

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

***“FINANCIAL HARDBALL: CORRALLING  
TERRORISTS AND PROLIFERATORS”***

A Statement by

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**Testimony of Juan C. Zarate**  
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**Before the House Committee on Foreign Affairs**  
**Subcommittee on Terrorism, Nonproliferation, and Trade**  
**“Financial Hardball: Corraling Terrorists and Proliferators”**  
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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 corraling 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.<sup>4</sup> 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 abuses, 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 Gbagbo – 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 fill 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.



