targets and actions that have a strategic impact and a ripple affect, as opposed to doing things, designations, other activities that appear to be more "Whac-A-Mole" as you described with companies, individuals renaming themselves.

So I would recommend three categories of activities.

One, I think a Section 311 designation of the Central Bank of Iran, something I have been calling for a long time, I think that would have a dramatic ripple affect in terms of Iran's ability to finance its activities.

Second, I would pick a Chinese bank that is of grave concern and not only use it as a prompt for diplomatic discussions with the Chinese but hold the Sword of Damocles of some sort of designation or action against that Chinese bank.

Mr. SHERMAN. You want to pick one?

Mr. ZARATE. I am not in a position——

Mr. SHERMAN. I look forward to talking to you.

Mr. ZARATE [continuing]. To know all the ins and outs. But I would say a good place to start, sir, is the March 10th, 2011, letter from the senators concerned with this issue to the Secretary of

State which lays out a number of companies and banks of growing concerns.

Mr. SHERMAN. I would say if we want to actually do something we have got to pick one in Congress, and we have got to decide what sanctions would be applied and make them mandatory, with no waivers.

Mr. ZARATE. The one thing I would recommend, Congressman, is coordination with the administration. Because I think, again, this cannot be—in all seriousness, this cannot be a one-off action. It has to be part of an ongoing campaign.

Mr. SHERMAN. Did I mention this is the administration that wants to take affirmative action to license the repair of the aircraft, the very aircraft that were used to ferry the 9/11 highjackers in and out of Afghanistan?

Mr. ZARATE. Congressman, I don't disagree with you and sort of subscribe to your view of that decision as being a mistake, but I would say that a piece of legislation that has a singular action in it or a set of actions that doesn't have a commitment by the administration to make it part of a strategy and a pressure strategy that is going to be part of the leverage change to the decision making in Tehran——

Mr. SHERMAN. Sir, if we leave the decision making to this or the last administration, we will see Iran have a nuclear and then a thermonuclear device. There is no doubt about that.

Mr. ZARATE. Well, I agree with you, sir. There is an important role, and I mentioned in my testimony, for Congress to not only hold the executive's feet to the fire but also to push particular actions. But, again, having one-off, Whack-A-Mole actions is not the right approach. I think having strategic steps of the kind you mentioned and the kind that we are talking about here is really——

Mr. SHERMAN. Do any harm to whack a few moles while you are taking the strategic steps? And I see no reason to have a short bill when they will print a long bill for me for the same price.

Mr. Asher.

Ms. ASHER. Thank you very much, Congressman Sherman.

I would add a focus on the potential sources of nuclear weapons. Because what is missing from our picture right now is an understanding, based on our own experience and personal experience, is that the Government of North Korea, for example, blasted through every redline we ever delivered in the Six-Party Talks which I participated in and helped start as well as was involved in the pressure.

They really just—it was very, very difficult to stop them. They are sanctioned under the United Nations Security Council now. But I would sense that many entities that are sanctioned are still actually in business. They are operating under diplomatic cover, through the network of North Korean Embassies around the world and their commercial officers in the Embassies or their intelligence service. And there really needs to be a look at the potential connection of the dots between North Korea's rapidly growing supply of apparently highly enriched uranium or at least certainly enriched uranium which could be highly enriched and Iran's demand.

I just feel like the North Korea problems that have been sort of put off to the side, but you can't approach the Iran problem set as

seriously as I know you do and I know Chairman Royce does without understanding North Korea is the most likely source of nuclear material and even weapons to the Iranian regime in the world. And the Iranians, the more they get financially squeezed and the more the North Korean's economy erodes, supply and demand seems to set the price. I urge to you consider adding that to your legislation.

Mr. SHERMAN. Can you be more specific on the legislation? I realize the chairman has already indulged me with way too much time.

Ms. ASHER. Well, I think there should be serious review of the current sanctions and whether they actually have effectively crippled the companies which have been designated, to include Nom Chom Gong Corporation, ComEd, the missile company. Are these companies out of business or not?

I mean, one simple thing I saw a reporter do was just start making phone calls looking up numbers in the phonebooks in different countries, and people were answering the phones. So, obviously, somebody must be in business to some degree.

That is a problem, and that we may need to remedy perhaps through a further U.N. Security Council action or further unilateral U.S. action.

Mr. SHERMAN. My bill to revoke MFN for China might be called for here, and I yield back.

Ms. ASHER. I yield back.

Mr. ROYCE [presiding]. Thank you, Mr. Sherman.

Dr. David Asher, you call for relaunching the Illicit Activities Initiative. Last summer on a trip to South Korea, Secretary Clinton announced that the administration would take steps to tackle the illicit activity coming out of the North. Is there evidence of the type of coordinated campaign that you led in the past, the type of success we saw? Is there evidence of that? Because I haven't seen any.

Ms. ASHER. The ultimate evidence of the Illicit Activities Initiative was evidence. We developed tremendous undercover investigations through the Department of Justice with the State Department's full support.

And I sort of acted as a bit of an ambassador, opening doors for Department of Justice law enforcement officers globally, into 15 different countries, 5 global investigations. And at the end of the first term of the Bush administration—actually, at the beginning of the second term, I should say—it was decided essentially to remove that evidence from the judicial process.

We had two of the largest Asian organized crime cases in United States history, involving the Gambino crime family at one end, Chinese triads at the other, and the North Korean Government sort of in the middle. It was quite spectacular stuff. And although there were people arrested in some pretty interesting operations in the United States and elsewhere, the hand of North Korea was never fully identified.

Mr. ROYCE. You think that was for diplomatic reasons?

Ms. ASHER. It was for diplomatic reasons, and I seriously objected to it. Because it wasn't like the North Koreans didn't know they were engaged in counterfeiting the U.S. dollar, cooperation with organized crime groups, including Chinese triads, and work on illicit proliferation, which we approached as a criminal activity as well. There was preparation to bring criminal charges against

some of the proliferation networks down the road as well. So the question is, whatever happened to all that information?

Mr. ROYCE. Right.

Ms. ASHER. At the very least, I would encourage this administration to consider briefing the American people on what we learned and perhaps briefing the United Nation's Security Council, probably in the context of reexamining whether they should be back on the terrorism list.

I found the Cheonan incident, where the South Korean ship was sunk, vicious, savage, and absolutely inconsistent with a terrorist-type approach. I think that would cause North Korea some concern if it were coupled with revelations of some of the law enforcement information or restarting of an active initiative which involved, in our case, 14 different government agencies and departments and 15 government partners around the world. I can't imagine that is going on right now.

Mr. ROYCE. This takes me to an issue that we have long talked about in this committee. But you note that the Illicit Activities Initiative could have had a much broader impact to affect North Korea's proliferation activities. And, as you said, "we never were given sufficient latitude to have a deeper and sustained counterproliferation impact, and on repeated occasions were waved off from taking actions that were well within our mandate and authorities." You have laid out some of this, and I know a lot of it just from our engagement at the time. I remember how desperate the effort was to shut down what you were doing. What do you think drove that?

Ms. ASHER. I think there was—I have discussed this with several senior colleagues before. Part of it appears to be a misperception at the highest levels in the administration as to what was actually going on.

I recall a conversation I had with Secretary Powell at the very end of his time where he said, what do you mean? We are not doing this stuff?

I think that sometimes there were discussions—and this is in some of these memoirs which are coming out—at the principals' level during the Bush administration where they sort of agreed on something and then it sort of got—somehow it didn't quite happen.

I did co-chair a coordinating committee at the National Security Council in addition to being at State, and it was directly involved in this issue set.

Mr. ROYCE. It was a coordinated campaign that somebody shut down.

Ms. ASHER. We were essentially abbreviated, and then we were emasculated. And this was a problem. Because this was right when the North Korean Government was building illicitly a Syrian nuclear reactor. All sorts of very strange and extremely disturbing stuff was going on with Iran. We have heard about Burma in the press recently.

Mr. ROYCE. And you had them dead to rights. I was in Macau. I have seen the phony Treasury notes that were counterfeited by the North Koreans, our Treasury notes.

Ms. ASHER. Yeah. That was really a tool. The fact that they were engaged in illegal activities put them in their own trap. We thought it was almost essentially self-sanctioning. So all we had do,

without using sanctions, which we felt we couldn't get without the evidence coming out on nuclear proliferation, was just to start charging them for their own offenses, knowing that the leadership in North Korea itself was directly engaged in those activities.

Mr. ROYCE. Right.

Now, let me ask a question of Juan Zarate. You call in your testimony for deploying the 311 sanctions against Iran and its Central Bank. I talked about that in my opening statement. What is the holdup and does the fact that Section 311 sanctions were only just deployed after a 5-year hiatus reflect the difficulty of identifying targets, or is it the result of the restrictions that political considerations place on their use?

Mr. ZARATE. I think there are three issues, Congressman Royce.

I think, first, that was a tendency not to use 311 after Banco Delta Asia. There was a string of 311 actions that we used against bad banks in my tenure at the Treasury. And I think a tendency was shifted to use other tools, executive orders and other tools of financial suasion, which is fine, but there was less of an emphasis on the development of the use of 311.

Second, you have a concern about using a financial tool of this magnitude against the central bank of a country, which has never been done before and would call into question how the mechanics of that would actually work. And I think there are ways of crafting a 311 regulation that would allow you to get around some of the sensitivities of targeting a central bank while getting at the illicit activity that the Central Bank of Iran is actually facilitating.

Finally, I think there is a deeper policy question at play, which is how far are we willing to go to actually strangle the Iranian economy? Part of the challenge here has been a message and a policy decision that the efforts we would undertake publicly and diplomatically would be targeted at the regime itself.

Mr. ROYCE. Yeah, but we targeted Iraq's Central Bank under Saddam Hussein, so——

Mr. ZARATE. That is right. Again, this goes to the deep fundamental policy question. Will this be a maximalist pressure campaign that ultimately impacts the people in Iran or will we constrain ourselves to the effect we really don't want to demonstrate we are going after the whole of Iranian society? And so I think that is at play as well in the context of the debate about 311.

Mr. ROYCE. Mr. Zarate, I want to thank you and Dr. Asher and Mr. Kittrie and all of those who have been architects of a policy here that had great promise, great likelihood of success if fully deployed, in my opinion.

I hope you will continue to work in this direction. Because I think it is the least confrontational way in order to engage and prevent the types of proliferation activities that we have seen, for example, in North Korea. If they can't get the hard currency—we know from talking to detectors who worked in their military and their civilian government, if they can't get the hard currency, it is very difficult for them to buy the gyroscopes on the black market that they need for their missile systems. It is very difficult for them to pay for the type of hardware that they need to go forward.

So I want to thank you. We appreciate the time and expertise you brought to this; and when considering states like Iran and

North Korea, the stakes for us, frankly, do not get any higher. So we appreciate your insights in how to tackle the challenges that these two states pose, and we look forward to pressing the Obama administration on many of the points that you made here today.

This hearing is adjourned.

[Whereupon, at 4 o'clock p.m., the subcommittee was adjourned.]

# APPENDIX

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## Material Submitted for the Hearing Record

# SUBCOMMITTEE HEARING NOTICE
# COMMITTEE ON FOREIGN AFAIRS

*U.S. HOUSE OF REPRESENTATIVES*
*WASHINGTON, D.C. 20515*

**Subcommittee on Terrorism, Nonproliferation and Trade**
**Edward R. Royce (R-CA), Chairman**

April 5, 2011

You are respectfully requested to attend an OPEN hearing of the Subcommittee on Terrorism, Nonproliferation, and Trade, to be held in **Room 2172 of the Rayburn House Office Building (and available live, via the WEBCAST link on the Committee website at http://www.hcfa.house.gov):**

**DATE:** Wednesday, April 6, 2011

**TIME:** 3:00 p.m.

**SUBJECT:** Financial Hardball: Corralling Terrorists and Proliferators

**WITNESSES:** **Panel I**

Mr. Juan C. Zarate
Senior Adviser
Center for Strategic and International Studies
*(Former Deputy Assistant to the President and Deputy National Security Advisor for Combating Terrorism, and former Assistant Secretary for Terrorist Financing and Financial Crimes, U.S. Department of the Treasury)*

David Asher, Ph.D.
Non-Resident Senior Fellow
Center for a New American Security
*(Former Senior Adviser, East Asian and Pacific Affairs, and Coordinator, North Korea Working Group, U.S. Department of State)*

Professor Orde F. Kittrie
Sandra Day O'Connor College of Law
Arizona State University

**By Direction of the Chairman**

*The Committee on Foreign Affairs seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202/225-5021 at least four business days in advance of the event, whenever practicable. Questions with regard to special accommodations in general (including availability of Committee materials in alternative formats and assistive listening devices) may be directed to the Committee.*

## COMMITTEE ON FOREIGN AFFAIRS

MINUTES OF SUBCOMMITTEE ON Terrorism, Nonproliferation and Trade HEARING

Day Wednesday Date April 6, 2011 Room 2172

Starting Time 3:04 pm Ending Time 4:00 pm

Recesses [ ] (____ to ____) (____ to ____) (____ to ____) (____ to ____) (____ to ____) (____ to ____)

**Presiding Member(s)**

Chairman Ed Royce

*Check all of the following that apply:*

**Open Session** [✓]
**Executive (closed) Session** [ ]
**Televised** [✓]

**Electronically Recorded (taped)** [✓]
**Stenographic Record** [✓]

**TITLE OF HEARING:**

"Financial Hardball: Corralling Terrorists and Proliferators"

**SUBCOMMITTEE MEMBERS PRESENT:**

Royce, Sherman, Duncan

**NON-SUBCOMMITTEE MEMBERS PRESENT:** *(Mark with an * if they are not members of full committee.)*

**HEARING WITNESSES: Same as meeting notice attached? Yes** [ ] **No** [ ]
*(If "no", please list below and include title, agency, department, or organization.)*

**STATEMENTS FOR THE RECORD:** *(List any statements submitted for the record.)*

**TIME SCHEDULED TO RECONVENE** _____
or
**TIME ADJOURNED** 4:00 pm

**Subcommittee Staff Director**

# Terrorism, Nonproliferation and Trade Subcommittee

Member Attendance

**Republicans**

- ☑ Rep. Edward Royce (Chair)
- ☐ Rep. Ted Poe
- ☑ Rep. Jeff Duncan
- ☐ Rep. Bill Johnson
- ☐ Rep. Tim Griffin
- ☐ Rep. Ann Marie Buerkle
- ☐ Rep. Renee Ellmers

**Democrats**

- ☑ Rep. Brad Sherman (Ranking Member)
- ☐ Rep. David Cicilline
- ☐ Rep. Gerry Connolly
- ☐ Rep. Brian Higgins
- ☐ Rep. Allyson Schwartz

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