

ENGAGING IRAN: OBSTACLES AND OPPORTUNITIES

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BEFORE THE

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WEDNESDAY, MAY 6, 2009

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room SD-419, Dirksen Senate Office Building, Hon. John Kerry (chairman of the committee) presiding.

Present: Senators Kerry, Feingold, Cardin, Shaheen, Kaufman, and Risch.

OPENING STATEMENT OF HON. JOHN F. KERRY, U.S. SENATOR FROM MASSACHUSETTS

The CHAIRMAN. The hearing will come to order. Thank you all for being here and, again, thank you for being here at this early hour.

Let me just announce ahead of time that we are going to have a little bit of a truncated hearing, and I'm going to try to expedite it, the reason being the U.S. Senate, in its wisdom, has scheduled 10 votes at about 10:40. And 10 votes, as we all know, takes about 1½ to 2 hours around here. So we're going to try to really move through this as expeditiously as we can. And I appreciate everybody understanding that. It's just one of those things that happens.

It is a huge privilege to welcome our guests here today, and I'll say a few words about both of them in a minute. But let me just say that faced with a crowded field, the foreign policy challenges, we're here today to discuss one of the most complicated and important to all of us, and that is the question of how to engage with Iran and to prevent it from becoming a nuclear-armed nation.

This is our third public hearing on Iran in the last 2 months, and it is not going to be the last. We're very fortunate to have two panels of witnesses whose broad experience will help us look at the issues that are front and center in this relationship.

Obviously, there are obstacles in our path as we pursue a new policy, but there are huge opportunities, and I want to emphasize the opportunities. Iran is a country with a huge and important history. We need to recognize that history and we need to understand the extraordinary skills and capabilities and heritage of the Iranian people.

Theirs is a country with enormous history, with great literature, great art, great architecture, great accomplishment. And I think that it is important for us to view the Iranians and the country in its entire context, not just in the years of difficulty since 1979.

All of us have a right to hope for a restoration of a relationship with Iran that reflects that history and the prospects of what a honest relationship, even with its differences, could bring to us in terms of our mutual interests and the interests particularly of the Middle East and of that region.

As I've said before, I believe President Obama is 100 percent correct to open the door to direct talks with Iran. We want to join with him here in this committee in seeking a new way forward based on mutual respect and mutual interests.

We start with the reality recognized by the administration that merely expressing your desire to engage and then engaging is not in itself a strategy, and talks are not an end unto themselves. They're the beginning of what is a complicated effort, to forge a new relationship, a new era in United States-Iran relations.

Clearly, progress is not automatic. Our efforts need to be reciprocated by the other side. It is important to note that Iran, for a number of years, has perceived that the United States policy is fundamentally regime change. And that perception drives a certain set of choices.

That is not the current policy of this new administration, and it is important for Iran to understand that. Just as we abandoned calls for regime change in Tehran and recognize a legitimate Iranian role in the region, Iran's leaders need to moderate their behavior and particularly that of their proxies, Hezbollah and Hamas.

And Iran's leaders must comply with the international community's requirements that its nuclear program is strictly for peaceful purposes, and meet its nuclear nonproliferation treaty obligations. Let me emphasize here: That is not a requirement that singles out Iran. That would be a requirement for any country that is a signatory to the NPT that has not complied with NPT requirements.

We obviously can't succeed in this effort alone. We need to work with our allies to establish realistic goals for negotiating with Iran and reach a private agreement on a set of escalating measures, should Iran fail to respond to negotiations.

I emphasize, again, our preference is engagement. Our preference is not to have confrontation of any kind, through sanctions or otherwise. But that will depend on choices that Iran itself makes. This is neither the time nor the forum to outline all of the contingencies available to the United States in the event that we fail. This is a time to reaffirm our commitment to giving meaningful negotiations with Iran's leaders a chance and not simply fall back on the stale rhetoric and failed strategies of the previous years.

Still, as policymakers, we also need to understand the nature of the sanctions that have defined our relationship with Iran for more than two decades now, and understanding the past and the choices we have made in implementing it or enforcing it is really critical to understanding how we're going to build a new relationship or how we're going to deal with contingencies in the event we fail to.

Sanctions, even coordinated multilateral sanctions, still remain a fairly blunt instrument with an imperfect track record. And when it comes to Iran, the verdict on them is mixed at best, and that's part of what we examine here today. Sanctions did slow Iran's

nuclear program, but bottom line, they did not prevent it from acquiring the capacity to enrich uranium on an industrial scale.

With the help of other countries, we've had more success in denying banks and companies involved in Iran's proliferation and terrorism activities access to the United States financial system. But as our first witnesses will explain, the firewalls and filters there don't always work.

The most startling example came to light recently when Britain's Lloyds Bank settled a criminal case with the New York district attorney and Justice Department, and I emphasize, they did settle the case, so that is now a matter of court record. Lloyds agreed to pay a \$350 million fine for helping Iranian banks wash hundreds of millions of dollars' worth of prohibited transactions through United States financial institutions.

The scheme was so pervasive that bank employees were given a handbook on how to evade U.S. prohibitions. The CIA and FBI are reconstructing several hundred thousand individual transactions to determine whether they involved material and technology destined for Iran's nuclear and missile programs.

We're going to hear about the case and others from a man whom I've known and respected for more years than either of us care to count, and that is Robert Morgenthau, the distinguished district attorney of New York.

Let me say two things here. One, before I say a few words about District Attorney Morgenthau, the majority on the committee will be releasing today or tomorrow—it's more logistical, but it'll be either later this afternoon or tomorrow—a report on Iran's nuclear program, sort of establishing a baseline with respect to how we got where we are and where Iran is with respect to its nuclear program.

Needless to say, we have been spending great efforts through the Treasury Department and the FBI and others to enforce those sanctions that are currently in place. I was first assistant district attorney in one of the largest counties in America back in the 1970s to 1980, and I will remind folks that there was a saying that crime knows no border.

The truth is, there's one district attorney in the country who from the 1970s until today, has a reputation that knows no borders, and malefactors fear his name, not just in mob hangouts in New York or in the corridors of Wall Street, but in foreign capitals too.

And I learned that full well when we worked very closely when the Foreign Relations Committee in the 1980s uncovered the Bank of Credit and Commerce International scandal, which involved not just General Noriega laundering money through it, but also had the bank account of a fellow who was to become well-known by the name of Osama bin Laden. That's when we first learned of this interconnected, interlocked series of fronts, shell companies, and various bank accounts that link arms trafficking with narcotics trafficking with terror.

It's an important network for our criminal justice system and law enforcement authorities to understand. I'm grateful to Mr. Morgenthau for his role in helping to make that happen. But let me just say that from the first days I stepped into a responsible role in the

district attorney's office, all of us in the country back then were modeling many of our efforts on what District Attorney Morgenthau had done. He was a groundbreaker in the way he organized his office, professionalized the office, created different task forces, and really reformed what until then had been a backwater of the criminal justice system. And he set an extraordinary example.

After 35 years of service, he will be retiring at the end of his current term. Mr. District Attorney, we are really privileged to have you here today, and we're very grateful to you.

Following his testimony will be another distinguished and familiar face and public servant. Ambassador Nick Burns was the Bush administration's point man on Iran as Under Secretary of State from 2005 to 2008, a very well-regarded and strong advocate for diplomacy. And many of the policies that Secretary Burns advocated and talked about with us are now being implemented. I'm sure he is pleased to see that, though some of it probably is a little bittersweet.

He'll pick up on the other side of the coin and help us understand the diplomatic challenges and the opportunities for success. I might add that after serving many years overseas and wandering in the wilderness of Washington, DC, he is now teaching at Harvard, and I'm very pleased to welcome him here today, and back to his home State of Massachusetts. So we thank you for being here today.

I should mention the district attorney's assistant, Adam Kaufmann, is here, and he will also present testimony with him, and we're delighted to have you here.

Mr. District Attorney, thank you for being with us, sir.

STATEMENT OF HON. ROBERT M. MORGENTHAU, DISTRICT ATTORNEY, NEW YORK COUNTY, FORMER U.S. ATTORNEY FOR THE SOUTHERN DISTRICT OF NEW YORK, NY

Mr. MORGENTHAU. Well, thank you for giving me the opportunity to testify here today. Twenty-one years ago, when you were the chairman of the Subcommittee of the Foreign Relations Committee on Terrorism and Narcotics, I had the honor of testifying before you in connection with the activities of BCCI.

I learned that day the importance of disclosure, the importance of sunlight on corrupt activities. You asked me whether we were getting any cooperation from the Bank of England, and I said no, and that was in the papers the next day, and the following day, I got a call from Eddie George from Bank of England saying, "How can we help you?"

So a lot of people who do things in the dark, when there is sunlight—when this committee focuses attention—things change. So that's why I'm particularly grateful for the opportunity to be here today and to talk about two activities of Iran: One, the international money movement, hiding the sources of that money; and two, the people who are providing Iran, through dummy companies, with the material for long-range missiles and nuclear weapons.

And this is an ongoing and serious problem, very serious. In addition to these first cases that we brought, we've had a number of investigations which have stopped Iranian activities, but we can't talk about those.

But the Lloyds case, which we investigated in very close cooperation with—with the Department of Justice, Asset Forfeiture and Money Laundering Section, showed how the Iranians were moving money through a British bank, stripping the identification information so that the New York banks that were receiving that money did not know it was Iranian money.

There was a settlement of that case. Lloyds paid a fine of \$350 million, evenly divided between New York and the Department of Justice. But that matter had widespread repercussions because people suddenly realized, hey, you do this kind of illegal activity in the dark—eventually somebody's going to find out about it.

And we have other similar investigations, fairly well along. We hope to stop—with the cooperation of the Department of Justice, we hope to stop the movement of Iranian money for the purchase of materials for long-range missiles.

The second case we brought was against a Chinese provider of material. This company used six dummy corporations and the Iranians used four dummy corporations. And the Iranian military was buying serious material to be used for long-range missiles. Just to give you an idea of what was involved and to show that they are definitely serious about proceeding with their missile and nuclear programs.

For instance, the materials shipped to Iran included 15,000 kilograms of a specialized aluminum alloy used almost exclusively in long-range missile production; 1,700 kilograms of graphite cylinders used for banned electrical discharge machines, which are used in converting the uranium; more than 30,000 kilograms of tungsten-copper plates; 200 pieces of tungsten-copper alloy hollow cylinders, all used for missiles; 19,000 kilograms of tungsten-metal powder; and 24,500 kilograms of maraging steel rods. Maraging steel—and I must say, before we got into this, I'd never heard of it. But it's a specially hardened steel suitable for long-range missiles.

And that's just the partial list. There were gyroscopes, accelerometers, armor piercing tantalum. Again, I had never heard of the tantalum, but we learned about it during the investigation. Tantalum is found in those roadside bombs that are being used against troops in Iraq and Afghanistan.

So this is a serious problem. These missiles can reach anywhere in the Middle East. We have troops in Afghanistan and Iraq and elsewhere. And I just think that the work of this committee is so important to let the public know that the Iranians are deadly serious, and they're making good progress, and we've got to intensify our efforts to embargo the shipment of WMD, as it's called, to Iran. And equally important, we've got to let the public know what's going on. That's why the work of this committee is so valuable: To shed some light on this. To use the words of Justice Louis Brandeis, "The best disinfectant is, in fact, sunlight," and that's what this committee is showing.

And I thank you for the opportunity to be with you.

[The joint prepared statement of Mr. Morgenthau and Mr. Kaufmann follows:]

JOINT PREPARED STATEMENT OF HON. ROBERT M. MORGENTHAU, DISTRICT ATTORNEY FOR NEW YORK COUNTY, AND ASSISTANT DISTRICT ATTORNEY ADAM S. KAUFMANN, CHIEF OF INVESTIGATION DIVISION CENTRAL, NEW YORK COUNTY DISTRICT ATTORNEY'S OFFICE, NEW YORK, NY

We would like to express our appreciation for the work undertaken by the committee, and our gratitude to the committee, and Senators Kerry and Lugar, for the opportunity to appear on this important issue. There are few issues in international security policy more pressing than Iran's efforts to develop long-range ballistic missiles and nuclear weapons. The Manhattan District Attorney's Office has played a role in enforcing U.S. sanctions and the rule of law through the use of traditional law enforcement means, and we welcome the opportunity to discuss two recent investigations.

The Office of District Attorney for New York County has a unique role in the law enforcement community. A local prosecutor is charged with maintaining the safety and security of the public he or she represents. However, in the case of New York County, the task of protecting the public and maintaining the public trust includes policing the most important financial markets in the world, watching over the biggest financial institutions on the planet, and ensuring the integrity of the global financial system. From Main Street to Wall Street, from Harlem to the Financial District, the Manhattan D.A.'s Office endeavors to maintain that public trust. To put it another way, there is nothing like a good beat cop to keep the streets safe, and the District Attorney's Office is the beat cop for Manhattan's city streets and its financial markets and institutions.

Our international investigations have covered many areas, both in geography and criminal conduct. Our investigation and prosecution of members of BCCI in the early 1990s, a matter well known to Chairman Kerry from his investigation of the same group, shined a spotlight on corrupt banking practices and the undisclosed involvement in United States banking activities by secret interests in the United Arab Emirates and Pakistan. We could not have successfully prosecuted BCCI without the expertise and assistance of Senator Kerry and members of the staff of the Subcommittee on Terrorism, Narcotics and International Operations, which Senator Kerry then chaired. We investigated and prosecuted the looting of a Venezuelan-owned bank by its wealthy owners in the early 1990s, and also discovered their payments of illegal campaign contributions to United States political interests through intermediaries in the United States. More recently, we have brought cases to highlight problems associated with black market casas de cambio in Brazil, Uruguay, Paraguay, and Argentina and the United States banks that turned a blind eye to their misconduct. These investigations tracked money flowing from the Tri-Border Area of South America to bank accounts associated with terror organizations in the West Bank; as well as the use of black market systems to launder millions of dollars of embezzled public funds from Brazil to secret accounts in Switzerland and the Isle of Jersey by Paulo Maluf, the corrupt former mayor and current Congressman from Sao Paulo, Brazil. Other cases have included the use of electronic digital currency and United States shell companies by Russian organized crime to perpetrate identity theft and fraud, the use of offshore shell companies by a securities fraud ring to launder its illegal proceeds and hide its activities, and our ongoing efforts to target and bring to justice the tax cheats who use offshore accounts and shell companies to avoid paying their fair share of taxes.

All of these cases, and many others pursued by the District Attorney's Office, involve the misuse of New York banks by criminals to launder ill-gotten goods or otherwise violate the criminal laws of New York State. And, they share a common theme. In each case, the investigation of discrete criminal conduct by specific individuals served to illustrate black market or otherwise opaque financial systems that allowed criminals to move their money. Corrupt and illicit systems are often set up to facilitate tax evasion and capital flight, but are also susceptible to use for more sinister purposes by criminals and the financiers of terrorism. Once an underground system exists to help people move money anonymously, those in control of it become accustomed to not asking too many questions, and criminals and terrorists can, and will, take advantage of that. Bringing these criminal cases has exposed these systems to the strong light of day, and has contributed to the recognition of systemic problems by the financial industry and financial regulators. To borrow a phrase from Justice Louis Brandeis, all of these cases demonstrated that sunlight is the best disinfectant. This theme—of transparency—runs through all of these cases and is evident in the matters we will address today.

More recently we turned our attention—and brought a degree of sunlight—to dangers well known to this committee: The threat to the United States and global peace posed by Iran's efforts to build nuclear and long-range ballistic missiles. Our focus

today is not on United States policy toward Iran per se, rather it is on the enforcement of the rule of law and the implementation of transparency in cross-border payments in the international banking system. The two investigations highlighted today examine the efforts of Iran and its providers of weapons material to move money through the international markets, including banks in New York, through deceit and fraud. Our efforts uncovered a pervasive system of deceitful practices and fraud designed to let Iranian banks skirt United States and international sanctions and move money all over the world without detection. It is our hope that this hearing, and our testimony, will enhance efforts to curtail these practices and have an impact on the enforcement of sanctions and the adoption of transparent banking practices worldwide.

Our efforts have, thus far, led to two publicly announced investigations that culminated in a deferred prosecution agreement with a British bank and with the indictment of a Chinese citizen and his corporation. We will refer to these two matters as the Lloyds investigation and the Limmt indictment, respectively.¹

One important goal of cases like the Lloyds investigation and the Limmt indictment is to encourage change from within the banking industry and bring change to the regulatory playing field. Regulatory schemes are generally, and appropriately, set up to work with industry to promote government policies. However, there is a degree of clarification brought by criminal prosecutions that differs from the results of any regulatory inquiry, particularly when addressing intentional misconduct. Targeted criminal prosecutions of serious misconduct can send a message of deterrence that regulatory schemes cannot match. And, as discussed below, it is the effect of this message of deterrence in the banking community that may prove to be the most valuable result of these prosecutions.

Law enforcement plays an important role in cases involving violations of sanctions and intentional fraudulent conduct. If the United States imposes sanctions and requires U.S. banks to comply with them, then prosecutors should target and expose to the light of day those who intentionally violate the law and defraud our financial institutions. If foreign banks, businesses, and persons engage in conduct that violates New York and U.S. law, they should expect to be held accountable for their misconduct. And the threat of public accountability has a tremendous deterrent impact on the conduct of banks and financial institutions. A recent article in the periodical *Foreign Affairs*, by Rachel Loeffler, recognizes and articulates this point.² Ms. Loeffler examines various sanctions and actions brought to enforce them, and notes the importance of interaction between government policy and financial institutions to curtail the access of rogue regimes to international money centers. She comments that enforcement actions such as the Lloyds deferred prosecution agreement “provide a lever of influence when fewer and fewer seem to exist.” A foreign bank that might otherwise ignore U.S. sanctions in its business model might be reluctant to do so in the wake of the Lloyds settlement. As discussed further below, we have seen multinational banks change their behavior after the Lloyds settlement, which makes United States sanctions more effective, further isolates the Iranian regime, and hampers Iran’s ability to obtain items needed for its weapons programs.

These themes—transparency, accountability, and deterrence—are explored in the two case studies presented below.

¹ Cases such as these are the result of difficult and long-drawn investigations. We wish to recognize the efforts of the following members of the District Attorney’s staff for their contributions to these matters. For Lloyds: Senior Trial Counsel Richard T. Preiss, Assistant District Attorney Aaron Wolfson, Investigation Division Central Deputy Chief Gary T. Fishman, former Assistant District Attorney Laura Billings, former Intelligence Analyst Eitan Arusy, Financial Intelligence Director David Rosenzweig, and Paralegals Gregory Dunleavy, Aaron Davidowitz, Sarah Schoknecht, and former paralegals Melissa Clarke and Jamelia Morgan. In addition, the investigation was pursued jointly with the Asset Forfeiture and Money Laundering Section of the Department of Justice and the New York State Banking Department, and the efforts of the Federal prosecutors and Federal and State investigators assigned to the investigation should be recognized. For Limmt: Assistant District Attorneys Adam S. Miller and Aaron T. Wolfson, Investigative Analysts Lauren Lichtman and Max Adler, Intelligence Analyst Jasmine Sicular, Financial Intelligence Director David Rosenzweig and Investigators Jonathan Savel and Alex Arenas of the DANY Special Investigations Group. Assistant District Attorneys Marc Krupnick and Marc Frazier Scholl, Senior Investigative Counsel, also assisted. In addition, a parallel investigation was pursued by the Office of Foreign Assets Control of the Department of the Treasury that resulted in SDN designations for activities relating to weapons proliferation. The expertise of the staff at OFAC as well as at the Federal Reserve Bank of New York provided a tremendous contribution to the success of the investigation.

² “Bank Shots: How the Financial System Can Isolate Rogue Regimes,” *Foreign Affairs* (March/April 2009).

I. "STRIPPING" OF WIRE TRANSFER DATA: THE LLOYDS TSB INVESTIGATION AND DEFERRED PROSECUTION AGREEMENT

The term "stripping" refers to the practice of removing wire transfer information that would reveal that the transfers originated from a prohibited source. By stripping out the originator information, the wire transfers can pass through the screening software used by U.S. banks that would otherwise reject or freeze them for further inquiry. The stripping of wire transfer information in this manner effectively conceals that the parties involved are sanctioned entities.

The U.S. Government places restrictions on certain countries, entities, and individuals from accessing U.S. financial institutions and the U.S. banking system. These sanctions are administrated and enforced by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"). OFAC imposes controls and administers economic sanctions against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States. Many of the sanctions are mirrored in United Nations and other international commitments, and involve close cooperation with governments around the world. The sanctioned entities are blocked from accessing the U.S. banking system and, with minor exceptions, U.S. citizens and institutions are prohibited from conducting financial transactions with them.

In the spring of 2006, the District Attorney's Office discovered evidence of fraud in the processing of international wire transfers by certain European banks on behalf of their client Iranian banks. The Iranian banks maintained correspondent accounts with the European banks. Correspondent bank accounts constitute the relationships between banks that allow funds to move all over the world, and are a foundation of international commerce.³ In the case of Lloyds, Lloyds maintained correspondent accounts on behalf of a number of Iranian banks, all sanctioned entities banned from doing business in the United States or with United States financial institutions.

The initial evidence of criminal conduct by Lloyds and other banks discovered by prosecutors from the District Attorney's Office consisted of information concerning individuals with close ties to the Government of Iran located in the New York area. These individuals received wire transfers from Bank Melli and other Iranian banks. However, the incoming wire transfers to the U.S. accounts of these individuals did not contain any reference to the Iranian banks or individuals that originated the funds transfers.⁴ Instead, the payment messages made it appear that the wire transfers originated from Lloyds (or from other European banks engaged in similar practices).

To ensure that the U.S. financial institutions that process international wire transfers do not unintentionally engage in prohibited transactions, they use sophisticated computer systems to monitor and screen all wire transfer activities. Banks in New York that process most of the world's U.S. dollar payments depend on these automated systems to prevent sanctioned entities as well as terrorists, money launderers, and other criminals from gaining access to the U.S. banking system. In this way, the financial institutions are the first line of defense to protect our financial system.

The Lloyds investigation focused primarily on Lloyds' handling of accounts for financial institutions from three designated countries: Iran, Sudan, and Libya (Libya was removed from the list of sanctioned countries in 2004 and was less prominent in Lloyds' stripping scheme). Knowing that they could not legally access United States banks, Iranian and Sudanese banks with accounts at Lloyds sought to evade these sanctions. Beginning in the mid-1990s, Lloyds began removing any information from Iranian and Sudanese wire transfers that would trigger the detection systems at the United States correspondent banks. This was a systemic, across-the-board operation on behalf of the sanctioned banks. To execute this policy, Lloyds payment center personnel removed any Iranian and Sudanese wire payment messages from the automated processing system, stripped out the identifying data, and

³The role played by international correspondent banking in global finance and the risk of money laundering it can pose is ably described and analyzed in a report from the U.S. Senate entitled "Role of U.S. Correspondent Banking in International Money Laundering," Senate Permanent Subcommittee on Investigations, July 15, 2004.

⁴These payment messages consisted of communications sent by the Society for World Wide Interbank Financial Telecommunication, or "SWIFT." SWIFT is the predominant system used for international funds transfers with over 80 percent of the world's transfers executed by SWIFT message, or almost 15 million payment messages per day on average. SWIFT can be likened to a secure e-mail system used by banks to ensure that payment orders are sent and received with accuracy and security.

then manually reentered the payment information so that the transfer would be processed undetected by United States banks.

From 2001–04, Lloyds’ conduct allowed the illegal transfer of more than \$300 million on behalf of Iranian banks and their customers to accounts in the United States. In addition, Lloyds sent billions of dollars in Iranian payments through United States banks in so-called “U-Turn” payments (payments that begin and end in foreign banks and merely transit through the United States). For example, a U-Turn payment would include a commercial transaction sent from the account of an Iranian bank at Lloyds, through a correspondent account at a United States bank, for payment to an Italian company for a commercial invoice. U-Turn payments also included overnight time deposits sent on behalf of the Iranian banks themselves from Lloyds through correspondent accounts at United States banks to banks in Cayman and elsewhere, and then processed back to Lloyds via the same route the next day. In our opinion, the U-Turn exemption constituted a glaring hole that undermined both the enforcement of, and the rationale behind, the Iranian sanctions program. Effective November 10, 2008, the authority for the U-Turn exemption was revoked.

While Lloyds voluntarily exited the Iranian business by 2004, the Sudanese business, which resulted in the illegal transfer of approximately \$30 million, continued into 2007 (after the beginning of the investigation by the District Attorney’s Office and the Department of Justice). Also during the period from 2001–04, Lloyds’ conduct allowed one Libyan customer to transfer approximately \$20 million to United States banks.

The District Attorney’s Office and the Department of Justice agreed that the appropriate resolution of the Lloyds investigation was through joint Deferred Prosecution Agreements. As a result of the settlement and Deferred Prosecution Agreements with the District Attorney’s Office and the Department of Justice, Lloyds agreed to adhere to best practices for international banking transparency, to cooperate with ongoing law enforcement investigations, to conduct an internal review of past transactions, and to pay \$350,000,000 in fines and forfeiture.

The message of deterrence from the Lloyds resolution should not be underestimated. In many of the financial industry’s international antimoney laundering conferences in the past few months, the top item on the agendas is cross-border payment issues and the Lloyds case. While somewhat apocryphal, this observation highlights the deterrent effect of a successful criminal investigation, which goes well beyond the deterrent effect of a regulatory finding. This is not intended to undermine the value of regulatory work. To the contrary, most matters involving financial institutions are best handled by regulators who can identify problems and work with the banks to rectify them. However, intentional and systemic misconduct resulting in fraud constitutes criminal conduct and should be treated as such.

As we assess the deterrent effect of the Lloyds settlement, we have begun to observe a ripple effect move through the international banking community. At a recent antimoney laundering conference, one of the assistant district attorneys from the Lloyds investigation participated in a debate as to whether the Lloyds matter was an unwarranted extra-territorial application of U.S. sanction laws to a non-U.S. bank. We argued that the Lloyds case was simply the application of domestic (U.S.) fraud provisions to conduct that originated in Europe but exercised its fraud on correspondent banks in the United States. From the prosecutorial analysis, the violation of sanctions law was the motive and reason for the fraud, but the fraud perpetrated on the U.S. clearing banks was the gravamen of the criminal conduct. The charge in the state deferred prosecution agreement reflects the duality of this analysis. The charge admitted by Lloyds was a violation of the New York State Penal Law crime of Falsifying Business Records in the First Degree, alleging that Lloyds caused false entries to be made in the records of the U.S. clearing banks, in furtherance of and to conceal the commission of another crime, specifically, the Federal sanctions/IEEPA violation.

The final assessment of success for the Lloyds investigation and resolution will come from the deterrent effect and whether we successfully change behavior on the part of international banks. Already we have seen some impact as Lloyds becomes the topic of the day in conferences and industry periodicals. The impact on the international banking community was well reflected in comments from the head of global antimoney laundering for a major U.K. banking institution. This gentleman, who is a leader in the field of global compliance, explained that it mattered not whether one agreed with this application of U.S. law, or whether one viewed it as a criminal fraud case, or whether one viewed it as a violation of U.S. sanctions, or something in between. As he saw it, what mattered was that the world was now on notice that it could not disregard any country’s sanctions without running afoul of the analysis employed in Lloyds. The result for his bank, as he explained it, was two-fold. First,

his bank was now looking at sanctions with a fresh eye to make sure that cross-border transactions originating in one country and transiting another did not violate any local sanctions regimes. Second, his bank was withdrawing or curtailing international payment services for banks from sanctioned countries such as Iran and Sudan. When we speak of deterrent effect and making sanctions more effective, this may be the ultimate model of success.

II. THE PROLIFERATION OF WEAPONS OF MASS DESTRUCTION: CHINA TO IRAN

In April of this year, the District Attorney's Office announced the indictment of a Chinese businessman named Li Fang Wei and his metallurgical production company, Limmt Economic and Trade Company, Ltd., on charges that they falsified the records of banks in New York and conspired to send illegal payments through New York banks (a copy of the indictment is attached*). Defendant Li Fang Wei is the manager of Limmt, a provider of metal alloys and minerals to the global market. The investigation revealed that Limmt has two primary lines of business. First, Limmt sells standard metallurgical products to commercial customers throughout the world. Second, Limmt sells high-strength metals and sophisticated military materials, many of which are banned from export to Iran under international agreements, to subsidiary agencies of the Iranian Defense Industries Organization (DIO).

In June 2006, the United States Department of the Treasury, Office of Foreign Assets Control (OFAC) sanctioned Limmt for its support of and role in the proliferation of weapons of mass destruction (WMD) to Iran. As a result of the sanctions, Limmt was banned from engaging in transactions with or through the U.S. financial system, and remains banned to this day. Subsequently, Li Fang Wei and Limmt used aliases and shell companies to continue Limmt's international business.⁵ Li Fang Wei and Limmt's purpose in doing so was to use fraud and deception to gain access to the U.S. financial system, to deceive U.S. and international authorities, and to continue the proliferation of banned weapons material to the Iranian military.

The indictment charges that during the period from November 2006 through September 2008, Limmt sent and received dozens of illegal payments through U.S. banks by using aliases and shell companies. Because Limmt was banned from transacting with U.S. banks, any transfers sent in its real name would have been detected by the sophisticated wire transfer monitoring systems at the U.S. banks and blocked. By substituting aliases in the place of its true name, Limmt deceived U.S. banks into processing its transactions. Thus, Limmt's conduct was specifically designed to defeat these filters through the use of false information. The result was the falsification of the records of banks located in Manhattan relating to dozens of illegal transactions.

The investigation revealed that in the almost 3-year period since Limmt's designation, Limmt used its aliases to continue sending banned missile, nuclear, and so-called dual-use materials to subsidiary organizations of the DIO. The investigation identified subsidiary organizations set up by the DIO to procure and produce high-tech weapons systems, including: Amin Industrial Group, Khorasan Metallurgy Industries, Shahid Sayyade Shirazi Industries, and Yazd Metallurgy Industries.⁶

Some of the materials shipped from Limmt to the DIO front companies included:

- 15,000 kilograms of a specialized aluminum alloy used almost exclusively in long-range missile production;
- 1,700 kilograms of graphite cylinders used for banned electrical discharge machines;
- More than 30,000 kilograms of tungsten-copper plates;
- 200 pieces of tungsten-copper alloy hollow cylinders;
- 19,000 kilograms of tungsten metal powder;
- 24,500 kilograms of maraging steel rods;
- 450 metric tons of furnace electrodes; and
- 1,400 metric tons of high carbon ferro-manganese.

⁵Aliases used by Limmt and Li included Li Fang Wei a/k/a Karl Lee, a/k/a Patric, a/k/a Sunny Bai, a/k/a K. Lee a/k/a KL, a/k/a David Li, a/k/a F.W. Li) and Limmt Economic and Trade Company, Ltd., a/k/a Limmt (Dalian ftz) Metallurgy and Minerals Co., Ltd., a/k/a Limmt (Dalian FTZ) Minmetals and Metallurgy Co., Ltd., a/k/a Limmt (Dalian FTZ) Metallurgy and Minerals Co., Ltd., a/k/a Ansi Metallurgy Industry Co. Ltd., a/k/a Blue Sky Industry Corporation, a/k/a SC (Dalian) Industry & Trade Co., Ltd., a/k/a Sino Metallurgy and Minmetals Industry Co., Ltd., a/k/a Summit Industry Corporation, a/k/a Liaoning Industry & Trade Co., Ltd., a/k/a Wealthy Ocean Enterprises Ltd.

⁶As a result of our joint effort with OFAC, these entities are now on the Treasury Department's list of sanctioned entities.

In addition, Limmt and the DIO engaged in negotiations to have Limmt send the DIO 400 Gyroscopes, 600 Accelerometers, and 100 pieces of Tantalum. Gyroscopes and Accelerometers are crucial technology for Iran's development of long-range missiles, and Tantalum in the form indicated can be used to manufacture armor-piercing projectiles of the sort found in improvised explosive devices (IEDs).

Limmt conducted its nonmilitary commercial business primarily with U.S. dollar payments. These payments were processed, or "cleared," by U.S. banks. These payments, although from non-military customers, were nonetheless illegal under U.S. law because of Limmt's status as a proliferator of WMD. Limmt's Iranian military shipments were paid for primarily in euros. For all of these payments, from both the Iranian military subsidiaries and Limmt's commercial customers, Limmt used its aliases to complete the transactions. The District Attorney's Office has been in contact with European law enforcement personnel to continue the investigation into Iran's use of European banks to clear its euro transactions. Many of the euro transactions relate directly to the procurement of weapons materials by the Iranian military front companies in clear violation of international law. It is unclear at this time whether the European banks acted intentionally or whether these transfers violated any laws of the countries where they occurred. We are working with foreign law enforcement and regulatory authorities in the specific countries to find answers to these questions.

In addition, the District Attorney's Office has made preliminary contact with the Chinese Government concerning both the role of the Chinese banks as described in the indictment and the illegality of Limmt's conduct under Chinese law. In all of Limmt's transactions, the wire payments were sent to and from a limited number of Chinese banks that handled the accounts of Limmt's front companies. It is unclear whether these banks acted intentionally or knew the true identity of Limmt as the true interest behind the alias/front companies. However, it is clear that some of Limmt's shipments to Iran violated Chinese export control laws. We have stated our willingness to share this information with the Chinese authorities. We note that there is no extradition treaty between the United States and China, so that if Mr. Li is to face justice, it will be before a Chinese tribunal for his violations of Chinese law.

Many of the items shipped by Limmt in China to Iran were so-called "dual-use" items, suitable for both civilian commercial as well as military uses. In this case, certain communications made clear that the items were intended for military use by the Iranians, but the circumstantial evidence was equally strong. When the materials are sent to front companies set up by the Iranian military, and Limmt procured false end-user certificates for the shipments, the intent to use these materials for military purposes is readily inferred.

One communication from Li Fang Wei to an agent of the Iranian DIO in 2007 was especially telling. Li Fang Wei discussed with the Iranian agent the difficulties in producing certain aluminum alloys as requested by the Iranians. He went on to relate that there should be little doubt as to the quality of the alloy, as Limmt's factory had supplied the alloy for customers for many years, including for the Chinese military and for the Iranian Aerospace Industries Organization [another part of the Iranian military, responsible for development and procurement of long-range ballistic missiles]. Certainly this conversation demonstrates that despite his public protestations to the contrary, Mr. Li and his company were, in fact, intentionally selling weapons materials to the Iranians. In public statements to the media, Mr. Li denies his relationship with the Iranian military and denies supplying them with weapons materials. The factual record developed by our investigation and presented to a grand jury belies these self-serving claims. Mr. Li has supplied the Iranian military with weapons material for years while scoffing at international agreements restricting such trade. For Mr. Li and his co-conspirators, "business as usual" meant violating the law and providing materials for weapons of mass destruction to a dangerous regime.

III. CONCLUSIONS

Sanctions, both from the United States and from the international community, are an important tool to deter rogue regimes and encourage the path of diplomacy. Nations such as Iran need to be engaged in dialogue, and need to be invited to become responsible members of the global community, but also need to know there are ramifications for ignoring the path of responsibility. Sanctions provide an important arrow in the quiver of diplomacy. The question we face is how best to make sanctions effective, to deter misconduct, and to encourage adherence by the private sector. Regulatory actions are an important part of enforcement, but some matters, criminal in nature, need to be redressed through the mechanisms of criminal justice.

OFAC does a tremendous job identifying threats to the national security and bringing civil enforcement actions. Prosecutors should not become involved in this area lightly. Slight violations or ambiguous behavior do not lend themselves to criminal enforcement. But where there is systematic and pervasive intentional misconduct, criminal prosecutions are necessary. Criminal prosecutions of financial institutions send a strong message of deterrence.

Banks that provide access to the world's financial systems to criminals, proliferators and terrorists should expect that they will be found out and prosecuted. Sanctions are effective only if they are enforced. We may not be able to shut down Mr. Li's factories, but we can shine a spotlight on his conduct and the conduct of the foreign banks that permit these types of operations to flourish.

This fight will be won only if there is strong resolve on the part of the world's major economic and military powers to stand firm against Iran's efforts. We are working with Federal law enforcement, regulatory and intelligence agencies to develop more leads and to use the information we have already gathered, and we are also reaching out to law enforcement agents in foreign countries to target this conduct and to shut down the pipeline of weapons to Iran.

These are important matters that need to be addressed in a global framework. Law enforcement efforts should be part of the global equation to make sure that sanctions are enforced and illegal conduct deterred. Through strong and resolute action, this crisis may still be averted, but we do not have the luxury of waiting any longer.

[*EDITOR'S NOTE.—The copy of the indictment submitted with this prepared statement was too voluminous to include in the printed hearing but will be maintained in the permanent record of the hearing. A second article submitted for the record "Deferred Prosecution Agreement" can be found in the "Additional Material Submitted for the Record" section of this hearing.]

The CHAIRMAN. We thank you very, very much for that summary.

Mr. Kaufmann, did you want to add to that?

STATEMENT OF ADAM KAUFMANN, BUREAU CHIEF, INVESTIGATION DIVISION CENTRAL, OFFICE OF THE DISTRICT ATTORNEY, NEW YORK COUNTY, NEW YORK, NY

Mr. KAUFMANN. Senator, very briefly, if I may. What we found, to just give you an overview of the conduct that we looked at in the Lloyds investigation with the Department of Justice, so you understand exactly what Lloyds was doing and what its criminal conduct was, essentially, Lloyds offered banking services to Iranian banks to help the Iranian banks move money all over the world to pay for—at times, commercial transactions; at other times, military-related transactions.

The majority of contracts between international companies are denominated in U.S. dollars, which means that to clear—or execute those transfers—they have to transit through banks in the United States. That is generally the case.

What Lloyds did was to say to the Iranian banks, "Look, you're banned from transacting through the U.S. by the Department of Treasury regulations and the Office of Foreign Assets Control." United States banks—all of the major United States banks that operate in this business of clearing United States dollar transfers—have very sophisticated systems that if a transfer came in referencing Iran, the bank would block it and then investigate it and either reject or freeze or block the money.

Lloyd's provided a service to the Iranian banks to make sure their transfers went through the United States banks undetected,

to effectuate Iranian commerce. And the way they did this was by what we've referred to as "stripping."

Every wire payment message that came in from an Iranian bank to Lloyds would be taken out of the automated payment processing system. Then, any information that would identify the payment as being Iranian would be removed. Then that altered payment message would be sent by Lloyds to the U.S. banks to complete the transaction.

I have here—it was going to be on a PowerPoint presentation, but since that's a—we're a little technologically disabled at this table, we have a sample. This is not an actual stripped SWIFT message. It's one that I put together as an example or a hypothetical.

But I'll pass it up to the committee. And you'll see what it shows is an incoming message sent from Melli Bank, which is a banned Iranian bank, to Lloyds, asking for a payment message to be sent on in United States dollars.

You'll see in the bottom field, which is a—this is a SWIFT message, which is an international payment system. At the bottom, it says, "Please do not mention our name"—that's Bank Melli's name—"to any bank in the U.S.A." And then underneath that, you'll see an outgoing SWIFT message that is sent to a correspondent bank in the United States. When this payment message was reviewed by the automated filtering systems at the United States bank, not only does it not mention anything about Melli Bank or Iran, it actually gives the appearance of having originated with a Lloyds customer.

So in terms of the conduct, it was an intentional effort to defraud the systems of the U.S. banks, and that was the gravamen of the criminal conduct that we investigated.

Now, what we did with the Department of Justice was determine that it was appropriate to resolve the case with a deferred prosecution agreement and a rather large fine. One of the important things about this case that we've seen, in terms of the deterrent effect, is the impact it's having on other banks that are handling accounts for Iran. And I should note it wasn't just Iran. It was also Sudan and, for a time, Libya.

What we're hearing from other banks is that they are taking a very hard look—and not just U.S. banks, but more significantly, international banks, foreign banks—they are taking a hard look at how they handle international payments to make sure that the payments do not violate any sanctions, not only U.S. sanctions, but also sanctions in other countries that might be involved in the transiting of these international wire transfers.

So the deterrent impact that we are starting to see from Lloyds—and as the district attorney mentioned, we have a number of similar cases coming in—I think we're going to see a new respect on an international level, an effect on the international banking system of respecting and minding these sanctions, so as not to get caught as Lloyds did.

The CHAIRMAN. You've got a certain standard in England and a certain capacity to be able to investigate, as you did. What about some other locations? I mean, the same stripping and the same camouflaging can take place in any of the Gulf States or in any Far

Eastern States, South Asian State, could it not, and then be transferred from one of those banks—a bank in Bahrain, a bank anywhere, into the New York finance system, correct?

Mr. KAUFMANN. That's correct, Senator.

The CHAIRMAN. And the only real way to prevent that from happening ultimately is to have their cooperation in this sunshine effort. I mean, you've got the banks knowing your customer, the international standard of the banking community, that is essential here, is it not?

Mr. KAUFMANN. It is. I think one answer is that there are two kinds of cooperation. There's truly voluntary cooperation, and there is an appeal to enlightened self-interest. And if we can—what we're starting to see in regards to the China proliferation case, we've spoken with some of the Chinese banks that were involved in handling those accounts. And it is—it may not be the world's most voluntary cooperation, but if people or banks think they're going to get caught or exposed, they'll hopefully straighten up their act. And it can't be a universal impact, but—

The CHAIRMAN. I've often wondered about this, going way back to the BCCI days—is it possible that we should be asking that the U.S. financial system, which is a critical hub in the flow of funds from various places—ought to demand a higher standard of scrutiny of those funds to make commingling more difficult, to make the stripping effort less simple.

Mr. MORGENTHAU. Well, I think the U.S. banking system is—in these cases that we've seen, has acted responsibly. The weak link is these foreign banks that are happy to facilitate illegal transactions, provided they don't get found out. And that's why this committee, you turn the spotlight on them, and then it goes away.

In several transactions—eight total—we've started an investigation and the transaction has halted completely, because they don't want to be found out, and they don't want to be held up to international ridicule for dealing with WMD and Iran.

The CHAIRMAN. What I'm wondering—

Mr. MORGENTHAU. The more we can expose this activity, the better.

The CHAIRMAN. I couldn't agree with you more. The question is how—in this case, you had information which empowered you to investigate. If you don't have the information that empowers you to investigate, the question is, What's the standard by which people are operating day to day?

And I'm thinking that as we look at the world financial crisis and the demands of the G20 and others to really sort of reform the effort and to rewrite how we do this, a little more scrutiny with respect to some of the securitized entities, a little more sunshine with respect to the kinds of transactions that we're being sold in the marketplace would have prevented a lot of damage from being done.

So this doesn't only go to Iran. It doesn't only go to the question—it's the whole question of blind masked financial transactions that purport to be one thing are really another. And it could be in housing. It could be in derivatives. But it can also be in the illegal network to support the nuclear program.

Mr. MORGENTHAU. In the case of Lloyds, the bank actually printed a manual explaining exactly how to strip identification and avoid disclosure in the United States. So, I mean, this was not kind of an accidental rogue operation, but this was a major bank operation, and then so—

The CHAIRMAN. How did you discover that? How did this come to you, Mr. District Attorney?

Mr. MORGENTHAU. I'm sure we can—the United States banks can tighten up, but we have not seen a case where United States banks will knowingly handle Iranian money. I'm not saying it hasn't happened, but we haven't seen that.

The CHAIRMAN. How did you discover this?

Mr. MORGENTHAU. How what?

Mr. KAUFMANN. He asked how we discovered it.

Mr. MORGENTHAU. We were looking at the Alavi Foundation. It was a major Iranian foundation in New York. And we found money going overseas to suspect people. And then we were looking at their banking transactions, and we discovered Lloyds through that.

We went to the CIA because we thought they would be primarily interested, and they said, "Well, that's within the FBI's jurisdiction." So we then talked to the FBI. And then they said, "Maine Justice is interested in this." So we then got in touch with Maine Justice, and we formed a partnership and did the work together.

The CHAIRMAN. And you're saying that the international banks have, in fact, been cooperative with you in this effort?

Mr. MORGENTHAU. No.

Mr. KAUFMANN. Sometimes yes; sometimes no. I think, Senator, to go back to your point, if I may for a moment, about what do we do and transparency across the board in the financial sector, you're certainly preaching to the choir to this table, where we've been battling issues, especially the district attorney, for 35 years against secrecy, opaque systems.

A lot of the cases we look at—and you spoke in your introductory remarks about the interconnectedness of different types of criminal systems. Again and again and again, we see that. We see opaque networks being used—set up for tax evasion, being used by narcotics money launderers. We see those same systems sending money to accounts associated with Hamas on the West Bank, so the need for transparency is great.

The CHAIRMAN. Is that the single most important weapon in efforts to fight this?

Mr. KAUFMANN. I think it is. I think at a macrolevel, the more transparency you have in financial systems, the more difficult you make it for criminals to use systems to move their money and hide it. You're never going to legislate to address fraud. We already have fraud laws, and this was a case of fraud.

In this area where you talk about how do we—what can the U.S. banks do, I think Mr. Morgenthau is right. The U.S. banks are primarily doing a pretty darn good job of screening for this type of behavior. This was fraud and it was difficult to detect.

I think you have to be careful. There certainly is a need to screen and have a high level of certainty by the banks, but you also can't make it so difficult that you shut down international commerce.

We're talking trillions of dollars a day in wire transfers. So it's a very difficult matter to address proactively.

The CHAIRMAN. Which is why it came down to this question of this international standard adopted at the Basel Convention with respect to banking, which is "know your customer." I remember, that's when we put into place—it was a result of our early investigation that we put in place the \$10,000 reporting requirement and subsequently went after some of the cooperative agreements, the mutual legal assistance treaties and other efforts in order to require countries to cooperate with us when we had probable cause.

And I think the cooperation has been raised significantly. The financial syndicate office down at Treasury Department has done a darn good job with too little resources, frankly, in pursuing some of this. We could do more, I think, to hold people accountable if we put more resources into that effort.

Mr. KAUFMANN. The—

The CHAIRMAN. Senator Shaheen. I'm going to call Senator Shaheen in a minute.

Mr. KAUFMANN. I'm sorry.

The CHAIRMAN. Go ahead. Make a comment.

Mr. KAUFMANN. The MLAT system has improved matters. I will tell you that the view from the trenches, it is still very slow and difficult to obtain information. Any efforts that would encourage direct cooperation between prosecutors without necessarily going through a centralized clearing system would, I think, go a long way to enhance and expedite matters. It can take—in a criminal investigation, 6 months is the end of the world, and it can take 6 months, a year for us to get anything from the most cooperative countries.

The other thing I'll just say—you speak of Basel. There is one significant happening this year that will go a long way toward promoting transparency in international wire transfers, and that's a movement put forth under the Wolfsberg principles to require originator information on SWIFT payment messages of a certain type between banks.

Right now, the way it's—it's a little technical, but basically, 202 Cover Payments are bank-to-bank transfers. They're messages between banks to effect money transfers that do not have originator information contained in them.

In November of this year, there's a new message system—and it was as simple a matter as creating a new form and a new computer field so the automated system will require originator information on those payment messages. In terms of transparency, that is tremendously significant.

The CHAIRMAN. Good. Senator Shaheen.

Senator SHAHEEN. I just want to follow up on Senator Kerry's question about what more can be done to close the loopholes that exist, and wanted you to talk a little bit more, if you would, about what you meant when you said prosecutor-to-prosecutor cooperation without going through a centralized system. What more could be done to encourage that kind of cooperation?

Mr. KAUFMANN. Right. About the MLATs?

Mr. MORGENTHAU. Well, I mean, the problem with MLAT is even with phenomenal cooperation, I mean, we have to go to the Justice

Department. That has to go to the State Department. That has to go to the Embassy. And by that time, not only has the horse been stolen, but the barn has been burned down.

So it's a very cumbersome operation, even with the best of intentions. It takes—I mean, recently we had a case where we had to get information on London, and it took us a year and a half before the MLAT information came back. So we've got to figure out a way to speed that system up, both internally and with our cosigners. It's a very, very cumbersome process, and by the time you get the information, usually it's too late to do anything about it.

Senator SHAHEEN. And is the difficulty the system that's been set up, the process itself, or is it that the players who are part of that use this as a convenient excuse for delaying information?

Mr. KAUFMANN. It can be both, Senator. Some countries are more hypertechnical about their requests than others, and that can provide difficulties, or as you say, cover. Some MLATs contemplate direct cooperation between local prosecutors or police. And that is a very simple—it's usually just a paragraph within the treaty that both country parties are recognizing that while there is a treaty mechanism, there can also be a direct cooperation mechanism.

And where that exists, we are much more able to reach out directly to our foreign counterparts and establish the kind of direct working relationship where if I can pick up the phone and talk to the prosecutor in Poland and explain to him exactly what I need, or find out directly from him what he needs from me to allow him to help me. Having some framework that allows that type of direct communication and cooperation is very helpful.

Senator SHAHEEN. So are you suggesting that we should have that kind of a provision as a matter of course in our treaty agreements or our cooperation agreements?

Mr. KAUFMANN. I would respectfully suggest that, yes, ma'am.

Senator SHAHEEN. Thank you.

The CHAIRMAN. That's a good idea. As a matter fact, I've just been prompted by your comments and I think we're going to request that the State Department formally see if we can't try to get some kind of a direct bypass. I couldn't agree with you more. I mean, you can take forever before you get to what you need to do.

You ought to be able to go directly and there ought to be an understanding through this process, since it's agreed upon, and if they have a problem, then there ought to be a stoppage route, rather than an access route. It seems to me it could become pro forma that way and we could proceed much more rapidly.

Mr. KAUFMANN. Just remember, sir, to include State authorities in those provisions and not just Federal. I'll throw that in for the local guys.

The CHAIRMAN. I'm very sensitive to that.

Mr. MORGENTHAU. Senator, if I can make—emphasize one point, and that is, I mean, we have Iran's shopping list for materials related to weapons of mass destruction. We have literally thousands of records.

We have consulted top experts in the field from MIT and from private industry and from the CIA, and the one thing that comes out loud and clear is that, one, the Iranians are deadly serious

about proceeding with this program, and No. 2, that it's later than a lot of people think. Frankly, some of the people we've consulted are shocked by the sophistication of the equipment that they're buying.

So we don't have a lot of time to waste. I'm not an expert on proliferation, but we've consulted a lot of people—and it comes out loud and clear. It's late in this game, and we don't have a lot of time to stop Iran from developing long-range missiles and nuclear weapons.

The CHAIRMAN. Well, Mr. District Attorney, that's a very, very important statement that you've just made. And it is a significant reason that we really wanted to have you here today, is so people can see inside—you know, take away the opaqueness and see what's really going on here. It's uncomfortable for some people, but it's necessary.

The report that we're going to issue from the committee builds on what you've just said and kind of lays out the realities of where we see the Iranian program now. Now, that has to be, in our democracy, discussed here. And the Senate and the various committees of jurisdiction here, the intelligence committee and armed services, need to really confront this question.

Your documents are very important, and we're going to make the committees aware of their existence to the degree that they're not yet, because it really does help shed light on the seriousness of purpose of their program and of how deep it runs and of what they're getting, in terms of materials, and how concentrated it's been.

And I think it's a great service that you're providing us through a law enforcement agency that in many cases would never have dared to touch this. That's been true of so many of the cases that you've taken on in the New York jurisdiction, and again, I thank you for that.

So with that note, because of our time constraint, what I'm going to do is leave the record open for any questions that may be submitted. We might just ask you for the lessons of the Chinese case particularly, but I don't want to go into it right now just because of the time constraints. But I would like to have that in the record so we can also see another side of the coin here, of how this plays.

But Mr. District Attorney, I know it's a long way to travel for a shortened testimony. I hope you'll forgive the committee for that fact. Or maybe you're thrilled. Maybe the Senate saved you. But at any rate, again, I can't say enough about your years of service and your friendship, and we thank you very, very much for coming in here today.

Mr. MORGENTHAU. Thank you for the opportunity, and thank you for putting some sunlight on this problem.

The CHAIRMAN. Well, we're going to keep doing that, I promise you, in your tradition.

Mr. MORGENTHAU. Thank you.

The CHAIRMAN. Thank you, sir.

Mr. KAUFMANN. Thank you, Senator.

The CHAIRMAN. If I could ask Secretary Burns to come up to the table, we'll have a transition here without interrupting the hearing, hopefully. Again, Secretary Burns, we're grateful to you for coming. I know this is an area you've thought about a lot.

[Off-the-record discussion.]

The CHAIRMAN. Mr. Secretary, thank you for coming. We look forward to your statement.

STATEMENT OF HON. R. NICHOLAS BURNS, PROFESSOR IN THE PRACTICE OF DIPLOMACY AND INTERNATIONAL POLITICS, HARVARD KENNEDY SCHOOL, FORMER UNDER SECRETARY OF STATE FOR POLITICAL AFFAIRS, CAMBRIDGE, MA

Ambassador BURNS. Thank you, Mr. Chairman. I think, as you know, I've submitted my written testimony for the record. I will not—I'll be merciful and not read that. But with your permission, I'd just like to make a few points to start off. First, I'd say—and as I said in my written testimony—I fear that we are on a collision course with the Iranian Government. We've had a 30-year deep freeze in our relationship.

We've had no substantial or meaningful discussions from the Carter administration to the Obama administration with a series of Iranian governments. There's no real understanding of each other, and we see each other as adversaries. So this is a situation that is fraught with a lot of danger for both countries.

I do see the Iranians as a real threat to our country. There's no question they're seeking a nuclear weapons capability. No one doubts that. They're the principal funder of most of the Middle East terrorist groups that are shooting at us, shooting at the Israelis and the moderate Palestinians, and they're influential in Iraq and Afghanistan, sometimes in ways that are very negative for United States interests.

So they pose a challenge for us in the most important region of the world to us, in the Middle East and South Asia. That's the dilemma. I do think, however, that our past policies, not just the George W. Bush administration, but for many administrations, of isolating Iran, of refusing to meet with its officials, of calling for regime change, have not worked. They've not influenced the behavior of the Iranian Government. So I see a twin test—

The CHAIRMAN. Could it have influenced them the wrong way?

Ambassador BURNS. Excuse me?

The CHAIRMAN. Could it have influenced them the wrong way?

Ambassador BURNS. Hard to say. Hard to say. I mean, the Iranians have been fairly consistent in their support for terrorism. They've been trying to build this nuclear-weapons program for a long time. This predates the Bush administration. So it's very hard to say that calling for a regime change had an additional negative impact on them.

But I do think that this poses a twin test for the Obama administration. On the one hand, we've got to counter, and if we can, roll back the more pernicious aspects of Iranian policy. On the other hand, I do think it makes sense for us to try to seek engagement, not because, as you say, diplomacy is an end. It's not an end. It's a means to an end. But because it might be a vehicle for us to exert greater influence on the Iranians, particularly in conjunction with other countries, like Russia and China and the European countries.

So I frankly think it's time for a new approach, and that the Obama administration ought to think very seriously of a policy of

engagement reinforced by the threat of sanctions and by the threat of force.

Now, I do not believe it's time for the use of military force by the United States or by anyone else. I don't think it would work. I'm not familiar with any scenario where military force could actually fully stop a program that is based on scientific research and whose most important elements are really in the minds of the scientists of Iran.

Second, we have to worry about unintended consequences. We learned in Iraq that sometimes when you start a war, you don't know where it's going to end. That would certainly be the case with Iran.

Third, there is every reason to indicate that if we use force now, the Iranians would use asymmetric force back against us, through Hamas and Hezbollah, and certainly through the Shiite militant groups in Iraq. I just can't see it being in our best interest to start a third war in the Middle East and South Asia at this time without having tried diplomacy for 30 years.

So, I do think that leaves diplomacy as our best option. I think what President Obama has been trying to do—and we only see at this point the outlines of his policy—has been fairly impressive. In a way, I think he is probably outpointing the Iranians, and he has put them on the defensive, which is a good thing.

I mean, the fact that he has offered to send a diplomat to these P5 talks, the fact that Secretary Clinton invited the Iranians to the U.N. conference on Afghanistan, the fact that President Obama says that he wants and is willing to sit down and talk about a variety of issues, I think has probably puzzled the Iranians, and you have not seen any kind of consistent response from the Ahmadinejad government. And if we are putting them on the defensive for the first time in a long time, I think that is favorable, and it is a good start for the Obama administration.

I would say, however—and you mentioned this in your early March—your March 3 hearing—we've got to negotiate from a position of strength. We can't go, hat in hand, to these negotiations and think that just by talking, we're going to make progress. Therefore, I think we've got to have an agreement with Russia and China in advance of sitting down for draconian sanctions on Iran.

Put it another way. If we're going to give up a long-held American position that we should not talk to Iran, if we're going to give that up and talk to them, then our partners in this process, particularly the Russians and Chinese, who are very influential, ought to be with us, agreeing beforehand that if the talks fail, they will join us in very, very tough sanctions. I think that makes sense.

And I do think it makes sense to keep the threat of force on the table. I don't see Iran negotiating seriously if there isn't a marriage between diplomacy and the threat of force. It's a language they understand, and it's certainly language that if we took it off the table, I think would probably injure our negotiating position.

So, just two final thoughts. Why should we then support diplomacy, and what reason do we have to feel that diplomacy might be useful? First, it may be the only way we'll ever know if there's a peaceful outcome here—if it's possible to have a peaceful outcome.

I don't know if it is. But it is the only way we'll ever be able to test that proposition.

Second, I think it would be unconscionable to go to war without having tried diplomacy first, given the record of the last 30 years. Third, it could actually work. There's a possibility—probably not a high probability—that a combination of American, Chinese, Russian, European influence and pressure on Iran could alter its behavior.

But fourth, even if that does not become the result, even if negotiations fail, we will be in a much stronger position having tried negotiations. We will be much more credible with the international community to then say to the rest of the world, to all the trading partners of Iran, "If you don't want to leave us with just one option, a military option, you need to join us in much tougher sanctions than those that we have tried in the past."

The three sanctions resolutions that I negotiated for the United States, for the Bush administration, are just the beginning. They haven't really made a dent in Iran's armor. We need to go far beyond that.

But a final thought. If we are going to try diplomacy, we need as a country to be patient enough to let diplomacy work. And what I would predict is if President Obama embarks on diplomacy, there will be the inevitable attempts by the hard-liners in Iran to try to deflect that by intemperate statements or even violent actions.

I'm sure there'll be rhetorical attacks on President Obama in our own country. They'll say that diplomacy is weakness, that diplomacy is naive, that diplomacy is appeasement, and I would reject that. I think that diplomacy can be an effective tool for the United States, even in a situation as perilous as this, and we're going to have to give the President some time and some flexibility to negotiate what is going to be an extremely complex diplomatic negotiation with lots of different countries involved, perhaps with a new Iranian Government. We'll see what happens in their elections after June.

And finally, I would suggest that as a country, in addition to trying to negotiate with the Government of Iran, we try to open up to the people of Iran. We should bring thousands of Iranian students to the United States, if it's possible to get them out to study in our universities.

I hope it will be possible for Members of Congress to be able to travel to Iran, for journalists and businesspeople to do that. We haven't had that kind of normal relationship in a long time. I think the combination of trying to open up to the people of Iran and trying to engage this very tough Government in Iran is probably the right way to go at this point.

Since 9/11, we've often led with the military, and at least in the case of Afghanistan, that was appropriate. Sometimes it's better to lead with diplomacy, with the military in reserve. I think this is one of those times.

That I think fairly summarized what I said in my written testimony.

[The prepared statement of Ambassador Burns follows:]

PREPARED STATEMENT OF AMBASSADOR NICHOLAS BURNS, PROFESSOR IN THE PRACTICE OF DIPLOMACY AND INTERNATIONAL POLITICS, HARVARD KENNEDY SCHOOL, FORMER UNDER SECRETARY OF STATE FOR POLITICAL AFFAIRS, CAMBRIDGE, MA

Chairman Kerry, Senator Lugar, and members of the committee, thank you for the invitation to testify today on United States policy toward Iran.

I have testified to this committee in the past as a government official. This is my first appearance as a private citizen and thus the views that follow are entirely my own.

In many ways, I fear that the United States is on a collision course with the Government of Iran. How we counter the multiple threats that Iran poses to our most important interests in the Middle East is surely one of our highest policy objectives. But, whether we can find a way to communicate more effectively with the Government of Iran and to agree to negotiations on the issues that divide us is another important goal. This twin test of American effectiveness with Iran will be an early and central concern for the Obama administration.

Consider the following ways in which American ambitions clash with those of the Government of Iran:

- The Iranian leadership seeks a more powerful and perhaps even dominant role in the Middle East. In nearly every arena, it poses the major challenge to America's own power in the region. Iran's pursuit of a nuclear-weapons future is a direct threat to Israel and our Arab partners. Its intrusion into the politics of Lebanon has been unhelpful and often destructive. Its opposition to a two-state solution between the Palestinians and Israel is a significant impediment to progress on that overarching priority;
- As the United States has sought to blunt and defeat the terrorist threat in the Middle East, we have found that Iran is the principal funder and even director of some of the most violent groups that sponsor terrorism in the region—Hezbollah, Palestinian Islamic Jihad, Hamas, and some of the Shia militant groups in Iraq;
- Iran is an influential neighbor of the two countries where we are at war—Afghanistan and Iraq. It sometimes uses that influence in ways that are directly contrary to American interests. Is it possible to find common ground with Iran as we seek to promote stability in both countries?

Everywhere we look in the greater Middle East, Iran often plays a negative and troublesome role. As this region is now, along with South Asia, the most critically vital for American foreign policy, it is essential for the United States to fashion a more effective strategy toward Iran. For three decades, Iran and the United States have been isolated from each other and we presently have no real ability to communicate effectively. This is surely a situation we should not wish to see continue.

I therefore believe the Obama administration has been correct in undertaking a full review of the present poor state of relations between our two countries. The time has come for new and more creative thinking so that we might, as a country, defend where we must against Iran's more pernicious influence in the world but also find a way to engage its government and people where and when we can.

With this in mind, I suggest three guideposts for American policy that may help to frame this issue for Congress.

First, given the lethal nature of Iran's challenge to the United States, we must respond to it with seriousness of purpose, toughness, and strength. One of our highest long-term priorities should be to maintain America's leading role in the Middle East and to deflect Iran's own ambitions.

Second, we need to recognize that the 30-year deep freeze in our relations with Tehran has resulted in an extraordinary situation—we know precious little about the very government and country that looms so large as a negative influence on all that is most important to us in the Middle East. Isolating Iran, resisting any contacts between our governments and threatening regime change have not resulted in positive changes to its behavior on issues critical to our security. In the absence of diplomatic relations and the lack of a substantial American business or journalistic presence in Iran, we have no real basis to understand its government, society, and people. It does not serve American interests for this deep freeze to continue.

Third, I therefore support a policy of strength but also realism and engagement with the Government of Iran. We need to be firm in defending Israel and the interests of the Arab States uneasy with Iran's rise to power. We should continue to oppose Iran's pursuit of nuclear weapons. But, we should do so while simultaneously opening a dialogue with the Iranian Government and people to test whether progress is possible through peaceful means.

Such a dialogue is most important on the most serious issue that divides us with Tehran—its pursuit of nuclear weapons. Some continue to argue that the only way

to halt Iran's accelerating nuclear research effort is through American or Israeli air strikes. But, there is no convincing scenario where such use of military force would work effectively to end the Iranian nuclear program. Even worse, air strikes would undoubtedly lead Iran to hit back asymmetrically against us in Iraq, Afghanistan, and the wider region, especially through its proxies, Hezbollah and Hamas. This reminds us of Churchill's maxim that, once a war starts, it is impossible to know how it will end. An America that is already waging two difficult and bloody wars should be wary of unleashing a third. Choosing military power at this stage would surely be precipitous and unwise.

That leaves diplomacy as the most plausible way to blunt Iran's nuclear ambitions. I have some familiarity with the difficulties and tradeoffs of a diplomatic approach. For 3 full years, between 2005 to early 2008, I served as the point person on Iran for Secretary of State Condoleezza Rice. We worked hard to find a path to the negotiating table with Iran.

In June 2006, we launched the most serious and ambitious American attempt since the Iranian revolution of 1978 to establish meaningful discussions with Iranian officials. Along with Russia, China, Britain, France, and Germany, we offered Iran negotiations on nuclear and other issues. We were determined to begin talks with Iran and expected that negotiations would take place. Unfortunately, Iran rejected over the next 2 years repeated offers by the United States and its partners for talks. Iran walked away and missed a rare opportunity to pursue a better relationship with the United States.

Since then, Iran has accelerated its nuclear research efforts despite three United Nations Security Council sanctions resolutions. As you stated in your March 3 hearing on Iran, Mr. Chairman, the recent IAEA report indicates that Iran has expanded significantly the number of operational centrifuges at its uranium enrichment plant at Natanz. Iran has also continued construction of the Arak reactor. These developments and its ballistic missile tests all point to a future nuclear capability that could cause further instability and pose another risk to peace in the Middle East and beyond.

How should the new American Government led by President Barack Obama respond to this open challenge? While I am not in a position to know what our Government will ultimately do, I am frankly encouraged by the initial statements of the President and his team to take the offensive against Iran through strong and active diplomacy. In this sense, I believe we are fortunate, indeed, that President Obama and Secretary of State Hillary Clinton have asked Ambassador Dennis Ross to coordinate our policy toward Iran. He is one of the most skillful and experienced public servants in our country and one of our foremost experts on the problems of the Middle East.

I think the Obama administration has made the right decisions on Iran in its first months in office. President Obama's new and positive appeal to Moslems worldwide, his video message to the Iranian people, his invitation for Iran to attend the U.N. conference on Afghanistan and his pledge that the United States will now participate in the P5 nuclear talks with Iran, have all put us back on the diplomatic offensive with the Iranian regime. The absence of a clear Iranian Government response to these steps is telling—accustomed to keeping the United States off balance in recent years, the Iranian leadership appears to not know how to respond to these more positive American initiatives. That is not an insignificant accomplishment at this early stage of the new administration.

Unfortunately, many in the Moslem world saw the United States, incorrectly, as the aggressor in the conflict with Iran in past years. They believed the United States was unwilling to meet with Iranian officials. They criticized the United States and its P5 partners for imposing a condition on talks—the prior suspension of Iran's enrichment activities.

With the benefit of 20/20 hindsight, it would have been more effective in 2006–07 if we had offered unconditional talks. Such an offer would have deprived Tehran of the excuse it used subsequently to some effect that such a conditional offer was unacceptable and unworthy of a true breaking of the ice between our two countries. And, the fact that there were no diplomatic contacts with Iran whatsoever during my 3 years as Under Secretary of State for Political Affairs was a reflection of the limitations of our approach.

In my judgment, President Obama has put the United States in a stronger position as he considers how best to proceed with Iran. He has taken a different path with the Iranians, showing openness and respect to the people of Iran and offering to have United States diplomats participate routinely in the P5 talks with Iran for the first time without conditions.

The work ahead, however, will be even more challenging. The key question now is how to frame negotiations with Iran so that they have the strongest possibility

of delivering the outcome we should want to have—engagement but with a resulting decision by the Iranian leadership to slow and stop altogether its pursuit of nuclear weapons and to accept intrusive international oversight of all of its activities.

As Senator Lugar mentioned in your March hearings, Iran is not in a strong international position as these talks begin. The decline in the world price of oil, the U.N. sanctions and the Ahmadinejad government's disastrous economic policies have all contributed to weakening Iran in the last year. Its transparent aim to become nuclear capable has caused nearly all its neighbors to seek its isolation. The new Iranian Government to be elected in June may have to reconsider the type of offer most likely to be made by the international community—expanded economic ties and a return of Iran to the community of nations in return for a halt to its nuclear efforts.

While agreeing to negotiations, President Obama should not want to go hat in hand to the Iranians. As you stated in the March 3 hearings, Mr. Chairman, we must negotiate with Iran from a position of strength. President Obama would be wise to set a limited timetable for talks. He should make clear that the United States and others would walk away and impose much tougher financial and economic sanctions if progress in the negotiations is not made in a reasonable period. This would prevent Iran from running out the clock until they become nuclear capable.

It will be crucial that the President agree on the automaticity of these sanctions with the P5 countries, especially Russia and China, in advance of talks. China has violated the spirit of the U.N. sanctions by becoming Iran's leading trade partner at the same time that our European allies have begun to withdraw from Iranian markets. Russia sells Iran arms and is helping Iran to construct its first nuclear reactor. If the United States is to break with past policy by meeting Iran halfway at the negotiating table, then it is only reasonable that our P5 partners, most especially China and Russia, pledge to join us in draconian sanctions on Iran should the talks break down.

Most importantly, the President should renew his campaign position that all options will remain on the table. This marriage of diplomacy with the threat of force is essential, in my view, to convince Tehran it needs to make a difficult choice and soon. Without this threat, I doubt Iran's leaders would take the talks seriously. The Iranian leadership wants more than anything else security guarantees from the United States. We should not give them such guarantees until they have met our core aims. This does not mean that the United States should default to the use of force if diplomacy and new sanctions fail. And, as I have said in this statement, it is in our overriding national interest to resolve our differences with Iran peacefully. Let us hope that will be possible.

Any negotiations with Iran will likely be frustrating with only a modest probability of success. So, why does President Obama's diplomatic approach now make sense for the United States?

First, it may be the only way we will ever know if there is a chance for a peaceful outcome in our long-running feud with Iran. Before contemplating the use of force, it is in our clear interest to see if we can avoid war by peaceful means. Diplomacy's great promise is that one can never predict where discussions will lead once they are begun. Certainly, it would be unconscionable to start a war with Iran without having first given negotiations a serious and sustained effort.

Second, a negotiation may now be the most effective way to slow down Iran's nuclear progress. One of the first tactical aims of a negotiation should be to prevail upon Iran to freeze its nuclear research as the talks proceed. Otherwise, Iran may steam ahead unimpeded.

Third, negotiations would serve to isolate Iran even further internationally and put it on the defensive. An unconditional offer deprives Iran's leaders of the excuse not to negotiate. Our sitting down with Iranian leaders brings another advantage—it will significantly undercut Iran's ability to posture as the leader of the anti-American front among the radical governments and movements of the Middle East.

Finally, we will be no worse off if we try diplomacy and fail. In fact, we might be stronger internationally. Having made a good faith effort at diplomacy, the United States would be in a far stronger position to convince Russia and China and other countries to join us in tougher sanctions. It would not be in their interest to see President Obama left only with the military option. I also believe we would be more credible around the world if countries saw that we had tried in good faith to resolve the crisis peacefully.

A diplomatic opening to Iran will require patience on the part of Americans. Progress is unlikely to be made in the early stages. As Karim Sadjadpour testified to this committee in March, there will certainly be those in Iran who seek through intemperate statements to derail the process. There will undoubtedly be criticism

by some in the United States that diplomacy is naive or even appeasement. We would do well to ignore these all too predictable attacks and to give President Obama the time and flexibility he will need to sustain a complicated and difficult diplomatic negotiation with Iran.

Ultimately, Mr. Chairman, conflict with Iran is neither inevitable nor desirable. A first, serious negotiation with Iran in three decades makes much more sense for the United States than risking the awful calculus of war. Having placed too much of the burden in recent years on our military to sort out the most difficult global security challenges, Americans need to have greater faith in our diplomatic power to resolve crises. This is such a crisis. It is the right place to begin anew with Iran.

Mr. Chairman, once negotiations begin, we should not limit them to the nuclear issue. As we did with North Korea, our Government should use the vehicle of multilateral talks to enable our own bilateral discussions on the margins. There are many issues to discuss with Iran. We need to find a way to convince the Iranian leadership that it is in its interest that Iraq emerge united and stronger as America brings home our troops. And, we know that Iranian interests would be served by greater stability in Afghanistan and the weakening of the current Taliban offensive. These issues and the dramatic struggle for stability and peace in Lebanon are all reason for us to begin a wide-ranging discussion with the Iranian leadership in the months ahead.

I have one final suggestion for the committee, Mr. Chairman. We should also want to have a much more open and diverse relationship with the Iranian people. One of the great ironies of America's position in the Middle East is that the Iranian people demonstrate consistently in opinion polls their high regard for the United States. While the pace and nature of our talks with the Iranian Government are difficult to predict, it is a much more certain bet that opening up channels to the people of Iran will benefit both of our countries for the long term.

It is also almost certain that an eventual normalization of relations with Iran and a peace between our governments—and those should be our most important long-term ambitions—will take some time. We have every reason to build bridges to the people of Iran in the meantime. Our Iranian-American community in the United States is evidence enough of the richness, energy, and talent of the Iranian people. We should have as primary objectives bringing thousands of Iranian students to study in our universities. We should want our religious leaders of all faiths to continue the interfaith dialogues that have begun tentatively in recent years. I hope it will be possible for Members of Congress and journalists to travel to Iran in much greater numbers in the coming months and years. Greater openness between us and more frequent people-to-people contacts will serve us and the cause of peace well as President Obama negotiates the trickier shoals of government-to-government diplomacy in the period ahead.

Thank you for the opportunity to testify before this committee today.

The CHAIRMAN. Well, it's a good statement, and we very much appreciate it. Let me explore a few of the implications of it, if I may.

What did you learn from your experience, and what do you believe as a result of it, China's and Russia's attitudes are about this?

Ambassador BURNS. I am sorry to say that based on my 3-year experience of negotiating with the Chinese and Russians, which was a weekly and sometimes daily occurrence for me to be on the phone with them, to meet them, I think both have approached this from a fairly cynical point of view.

For whatever reason, the Russians decided to withhold their full support from the P5 effort. I can't see it any other way. They continue to sell arms to Iran. Most of these sanctions and negotiations in the United Nations took 2 or 3 months longer than they should have because of Russian foot-dragging.

And so Russia, in an odd sort of way, is the one country among the P5 that has the most to risk, because it's closest geographically to Iran. It cannot be in Russia's interest to see Iran become nuclear capable. And yet, they held back. The Chinese I think probably more cynical—

The CHAIRMAN. Let me just stay with Russia for 1 minute.

Ambassador BURNS. Uh-huh.

The CHAIRMAN. I have had various Russian officials say to me point-blank, "We don't want Iran to be a nuclear power." They believe—at least they expressed to me that they believe it's a little further off than we believe it. Did you conclude that their sense of timing is different here, or are they just playing a double game, or is it, in fact, in their interest not to have an Iranian nuclear capacity?

Ambassador BURNS. Oh, I think it's very much in Russia's interest not to have.

The CHAIRMAN. And do they perceive that? Do they believe that?

Ambassador BURNS. I believe that some of their officials do, but for whatever reason, the leadership did not give the Bush administration the support that I think the Bush administration deserved from them.

So my hope would be that if the Russian Government sees an Obama administration willing to go the extra mile toward negotiations, Russia will choose to put its influence with the United States. But here is the only way I think we should proceed, Mr. Chairman. I don't believe it is in our interest to sit down with Iran unless we work out a deal with Russia and China ahead of time that when talks fail, Russia and China will show up at the sanctions effort.

So, the Russians, I think, are acting out of fairly cynical purposes, the Chinese even more so. What's happened with China is that as the Europeans have reduced their export credits to Iran—they were at €22 billion in 2005. They've more than halved that right now.

The Europeans are doing the right thing. They're pulling away from Iranian markets. The Chinese are rushing to fill the void, and China has become Iran's leading trade partner in the process.

So I do think that perhaps the most important element of the diplomacy is not with Iran at this stage; it's with Russia and China, the Europeans being largely supportive of the direction in which the Obama administration, I think, is heading.

The CHAIRMAN. Well, that's an important statement and an important concept, and I don't disagree with you. I believe we have to go two tracks here, and I hope the Iranians understand the genuineness of the American outreach to engage in a real dialogue, and that we are not in regime change mode.

I would say that again and again. This is not about regime change. It is about finding a relationship that meets the needs of the region and satisfies the global interests with respect to the nuclear program.

That said, we need to prepare for the possibility that things don't work. I'm convinced that the economic sanctions have far more likelihood of actually doing something than any potential military option that I've seen, which I think carries with it dramatic potential downsides.

But anyway, let me, since we have time constraints here because the vote's coming up, I want to let my colleagues go right at it, and we'll just sort of do a truncated round, if we can.

So, Senator Feingold.

Senator FEINGOLD. Thanks, Mr. Chairman, for holding our third Iran hearing in the last 2 months. There's a great deal to discuss. I continue to be very concerned by the threat that Iran poses, whether with regard to its nuclear ambition, its support for terrorism, or its general unwillingness to cooperate with the international community.

I am pleased that the Obama administration has tried to address the current impasse with a new approach—by calling for strong diplomatic engagements, and speaking directly to the people of Iran. I think that extending an open hand on multiple levels, while still keeping all options on the table, has strengthened the new administration's position and undermined any efforts by the Iranian Government to blame others for not coming to the table.

That said, tackling our longstanding tensions and problems with Iran is a considerable task, and the administration needs to continually reassess the situation in order to develop a realistic model for engagement that does not put our national security—or that of our friends and allies in the region—at risk.

Mr. Secretary, the State Department's recently released "Country Reports on Terrorism" notes that the "Quds Force provided aid in the form of weapons, training, and funding to Hamas and other Palestinian terrorist groups, Lebanese Hezbollah, Iraq-based militants, and Taliban fighters in Afghanistan."

These activities obviously affect our national security interests on a broad range of fronts, including not only the terrorist threat to the United States and our partners and allies, but also our policies with regard to stabilizing Afghanistan, redeploying from Iraq, and building support for a two-state solution for the Middle East.

So as we consider our options for engaging with Iran, how do we most effectively confront its support for terrorism—as a single overriding problem, or do we confront it as one of a number of problems—and what can we reasonably expect, in terms of marginal improvements in the behavior here?

Ambassador BURNS. Well, Senator, I agree with the way you've framed the problem. I think we've got three major threats from Iran. One is the nuclear threat. The second is the support for terrorism. The third is Iran's influence in Iraq and Afghanistan.

So as I said in my opening comments, in the region of the world which is arguably the most important to the United States, we see Iran everywhere as a negative force. I said in my testimony that I think we have to proceed in two ways.

One is I think it is time to have a policy of engagement with the Iranian Government, not because we believe it is highly probable it will succeed, but because we haven't tried it before in 30 years. It may be that through a process of negotiation and engagement and pressure on them, along with pressure from other countries, we're able to maneuver them to a different place.

If that is not possible, then particularly on the nuclear issue, we're going to have to consider other options. They would be much tougher sanctions than we've seen before. And it will be a real test for the Obama administration, and I wish them well, to put together an international consensus for those sanctions.

And if we believe that Iran is close to becoming nuclear capable, obviously, there will be this extraordinarily difficult choice. Do we

consider the use of force, or do we consider constructing some type of containment regime of the Iranians? There will be lots of countries who would want to see that happen. The moderate Arab States. Israel certainly would want to see that happen.

That is a very compelling and very difficult choice for any American President to make. We're not there yet. But if you play this out, that's certainly something that we have to think is a set of choices that we may face down the road.

Senator FEINGOLD. Thank you, Mr. Chairman. In fairness to my colleagues, I'm just going to ask that question. I had many other questions, but I want them to have a chance.

The CHAIRMAN. Well, thank you, Senator Feingold.

Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman. Ambassador Burns, it's a pleasure to have you back before our committee. I share the concerns of my colleagues. If Iran were to become a nuclear weapons power, it would be a game-changer that would cause major impact in that region—something we cannot allow to happen. We have to use every tool we have at our disposal effectively to try to make sure that doesn't happen. So I appreciate your observations.

I want to get your best advice as to how much time we have here. June elections are upcoming in Iran. We know that the Foreign Minister of Israel, Mr. Lieberman, suggested that 3 months might be the appropriate time to continue negotiations. After that, I don't know what he was implying, but that certainly raises some time issues.

We've all heard about the urgency of this issue to make progress, and we know that one of Iran's strategies may well be delay. The longer they can delay issues, the more they can advance toward achieving their goal of becoming a nuclear weapons power.

So I'd just like to get your advice to us as to how urgent these issues are, how much time we have, and what you would suggest as the next steps.

Ambassador BURNS. Well, Senator, as you know, I've been out of government for more than a year, so I am probably not the best person to ask, on an authoritative basis, how much time. But my assumption is that there is time. Now, how much is an open question, and that might be a dynamic question that you have to reassess from time to time.

I have not heard anyone else say that 3 months is the amount of time that we have. I've not heard anyone else support that statement of the Israeli Foreign Minister. So I assume there is a degree of time.

Now, having said that, and having read some of the testimony that was given to you in March, I very much agree with those who say—in fact, the chairman said it—that we have to impose a timetable on whatever negotiations we get into with the Iranians. If we just had an open-ended negotiation, they could run out the clock. They could continue to enrich, build those centrifuges and simply keep us at the table until they were ready to declare themselves nuclear capable.

So, I think the Obama administration would be well advised, if they go into negotiations, to do it in a very—a set basis. A couple

of months; if there's no progress, then move on to sanctions. I think that would be the best course of action.

Senator CARDIN. Thank you. Let me just ask very quickly a second question about Syria. We know that Syria has gotten much closer to Iran. We know that there are open discussions now taking place between the United States and Syria, or at least, there's been better communication.

And we also know historically, it's odd to see a close relationship between Syria and Iran, and we know that Israel was making some progress through Turkey in negotiations with Syria, which would be inconsistent with the relationship with Iran.

So is there hope that Syria, in fact, could be independent of Iran, and we could make progress in isolating Iran through Syria?

Ambassador BURNS. I certainly think that should be one of our objectives. I read in the paper this morning that Secretary Clinton is sending two senior diplomats to Damascus for their second round of talks, the paper said this morning. I think that's a good sign. And I frankly think that you might look at this—we all might look at this not just as a United States-Iran issue, how do we deal with Iran, but as a triangular issue. Israel is involved, too.

On Israel, our responsibility to safeguard Israel, protect its security, is an important, vital American interest. If Israel could make progress with the Syrians, if the United States could open up a better diplomatic relationship with the Syrians, that might help the diplomacy that we're conducting with Iran.

My own judgment would be that Syria's long-term interests are going to be much more involved with the Arab States and with Israel than they will be with the present Government of Iran.

Senator CARDIN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Cardin.

Senator KAUFMAN. Mr. Chairman, I want to thank you for these hearings on Iran. They have really been very, very helpful in terms of clarifying what we're about.

You know, we've talked about, and I agree with all the problems we have with Iran, serious problems, if we're going to do negotiations, we've got to start talking about some common interests. What kind of common interests do you think we have in Iran?

Ambassador BURNS. With Iran today?

Senator KAUFMAN. Yes.

Ambassador BURNS. It's hard to find them, but I think there are some. I certainly think that the Iranians have benefited strategically from the removal of the Taliban in power in Afghanistan in 2001. The Iranians have certainly benefited from the removal of Saddam Hussein in Iraq.

And so what we tried to do in the Bush administration was to open up some talks between our Ambassador, Ryan Crocker, and the Iranian Ambassador in Iraq. They didn't go very far. I would hope that we might look at those potential interests that we can share with Iran, try to work with the Iranians productively.

It was a good decision by Secretary Clinton to invite the Iranians to this conference in The Hague on narcotics in Afghanistan because there is another interest. The Iranians have a major drug problem in their country that emanates—drug usage that emanates from Afghanistan.

So in this case of diplomacy, we know where we oppose the Iranians. Perhaps by building on some common ground, we might be able to make some progress that could have some benefits elsewhere. I'm not predicting that will be the case. I don't see diplomacy as an absolute panacea here.

But I think it's worth a try because we have not done this in the past, and as the chairman said, and I agree with him, we ought to make it clear we're not out to change the regime of Iran. We ought to make it clear that we find them distasteful, the government, that we oppose much of what they stand for, but we're willing to work with them if we can find common ground, and certainly willing to work with them if we can convince them to roll back their nuclear efforts.

Senator KAUFMAN. You know, we all have talked ad infinitum about how so many other of the Arab States—Saudi Arabia, Jordan, Turkey—they're all very much in fear of Iran getting a nuclear weapon. I mean, is this—do you see them stepping forward and doing something substantial to actually help us in this process?

Ambassador BURNS. I hope so. I think what you did not see between 2006 and 2008 when the United States launched a diplomatic initiative to try to get Iran to negotiate—and Iran walked away. You didn't see a lot of the Arab countries or Turkey significantly diminishing their trade with Iran the way that we had done, the way that France and Germany were doing.

And so if sanctions are to work, and if economic pressure is going to work as an inducement to Iran, you have to look at all the trade partners: China, Russia, Japan, South Korea, United Arab Emirates, Saudi Arabia, Turkey. And I do think it is in the interest of some of the Arab States now to speak up a little bit more boldly than they've been willing to do in the past. Because privately, what you'll hear—as anyone who travels the Arab world—a lot of anxiety about the rise to power of Iran. But we haven't seen, at least in my judgment, the actions, particularly on economic sanctions, that would be very helpful.

So these sanctions will only work if they're nearly universal. They are nowhere close to that right now. And that's the real diplomatic challenge for the Obama administration.

Senator KAUFMAN. Thank you.

The CHAIRMAN. Thank you, Senator Kaufman, for your usual good probing questions. How far do you believe the Russians and Chinese are willing to go with respect to economic pressure?

Ambassador BURNS. Well, I think we're about to test that as the Obama administration sets out to participate in negotiations.

The CHAIRMAN. But you don't have a—I mean, your sense is—well, let me ask it this way, because I think it's a tricky question. I mean, it's not meant to be, but it is hard to get your hands around that.

Is it your sense from the discussions that you had that conceivably, over a period of time in the past administration, that there were enough other issues floating around, Georgia, missile defense, other kinds of things, that the climate just wasn't right for them to be able to be brought into an effort with respect to Iran, but if those dynamics are somehow further away in history and/or being

approached differently, whatever the dynamics may be, does that open up an opportunity in your judgment for them to say, “You’re right. This will be our primary area of cooperative focus with the United States, and we’re going to get something done”?

Ambassador BURNS. Well, I think you’re right, Mr. Chairman, to say this is the key issue. If sanctions are to work, these two countries have to be involved. So why didn’t they help us over the last 3 years? One reason might be that they were linking our interest in this with their interest on other issues, like missile defense.

A second possible explanation—and this is just really speculation on my part—is that they feared the United States was really out to use force against Iran, and they didn’t want to participate in that process. I think they were mistaken. They misread us.

I know, working for Secretary Rice, that we were very much determined to get into negotiations in 2006. We were planning for negotiations, hoping for negotiations. So I do think the Russians may have—particularly the Russians—may have miscalculated and misread and misunderstood the United States.

So the challenge now, for the present United States administration, for President Obama, is to convince the Russians and Chinese we are willing to give diplomacy a try. But there should be a price for that. The Russians and Chinese should, therefore, be willing to give sanctions a try. That might be the closing of a circle here that we’ve all been looking for the last few years.

The CHAIRMAN. Well, I might add to that that it seems to me that time is of the essence here, as we’ve heard. District Attorney Morgenthau has talked about the seriousness of the evidence that he’s been seeing. And so it seems to me that as much as you might like to begin at some lower level of talking about just narcotics or the Taliban or whatever we have interests in that regard, we may have to get right at the nuclear issue pretty quick, I think. Do you agree with that?

Ambassador BURNS. I do. And I think that the signals are from the administration that it intends to send an administration official to the next round of talks. That would be a good thing. But I do agree that if we can, perhaps on the margins of those talks, engage in some of these other bilateral issues, that would be of use as well.

The CHAIRMAN. And in addition to that, I might add, people forget that only 8 years ago, in 2001, when we launched our efforts against al-Qaeda in Afghanistan, Iran was very helpful. In fact, there was significant cooperation on a number of issues. I know they’re not fond of the Taliban, and I know they’re not happy with the narcotics situation on their border.

It seems to me there are legitimate interests, not to mention the possibility of a regional partnership. The fact is that under the right circumstances, unless they desire a confrontation, there are many, many things to cooperate on.

That said, I’ve been asked to go to the floor because I’ve got to lead off with my amendment. So Senator Risch, I’ll recognize you for questions, and Senator Kaufman, could you close out the hearing, and you’ll chair in my absence? Thank you. Thanks for being with us.

Ambassador BURNS. Thank you, Mr. Chairman.

The CHAIRMAN. I really appreciate it. Thank you.

Senator Risch.

Senator RISCH. Ambassador Burns, you believe that the Iranians understand that at the end of the day, however this comes out when it comes to negotiations, that the Israelis will never allow them to create a nuclear weapon and possess a nuclear weapon one way or another. Do they understand that, do you think?

Ambassador BURNS. You know, I don't know the level of sophistication in the Iranian Government in determining the Israeli position or our position. I think there may be a problem here of Iranians continually misunderstanding both Israel and the United States.

I certainly have heard both the past Israeli Government in their public statements, the current, the new Israeli Government of Prime Minister Netanyahu, say that this is an existential threat to Israel. And I think one of the obligations that the United States has, and the interest that the United States has, is to safeguard Israel, and to try to work in such a way that that threat never materializes to Israel.

My judgment is that the best way to do that would not be the immediate use of force against Iran, but this two-track policy that we've been discussing in this hearing of engagement and negotiations, but backed up by the threat of force and backed up by draconian sanctions. And at some point, if the negotiations fail, it would then be this very difficult decision that our President would have to make as to which direction to go in.

But you have asked a very good question. I think the Iranians have isolated themselves from us, from Israel, from a lot of other countries. It is unclear to me if they fully understand how angry and how worried many of their neighbors are, including Arab neighbors, about their rise to power, about their support for terrorism, particularly about the nuclear program.

Senator RISCH. And I don't disagree with that. It seems to me that the Iranians lump the United States and Israel together as far as those two countries' edginess toward the ultimate resolution of the issue. And I'm not so sure—I'm not only not so sure, I'm confident after discussing—that we aren't exactly on track with how close we are to that.

Having said that, it also seems to me that the Government in Iran seems to be the only people on the face of this planet that don't have a clear realization of what the Israeli position ultimately will be on this issue. And I frankly don't understand it. I don't know why they don't understand it. I mean, it seems to me to be clear to just about everyone except them as to what the ultimate resolution's going to be if they continue on the course that they're on.

Ambassador BURNS. Well, it's a regime that has isolated itself, not just from us, but from many other countries. And I think that strategic isolation is one of its dilemmas right now. So the test for our diplomacy is: Could we help them relieve that strategic isolation?

Essentially, what the Bush administration and the P5 countries offered Iran on this two-track policy was that we would be willing to have an economic relationship with them, we would be willing to facilitate their entry into the WTO, for instance, if they stood

down on their nuclear efforts. The Iranians never took us up on that two-track offer, unfortunately.

But it would seem to me that the long-range interest of the Iranian Government, a government that is suffering economically—the price of oil is falling, and they're having a hard time domestically just taking care of their own people—that opening up trade and investment is in their long-term interests. They seem to be putting other issues first right now.

So the task of these negotiations should be to focus on that issue. The Iranians need to halt their nuclear weapons development effort, in return for which there should be incentives by the international community to them to have a greater measure of trade and investment.

One other word on Israel. I think it is one of our central interests here to help Israel. I do think the United States is right to take the lead here, and I think leading diplomatically, not through military force, is in the best interest of both Israel and the United States at this point.

Senator RISCH. Thank you. I appreciate that. The other thing that seems to be wound up in this is there seems to be, when you read what comes out of Iran, almost—not almost—an actual national pride somehow tied in with this nuclear enrichment, and it permeates not only the government, but it seems the Iranian people—the Iranian people seem to be more reasonable than their government is, but both of them seem to be somehow tied up in this national pride thing, almost like a soccer team or something like that, that they have this national pride tied to nuclear enrichment, which really complicates matters, it seems to me.

Ambassador BURNS. It does, and President Ahmadinejad unfortunately has made this one of his central initiatives, to try to build this sense of pride out of the nuclear project. I think that the Iranian people ought to feel pride in trying to build a civil nuclear capacity.

It has been the position of the United States for a long time, including in the Bush administration, that we would have no objection to the properly monitored and regulated civil nuclear capacity of the Government of Iran, but they shouldn't take pride in unleashing proliferation in the Middle East, unleashing a situation where they might become nuclear weapons capable. Because the impact on the Iranians will be, as you said, to anger Israel, the United States, and nearly all their neighbors.

So helping the Iranian people understand that civil nuclear power is one thing, nuclear weapons are another, is really a task for our public diplomacy and for Arab public diplomacy as we go ahead, I think.

Senator RISCH. Thank you, Mr. Burns.

Ambassador BURNS. Thank you.

Senator RISCH. Thank you.

Senator KAUFMAN [presiding]. Mr. Ambassador, you've said several times today about we'd lead with diplomacy, we'd have the military—do you have any doubt that the Iranian Government understands that militarily, we would use what we have to use if we have to use it?

Ambassador BURNS. That's a good question, a hard question to answer. I do think it would be important for the Obama administration to reaffirm our willingness to use force if necessary, if absolutely necessary. Not that we would default to it, not that we wouldn't go through an agonizing process before doing it. But I don't see diplomacy succeeding unless that threat of the use of force is clearly visible. And I'm not sure, given the change of administration, and given the fact it's early days, given the fact that the policy as I've seen it publicly is not completely rolled out, I think we need to see more definition on that policy. And that would be my advice.

And I am someone who very much supports the direction that President Obama is heading in, and think that what he has done tactically has been very astute. His openness to the Arab world—the Nowruz message, the video message that he sent to the Iranian people over Nowruz, the fact that he said that we'll be at these talks. I think President Obama has done all the right things here, but as we get into the negotiations, the consequences of sanctions and the possible use of force, I think, need to be very clearly spelled out. That would be my judgment.

Senator KAUFMAN. I have two questions I just can't let you get away without answering, if you can do anything. The Ayatollah Khomeini's comment yesterday rebuking Ahmadinejad, do you read anything into that?

Ambassador BURNS. It is hard to say. It was interesting to see that during an election campaign, he chose to rebuke Ahmadinejad. The Supreme Leader chose to rebuke Ahmadinejad publicly. It has happened a few times in the past. I don't know what it means ultimately. We haven't seen him come out for or against—the Supreme Leader—any other candidates.

Obviously, what happens in June in their elections will be a major determinant of whether President Obama's policy of seeking a diplomatic approach can be successful.

Senator KAUFMAN. Well, that brings the second question, what do you think is going to happen in June?

Ambassador BURNS. It is hard to say.

Senator KAUFMAN. I know, and I realize this.

Ambassador BURNS. But, I do think that Ahmadinejad, unfortunately, has succeeded in some respects in the Muslim world in depicting himself as a champion of the Palestinian people, which he has not been, as Iran has not been much interested in the Palestinian cause until very recently. But at home, as best as I can see, Ahmadinejad is not as popular as he may want to be. His economic policies are largely considered to have been a failure at home. The Iranian people are hurting.

You have this incredible irony. It is a wealthy country. It is the second-largest gas producer in the world. It is a major oil producer. They can't even refine their own gasoline. They are importing nearly half of their gasoline needs. And average people are having a tough time in Iran.

Whether we see that expressed in the voting booths in Iran is an open question. But obviously, my own personal view is that Ahmadinejad has been a disaster for the Iranian people and for Iran's long-term interests.

Senator KAUFMAN. Great. Thank you for your usual spectacular testimony. And I'm going to adjourn the meeting.
 Ambassador BURNS. Thank you.
 [Whereupon, at 10:58 a.m., the hearing was adjourned.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

RESPONSES OF HON. R. NICHOLAS BURNS, TO QUESTIONS SUBMITTED FOR THE RECORD BY SENATOR ROBERT P. CASEY, JR.

EFFICACY OF INTERNATIONAL SANCTIONS TARGETED TO IRAN'S GASOLINE IMPORTS

In your opening statement, you made the following statement endorsing the value of international sanctions as an effective handmaiden to diplomacy:

While agreeing to negotiations, President Obama should not want to go hat in hand to the Iranians. As you stated in the March 3 hearings, Mr. Chairman, we must negotiate with Iran from a position of strength. President Obama would be wise to set a limited timetable for talks. He should make clear that the United States and others would walk away and impose much tougher financial and economic sanctions if progress in the negotiations is not made in a reasonable period. This would prevent Iran from running out the clock until they become nuclear capable.

Due to an inadequate domestic reprocessing capacity, Iran must import up to 40 percent of its domestic gasoline consumption, despite the fact that it is one of the world's leading oil producers. Last week, a bipartisan group of Senators introduced S. 908, the Iran Refined Petroleum Sanctions Act, a bill that would authorize the President to impose additional economic sanctions against those foreign firms that export reprocessed gasoline products to Iran. I am a cosponsor of this bill.

Question. How do you view the potential efficacy and viability of international sanctions that seek to target Iran's so-called Achilles heel—its dependency on imports of reprocessed gasoline for the functioning of its domestic economy?

Answer. As I stated in my testimony, I support President Obama's determination to begin negotiations with the Iranian Government. But, should those negotiations not produce progress toward ending Iran's quest for a nuclear weapons capability, the United States should then lead an effort to impose much tougher sanctions on Iran. To be successful, those sanctions would have to be supported and implemented by Iran's major trade partners, including China, Russia, Japan, South Korea, neighboring Arab States and European governments. In the event of failed negotiations with Iran, I believe sanctions on importation of reprocessed gasoline should be among the options the United States and other countries consider.

Question. Do you have specific thoughts on congressional legislation recently introduced to empower the President to levy sanctions on foreign companies that facilitate the export of reprocessed gasoline products to Iran?

Answer. To be successful, sanctions will need to be draconian in nature. Sanctions on reprocessed gasoline products would fit this definition. I would not favor tying the President's hands by having the Congress mandate sanctions automatically. Rather, it would be more effective, in my judgment, for the President to have the authority to decide when and if such sanctions should be imposed.

Question. Do you think it is useful for the administration and the Congress to play a "good cop, bad cop" routine when it comes to balancing diplomacy with coercive pressure?

Answer. I believe the administration should be given maximum flexibility and freedom of action in conducting the difficult diplomacy ahead with Iran, including determining how long to conduct diplomatic negotiations with Iran. It will surely be helpful for Congress to support negotiations with Iran but also to make clear that harsh sanctions would follow failed discussions. Such a determined posture on the part of Congress would be very valuable, in my judgment, to the administration in its talks with Iran. But, given the complexity of the U.S. relationship with Iran and the difficulty of holding together the international coalition of countries opposed to Iran's nuclear research efforts, I suggest President Obama be free to determine the timetable for both negotiations and the imposition of sanctions.

MATERIAL SUBMITTED BY ROBERT MORGENTHAU AND ADAM KAUFMANN

DEFERRED PROSECUTION AGREEMENT

Lloyds TSB Bank plc (“LLOYDS”) is a financial institution registered and organized under the laws of England and Wales. LLOYDS, by and through its attorneys, Linklaters LLP and Sullivan & Cromwell LLP, and the District Attorney of the County of New York (“DANY”) enter into this Deferred Prosecution Agreement (the “Agreement”). LLOYDS agrees to enter into a separate Deferred Prosecution Agreement with the United States Department of Justice (the “United States”).

1. LLOYDS agrees that it shall in all respects comply with its obligations in this Agreement and in the Deferred Prosecution Agreement it has entered into with the United States. A violation of LLOYDS’ obligations in its Deferred Prosecution Agreement with the United States may be deemed a violation of this Agreement, at the sole discretion of DANY.

2. LLOYDS accepts and acknowledges responsibility for its conduct and that of its employees as set forth in the Factual Statement attached hereto as Exhibit A and incorporated herein by reference (the “Factual Statement”).

3. As a result of LLOYDS’ conduct as set forth in the Factual Statement, DANY has determined that it could institute a criminal prosecution pursuant to New York State Penal Law Section 175.10 and forfeiture action against certain funds currently held by LLOYDS, and that such funds would be forfeitable under New York State law. Therefore LLOYDS hereby expressly agrees to settle and does settle any and all criminal and forfeiture claims presently held by DANY against those funds for the sum of \$350,000,000 (the “Settlement Amount”), half of which will be paid directly to DANY to be distributed to the City and State of New York at the discretion of the District Attorney,

in lieu of fines and forfeiture.¹ The parties to this Agreement agree that the Settlement Amount will fully satisfy all claims presently held by DANY. LLOYDS shall wire-transfer half the Settlement Amount to DANY within five (5) business days of the date of this Agreement.

4. In consideration of LLOYDS' willingness to: (i) acknowledge responsibility for its actions; (ii) voluntarily terminate the conduct set forth in Exhibit A; (iii) cooperate with DANY as stated in Paragraphs 14 and 15 of this Agreement; (iv) demonstrate its future good conduct and full compliance with international Anti-Money Laundering and Combating Financing of Terrorism ("AML/CFT") best practices and the Wolfsberg Anti-Money Laundering Principles for Correspondent Banking; and (v) settle any criminal claims currently held by DANY for any act within the scope of or related to the Factual Statement; DANY agrees as follows:

(a) that it shall defer prosecution of LLOYDS for a period of twenty-four (24) months from the date of this Agreement, or less at the discretion of DANY. DANY shall not prosecute LLOYDS if it complies with all of its obligations pursuant to this Agreement and its separate Deferred Prosecution Agreement with the United States except that DANY may choose to prosecute LLOYDS for any conduct that is specified in Paragraph 11 of this Agreement: and

(b) that if LLOYDS is in full compliance with all of its obligations under this Agreement and the Deferred Prosecution Agreement it enters with the United States for

¹ Pursuant to the Deferred Prosecution Agreement with the United States being entered into contemporaneously, LLOYDS has also agreed to pay separately \$175,000,000 to the United States for violations of Title 50, United States Code, and Section 1705, to wit, Title 31, Code of Federal Regulations, Sections 560.203 and 560.204.

the time period set forth above in Paragraph 4(a), this Agreement shall expire and be of no further force or effect.

5. LLOYDS expressly agrees that within six months of a material and willful breach by LLOYDS, any violations of New York State law that were not time-barred by the applicable statute of limitations as of the date of this Agreement and (i) which relate to the facts set forth in the Factual Statement or (ii) were hereinafter discovered pursuant to the review of information provided pursuant to Paragraph 14 may, in the sole discretion of DANY be charged against LLOYDS, notwithstanding the provisions or expiration of any applicable statute of limitations. LLOYDS expressly waives any challenges to the venue or jurisdiction of the Supreme Court of the State of New York for the County of New York.

6. DANY recognizes that the Deferred Prosecution Agreement between LLOYDS and the United States must be approved by the United States District Court for the District of Columbia, in accordance with 18 U.S.C. § 3161(h)(2). Should that Court decline to approve the Deferred Prosecution Agreement between LLOYDS and the United States for any reason, DANY and LLOYDS are released from any obligations imposed upon them by this Agreement, this Agreement shall be null and void, and DANY shall not premise any prosecution of LLOYDS, its employees, officers or directors upon any admissions or acknowledgements contained in this Agreement or the Deferred Prosecution Agreement between LLOYDS and the United States.

7. LLOYDS expressly agrees that it shall not, through its attorneys, board of directors, agents, officers or employees, make any public statement contradicting, excusing or justifying any statement of fact contained in the Factual Statement. Any such

public statements by LLOYDS, its attorneys, board of directors, agents, officers or employees, shall constitute a material breach of this Agreement, and LLOYDS would thereafter be subject to prosecution pursuant to the terms of this Agreement. The decision of whether any public statement by any such person contradicting a fact contained in the Factual Statement will be imputed to LLOYDS for the purpose of determining whether LLOYDS has breached this Agreement shall be in the sole and reasonable discretion of DANY. Upon DANY's notification to LLOYDS of a public statement by any such person that in whole or in part contradicts a statement of fact contained in the Factual Statement, LLOYDS may avoid breach of this Agreement by publicly repudiating such statement within seventy-two (72) hours after notification by DANY. This paragraph is not intended to apply to any statement made by any former LLOYDS' employee, officer or director, or statement made by any individual in the course of any criminal, regulatory, or civil case initiated by a governmental or private party against such individual regarding that individual's personal conduct.

8. Should DANY determine during the term of this Agreement that LLOYDS has committed any state crime other than those covered by this Agreement, LLOYDS shall, in the sole discretion of DANY, thereafter be subject to prosecution for any state crimes of which DANY has knowledge.

9. Except in the event of a breach of this Agreement, DANY agrees that it will not bring charges against LLOYDS, its employees, officers and directors, while acting within the scope of their duties, for any violations of law related to all matters contained in or involving the facts described in the Factual Statement or disclosed during the course of the investigation except as set forth in Paragraph 11 of this Agreement.

DANY agrees that if, in its sole discretion, DANY determines that LLOYDS its employees, officers and directors, did not act knowingly and willfully as to conduct described in Paragraph 11 any criminal violations related to such conduct will fall within the scope of this paragraph and will not be charged. If DANY determines, in its sole discretion, that LLOYDS, its employees, officers and directors, acted knowingly and willfully as to conduct described in Paragraph 11, DANY agrees that it will in good faith attempt to resolve any criminal liability arising out of that conduct, but any resolution of that criminal liability is within the sole discretion of DANY. The parties further understand and agree that the exercise of discretion by DANY under this paragraph is not subject to review in any court or tribunal.

10. Should DANY determine that LLOYDS has committed a willful and material breach of any provision of this Agreement, DANY shall provide written notice to LLOYDS of the alleged breach and allow LLOYDS a two-week period from the date of receipt of said notice, or longer at the discretion of DANY, to cure by making a presentation to DANY that demonstrates that no breach has occurred or, to the extent applicable, that the breach is not willful or material or has been cured. The parties hereto expressly understand and agree that should LLOYDS fail to make the above-noted presentation within such time period, it shall be presumed that LLOYDS is in material breach of this Agreement. The parties further understand and agree that the exercise of discretion by DANY under this paragraph is not subject to review in any court or tribunal. In the event of a breach of this Agreement that results in a prosecution, such prosecution may be premised upon any information provided by or on behalf of

LLOYDS to DANY or the United States at any time, unless otherwise agreed when the information was provided.

11. DANY agrees that it shall not seek to prosecute LLOYDS, its current or former employees, officers and directors, for any act within the scope of or related to the Factual Statement or disclosed during the course of the investigation that violated New York State law during the period of March 15, 1995 through the date of this Agreement, unless there is probable cause to believe that LLOYDS, or its employees, officers and directors, acting within the scope of their employment for the benefit of LLOYDS, knowingly and willfully transmitted funds that went to or came from persons or entities designated at the time of the transaction by the Office of Foreign Assets Control ("OFAC") of the United States Department of the Treasury as Specially Designated Terrorists ("SDTs"), Specially Designated Global Terrorists ("SDGTs"), Foreign Terrorist Organizations ("FTOs") and proliferators of Weapons of Mass Destruction ("WMDs"). LLOYDS agrees that it shall waive the provisions of Article 30 of the Criminal Procedure Law with respect to such conduct for a period of three years from the date of this Agreement.

12. LLOYDS agrees that, if it sells or merges all or substantially all of its business operations or assets as they exist as of the date of this Agreement to a single purchaser or group of affiliated purchasers during the term of this Agreement, it shall include in any contract for sale or merger a provision binding the purchaser/successor to the obligations described in this Agreement. Any such provision in a contract of sale or merger shall not expand or impose new obligations on LLOYDS beyond those contained

in this Agreement, including but not limited to the LLOYDS' obligations as described in Paragraphs 14 and 15.

13. It is understood that nothing in this Agreement shall require LLOYDS to extend the obligations in this Agreement to any company or entity that it acquires after the date of this Agreement nor shall it extend any protections to any such company or entity.

14. LLOYDS agrees that it shall, within 270 days from the date of this Agreement, conduct a review of payment data held by LLOYDS, its affiliates, successors or related companies as of the date of this Agreement related to United States Dollar ("USD") payments for the period from April 2002 through December 2007, as follows:

(a) Provide to DANY and the United States all available incoming and outgoing Society for Worldwide Interbank Financial Telecommunications ("SWIFT") Message Transfer ("MT") 100 and MT 200 series payment messages relating to USD payments processed during the period from April 2002 through December 2007 through the correspondent accounts held by Iranian banks (also referred to as "the vostro accounts"), in electronic format as well as in the form of a spreadsheet or other electronic summary, and all existing periodic or monthly account statements for the vostro accounts; and

(b) Conduct a review of all available incoming and outgoing USD SWIFT MT 100 and MT 200 series payment messages processed through (i) LLOYDS' payments processing centers located in the United Kingdom during the period from April 2002 through December 2007, and (ii) LLOYDS' branch in Dubai during the period from April 2002 through December 2007, and compare such data against the lists of persons

and entities designated by OFAC as Specially Designated Terrorists (“SDTs”), Specially Designated Global Terrorists (“SDGTs”), Foreign Terrorist Organizations (“FTOs”) and proliferators of Weapons of Mass Destruction (“WMDs”) who were on such lists at any time during the period from April 2002 through December 2007. LLOYDS will provide in electronic form to DANY and the United States a report containing information relating to any confirmed match, and any other match that cannot be eliminated as a false positive after investigation by LLOYDS and all payments messages and other documentation associated with such matches;

(c) The review shall be performed with the assistance of an independent consultant selected by LLOYDS, and approved by DANY.

15. LLOYDS agrees that for the term of this Agreement, in accordance with applicable laws, it shall, upon request of the United States and DANY, supply any relevant document, electronic data, or other objects in LLOYDS possession, custody or control as of the date of this Agreement relating to any transaction within the scope of or relating to the Factual Statement known at the time of the signing of this Agreement or discovered as a result of the review set forth in Paragraph 14 of this Agreement. This obligation shall not include production of materials covered by the attorney-client privilege or the work product doctrine. Whenever such data is in electronic format, LLOYDS shall provide access to such data and assistance in operating computer and other equipment as necessary to retrieve the data.

16. It is further understood that this Agreement is binding on LLOYDS and DANY, but specifically does not bind any federal agencies, or any state or local authorities, although DANY will bring the cooperation of LLOYDS and its compliance

with its other obligations under this Agreement to the attention of federal, state, or local prosecuting offices or regulatory agencies, if requested by LLOYDS or its attorneys.

17. It is further understood that this Agreement does not relate to or cover any conduct by LLOYDS other than that disclosed during the course of the investigation or described in the Factual Statement and this Agreement.

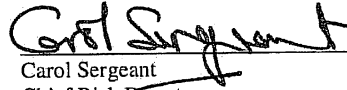
18. LLOYDS and DANY agree that this Agreement (and its attachments) shall be disclosed to the public.

19. This Agreement sets forth all the terms of the Deferred Prosecution Agreement between LLOYDS and DANY. There are no promises, agreements, or conditions that have been entered into other than those expressly set forth in this Agreement, and none shall be entered into and/or are binding upon LLOYDS or DANY unless expressly set forth in writing, signed by DANY, LLOYDS' attorneys, and a duly authorized representative of LLOYDS. This Agreement supersedes any prior promises, agreements or conditions between LLOYDS and DANY. LLOYDS agrees that it has the full legal right, power and authority to enter into and perform all of its obligations under this Agreement and it agrees to abide by all terms and obligations of this Agreement as described herein.

Acknowledgment

I, Carol Sergeant, the duly authorized representative of Lloyds TSB Bank plc, hereby expressly acknowledge the following: (1) that I have read this entire Agreement; (2) that I have had an opportunity to discuss this Agreement fully and freely with Lloyds TSB Bank plc's attorneys; (3) that Lloyds TSB Bank plc fully and completely understands each and every one of its terms; (4) that Lloyds TSB Bank plc is fully satisfied with the advice and representation provided to it by its attorneys; and (5) that Lloyds TSB Bank plc has signed this Agreement voluntarily.

Lloyds TSB Bank plc



Carol Sergeant
Chief Risk Director

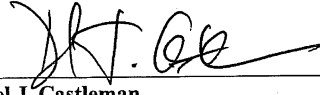
DATE

Counsel for LLOYDS

We, Joseph P. Armao and Samuel W. Seymour, the attorneys for Lloyds TSB Bank plc, hereby expressly acknowledge the following: (1) that we have discussed this Agreement with our client; (2) that we have fully explained each one of its terms to our client; (3) that we have fully answered each and every question put to us by our client regarding the Agreement; and (4) we believe our client completely understands all of the Agreement's terms.

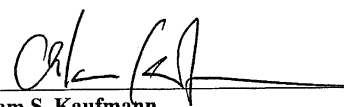
<u>JAN. 9, 2009</u> DATE	<u>Joseph P. Armao</u> Joseph P. Armao /s/s Linklaters LLP 1345 Avenue of the Americas New York, New York 10105
<u>JAN. 9, 2009</u> DATE	<u>Samuel W. Seymour</u> Samuel W. Seymour Sullivan & Cromwell LLP 125 Broad Street New York, New York 10004

ON BEHALF OF THE NEW YORK COUNTY DISTRICT ATTORNEY'S
OFFICE



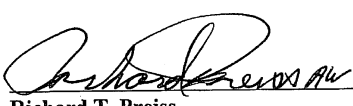
Daniel J. Castleman
Chief Assistant District Attorney

Date 1/9/09



Adam S. Kaufmann
Bureau Chief of Investigation Division Central

Date 1/9/09



Richard T. Preiss
Senior Investigative Counsel

Date 1/9/09

EXHIBIT A
FACTUAL STATEMENT

Introduction

1. This Factual Statement is made pursuant to, and is part of the Deferred Prosecution Agreements (the “DPAs”), dated January 9, 2009, between the New York County District Attorney’s Office (“DANY”) and Lloyds TSB Bank plc (“Lloyds”), and the United States Department of Justice (“DOJ”) and Lloyds.

2. Beginning in or about the mid 1990s and continuing until January 2007, Lloyds, in the United Kingdom, systematically violated both New York State and United States laws by falsifying outgoing United States Dollar (“USD”) payment messages that involved countries, banks, or persons listed as sanctioned parties by the United States Department of the Treasury’s Office of Foreign Assets Control (“OFAC”). In doing so, Lloyds removed material data from payment messages in order to avoid detection of the involvement of OFAC-sanctioned parties by filters used by U.S. depository institutions. This allowed transactions to be processed by Lloyds’ U.S. correspondent banks that they otherwise could have blocked for investigation, or rejected pursuant to OFAC regulations. During the course of the conduct, Lloyds employees commonly referred to this process as “stripping.” Lloyds’ criminal conduct was designed to assist its clients in avoiding detection by filters employed by U.S. banks because of United States economic sanctions against Iran, Sudan, and Libya.¹ Lloyds’ actions caused U.S. banks to provide services to those sanctioned countries, and falsified business records of banks primarily located in New York, New York (“New York”). This resulted in the processing of

¹ U.S. economic sanctions against Libya were lifted in 2004.

transactions in the United States by U.S. financial institutions which may have otherwise been prohibited.

3. In or around early 2002, facing generally heightened focus on industry-wide anti-money laundering and sanctions issues, and the possibility that the Financial Action Task Force (“FATF”)² would recommend to member countries that they require their banks to include originator information on payment messages, concerns were raised within Lloyds about the legal and reputational implications of continuing to provide “stripping” services to OFAC-sanctioned countries and clients. In April 2003, when the issue was brought to the attention of Lloyds’ Group Executive Committee (“GEC”), the GEC decided to withdraw from the USD clearing business on behalf of “U.K. Iranian Banks” (as defined below). Lloyds fully exited that business by April 2004. Notwithstanding the decision to cease providing USD clearing services to the U.K. Iranian Banks, Lloyds continued to perform these services on a smaller scale on behalf of four Sudanese banks until January 2007. Lloyds terminated its last relationship with a Sudanese bank in September 2007.

4. In April 2007, prosecutors contacted Lloyds’ representatives in New York and informed them of an investigation into Lloyds’ USD business on behalf of sanctioned entities, and that there was evidence of violations of New York State and United States laws. Prosecutors requested that Lloyds disclose the nature and extent of its misconduct and provide the evidence of that misconduct. As described herein, Lloyds promptly commenced a thorough internal investigation of its international USD clearing business.

² FATF is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is therefore a ‘policy-making body’ created in 1989 that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The FATF has published certain recommendations in order to meet this objective.

Lloyds has provided prompt and substantial assistance by sharing with DOJ and DANY, as well as other relevant regulators, the results of that internal investigation.

5. Lloyds accepts and acknowledges that the USD processing described in this Factual Statement constituted serious and systematic misconduct that violated both New York State and United States laws.

Lloyds' Business Organization and Background

6. Lloyds³ is a wholly owned subsidiary of Lloyds TSB Group plc. ("LTSB Group").⁴ LTSB Group, whose shares are publicly traded, was formed in 1995 by the merger of Lloyds Bank and the Trustee Savings Bank Group. Lloyds is a financial institution registered and organized under the laws of England and Wales. Lloyds provides a wide range of banking and financial services within its Wholesale and International Banking ("W&IB") division in the United Kingdom and has operations in countries around the world, including two branches in the United States, located in New York, New York, and Miami, Florida. Lloyds' U.S. branches are subject to oversight and regulation by the Board of Governors of the Federal Reserve System, the New York State Banking Department, and the State of Florida Office of Financial Regulation. None of the USD payments processed on behalf of OFAC-sanctioned parties were processed by Lloyds' U.S. branches. The United Kingdom's Financial Services Authority ("FSA") is Lloyds' primary home-country regulator.

7. As of December 2007, LTSB Group assets totaled \$701.4 billion (£353.3 billion), and the organization employed over 67,000 staff across its divisions. Net profit

³ The principal place of business is 25 Gresham Street, London, EC2V 7HN, United Kingdom.

⁴ The registered office of LTSB Group is Henry Duncan House, 120 George Street, Edinburgh, EH2 4LH, Scotland.

for LTSB Group was \$7.9 billion (£4 billion) for 2007. The W&IB business accounted for approximately 46%, or \$3.6 billion (£1.8 billion), of the LTSB Group profit.⁵

Applicable Law

8. In 1995 and 1997, President Clinton issued Executive Order Nos. 12957, 12959, and 13059 which strengthened existing United States sanctions against Iran. The Executive Orders prohibit virtually all trade and investment activities with Iran by U.S. persons or entities, regardless of where they are located, including but not limited to broad prohibitions on the importation of goods or services from Iran; prohibitions on the exportation, sale, or supply of goods, technology or services to Iran; prohibitions on trade-related transactions with Iran, including financing, facilitating or guaranteeing such transactions; and, prohibitions on investment in Iran or in property controlled by Iran (collectively, the “Iranian Sanctions”).⁶

9. With the exception of certain exempt transactions, the OFAC regulations implementing the Iranian Sanctions prohibit U.S. depository institutions from servicing Iranian accounts, and prohibit U.S. depository institutions from directly crediting or debiting Iranian accounts. OFAC regulations permitted U.S. depository institutions to handle certain “U-turn” transactions, in which the U.S. depository institution acts only as an intermediary bank in clearing a USD payment between two non-U.S., non-Iranian banks.

⁵ USD amounts calculated based on the foreign exchange rate as of December 31, 2007.

⁶ The Iranian Transactions Regulations are found at 31 CFR part 560 and can be reviewed at the OFAC website, located at www.ustreas.gov/ofac.

10. In 1997 and 2006, Presidents Clinton and Bush issued Executive Orders Nos. 13067 and 13412, among others, which imposed a trade embargo against Sudan and froze the assets of the government of Sudan (collectively, the “Sudanese Sanctions”).⁷

11. DOJ has alleged, and Lloyds accepts, that its conduct, as described herein, violated Title 50, United States Code, Section 1705, part of the International Emergency Economic Powers Act (“IEEPA”), which makes it a crime to willfully violate or attempt to violate any regulation issued under IEEPA, including the Iranian Transactions Regulations, principally, 31 C.F.R. Section 560.204, which prohibits the exportation of services from the United States to Iran, and the Sudanese Sanctions Regulations, principally, 31 C.F.R. Section 538.205, which, similarly prohibits the exportation of services from the United States to Sudan.

12. DANY has alleged, and Lloyds accepts, that its conduct, as described herein, violated New York State Penal Law Sections 175.05 and 175.10, which make it a crime to, “with intent to defraud,... (i) make or cause a false entry in the business records of an enterprise (defined as any company or corporation)... or (iv) prevent the making of a true entry or cause the omission thereof in the business records of an enterprise.” It is a felony under Section 175.10 of the New York Penal Law, if a violation under Section 175.05 is committed and the person or entity’s “intent to defraud includes an intent to commit another crime or to aid or conceal the commission of a crime.”

Lloyds’ “Stripping” of USD Payments for the U.K. Iranian Banks That Terminated at U.S. Banks

13. Prior to 2002, Lloyds maintained USD correspondent accounts for what were then the London-based branches of Bank Sepah, Bank Melli, Bank Tejerat, Bank

⁷ The Sudanese Sanctions Regulations are found at 31 CFR part 538 and can be reviewed at the OFAC website, located at www.ustreas.gov/ofac.

Mellat, Bank Saderat, and the Iranian Overseas Investment Bank. During this time, Lloyds was able to provide USD payment processing services through its relationships with other correspondent banks in New York and elsewhere in the United States. By 2002, these Iranian bank branches had become subsidiaries incorporated under United Kingdom law. The U.K. subsidiaries of the Iranian banks for which Lloyds maintained correspondent accounts were Melli Bank, plc., Bank Sepah International, plc., Bank Saderat, plc., and Persia International Bank, plc. The branches and successor U.K. subsidiaries are referred to collectively hereinafter as the “U.K. Iranian Banks.” Additionally, Lloyds’ branches in Dubai and Tokyo held USD correspondent accounts for certain Iranian banks.

14. The commercial relationships between Lloyds and the U.K. Iranian Banks were managed by personnel within Lloyds’ Financial Institutions (“FI”) unit, a business unit within the W&IB division of Lloyds.

15. Lloyds used the Society for Worldwide Interbank Financial Telecommunication (“SWIFT”)⁸ messaging system to transmit its international payment messages.

16. In June 1995, in response to the promulgation of heightened OFAC sanctions against Iran, Lloyds’ U.K.-based international payment processing unit (“IPPU”) implemented a procedure whereby its processing staff manually reviewed each SWIFT message received from the U.K. Iranian Banks before they were transmitted to the United States to ensure that references to Iran were removed from certain outgoing USD SWIFT messages. This process was described in an internal Lloyds letter dated

⁸ SWIFT is a cooperative organized under Belgian law that supplies to its members and certain other users secure messaging services for various types of financial transactions and is used by the international banking industry as a means of sending and receiving payment messages in a secure environment.

June 24, 1996, which stated that Lloyds' IPPU "decided to handle all the outward payments manually to ensure that the [U.K. Iranian Bank] names were not included on the payment instructions received in the U.S.A."

17. Lloyds' IPPU memorialized the processing steps in an internal document called the "Payment Services Aide Memoire." The Aide Memoire notes that "any [Iranian] payments received either in paper form or via BIT IMT [a branch system through which Lloyds received payment instructions] expressed in U.S. Dollars must not be processed and should be immediately referred to the section management." The Aide Memoire also states that: "[T]he instructions received from the London Branches of the following [Iranian] banks are to be processed in the normal way." The investigation has disclosed that "the normal way" included removing information when necessary from the Iranian bank's payment instructions. Over time, Lloyds dedicated specific payment processors to focus exclusively on reviewing and amending, if necessary, SWIFT messages pertaining to USD payments for the U.K. Iranian Banks.

18. For Iranian customer transactions that terminated either at banks located inside the United States or at U.S. banks located outside the United States, the Lloyds' IPPU processor removed the incoming SWIFT payment message from Lloyds' Common System and manually re-keyed the payment back into the Common System. The Common System is the automated payment processing system used by Lloyds to process payments. The processor amended the payment message to ensure the re-keyed message did not contain any references to Iran. The amended message was then transmitted to the relevant U.S. bank. This practice made it appear that the transaction originated with Lloyds.

19. The investigation has revealed that Lloyds' IPPU processors took the following steps to process the payments described in the preceding paragraph:

Step One: A member of Lloyds' IPPU would remove the payment instruction out of Lloyds' Common System by "busting out" the payment so that it could be manually processed (payments could be "busted out" of the Common System for a number of reasons, one of which included the presence of an Iranian reference).

Step Two: A member of Lloyds' IPPU then printed out a copy of the "busted out" payment instruction.

Step Three: A member of Lloyds' IPPU would physically mark up the printed payment instruction to show what information should be changed, including crossing out any reference to Iranian banks or other sanctioned entities and striking a line through Field 52 of the SWIFT payment instruction (Field 52 is used to identify the originating bank – in this case, a sanctioned entity).

Step Four: The marked up and crossed off message would be returned to Lloyds' IPPU repairers who would type the corrected information back into the Common System.

20. By manually amending these payment records in this fashion, Lloyds prevented the U.S. depository institutions located in New York and elsewhere in the United States from recognizing the transactions as originating from sanctioned countries, banks or persons, and then blocking them for investigation or rejecting such transactions. Lloyds additionally prevented those depository institutions from generating business records of transactions to be filed with OFAC, as required by law. Moreover, to the extent that any Iranian payments might have been permissible under an exemption to IEEPA or pursuant to a license issued by OFAC, Lloyds did not include such information in the payment message, and, made no inquiry into the existence of such exemption or license. Instead, Lloyds followed its practice of stripping information from certain outgoing Iranian payment messages. Lloyds' conduct deceived the OFAC filters at its U.S. correspondent banks, preventing them from detecting and blocking or rejecting wire

transfers processed on behalf of sanctioned entities, and preventing them from making and keeping accurate records of their transactions.

Lloyds' Removal of Iranian Payment Information from USD Payments in its Dubai and Tokyo Branches

21. Until October 2004, Lloyds maintained USD correspondent accounts for Iranian banks in its Dubai and Tokyo branch offices. In both branches, USD payments that terminated either at banks located inside the United States or at U.S. banks located outside the United States were transmitted on behalf of the Iranian banks in a manner designed to conceal the Iranian origin of the payments, in order to prevent the U.S. correspondent banks from blocking for investigation or rejecting the payments.

22. Lloyds' Dubai branch maintained USD correspondent accounts for the Bank of Industry and Mine, Bank Saderat, Bank Sepah, Bank Melli, Bank Mellat, Bank Karafarin, and Bank Refah-Kargaran. Between January 2000 and October 6, 2004 (the date by which all the accounts were closed) there were six transactions that terminated either at banks located inside the United States or at U.S. banks located outside the United States.

23. Lloyds' Tokyo branch maintained two USD correspondent accounts, one for Bank Refah-Kargaran and one for the Seoul branch of Bank Mellat. Between February 1, 2001, and October 26, 2004 (the date by which both accounts were closed), thirty-nine payments terminated either at banks located inside the United States or at U.S. banks located outside the United States.

Lloyds' Removal of Information from USD Payment Messages Processed on Behalf of Sudanese Banks

24. Beginning in 1987 and lasting until September 2007, Lloyds maintained United Kingdom-based USD correspondent accounts for four Sudanese banks: National

Bank of Khartoum; Al Baraka Bank; Animal Resources Bank; and the Commercial and Real Estate Bank, which became subject to U.S. sanctions in 1997.

25. While Lloyds did not have a dedicated “stripping” unit for Sudan as it did for Iran, Lloyds’ IPPU similarly ensured that on a transaction-by-transaction basis all outgoing USD payment messages for Sudan did not contain references to Sudan. This manipulation of the Sudanese payment instructions had the same intent and practical effect as the manipulation of the Iranian wire instructions.

26. Although Lloyds made the decision to exit from the Iranian USD payments business in April 2003, Lloyds’ IPPU continued to manipulate Sudanese USD payment instructions until January 2007, although at levels that decreased over time as Lloyds wound down the business and closed all of the Sudanese USD correspondent accounts by September 2007.

Trade Finance Activity

27. Lloyds also engaged in certain USD trade finance transactions, primarily from the United Kingdom, Tokyo and Dubai, involving banks from countries subject to OFAC sanctions, principally, Iran and Sudan. The trade finance transactions included import and export letters of credit, inward and outward documentary collections and guarantees. For the period that has been reviewed, from on or about January 1, 2002, to on or about December 31, 2007, Lloyds engaged in approximately 1500 trade finance transactions involving Iranian banks in its United Kingdom, Dubai and Tokyo offices with an aggregate value of approximately \$300 million. During the same time period, Lloyds engaged in approximately 300 trade finance transactions involving Sudanese banks in its United Kingdom and Dubai offices with an aggregate value of approximately \$21 million. Lloyds removed material information from certain USD payments used to

effect the underlying trade finance transactions. A detailed review of 300 of these transactions indicates that a large number of them were cancelled or rejected, and that of those transactions that were completed, only three involved funds that terminated either at banks located inside the United States or at U.S. banks located outside the United States, and many involved payments that did not clear through the United States. Additionally, a number of the Iranian trade finance transactions selected for detailed review involved exports of goods originating in the U.S. to Iran through third countries. Lloyds initiated trade finance transactions involving banks in OFAC-sanctioned countries until December 2007. None of these trade finance transactions were processed by Lloyds' U.S. operations.

Lloyds' Decision to Terminate the U.K. Iranian Bank Business

28. In or around early 2002, senior Lloyds' IPPU staff and the Director of Lloyds' Group Financial Crime Unit ("GFC") raised concerns with FI about the intentional removal of Iranian-related information in connection with the processing of USD payments for the U.K. Iranian Banks. Some of Lloyds' IPPU staff were concerned that this process might violate United States laws. In April 2002, FI proposed that Lloyds' IPPU no longer remove Iranian-related information from outgoing SWIFT messages sent by the U.K. Iranian Banks and instead, returned to the U.K. Iranian Banks any payment instruction containing an Iranian reference for correction by the U.K. Iranian Banks themselves. FI's proposal was implemented in or around July 2002. At that time, FI personnel met with representatives of the U.K. Iranian Banks and informed them how to format the SWIFT messages to avoid detection by the OFAC filters. Thus, instead of Lloyds' employees stripping the payment messages, the information would be removed by the U.K. Iranian Banks themselves. Lloyds' employees instructed the U.K.

Iranian Banks not to leave the originating bank information field blank, but rather to populate that field with a dot, hyphen, or another symbol. In connection with bank-to-bank payments which stayed in the United States, the inclusion of these symbols prevented the Common System from automatically populating that field with the name of the originating Iranian bank. Consequently, the payment message sent to the U.S. correspondent bank would not contain any reference to the ordering institution that would be detected by the OFAC filters at the U.S. correspondent banks. However, even after July 2002, Lloyds' IPPU staff continued to manually re-format outgoing messages on customer payments that terminated at banks in the United States to omit references to Iran because the Common System automatically populated the relevant field with the name of the originating Iranian bank.

29. Senior Lloyds' IPPU staff continued to raise concerns about USD payment processing for the U.K. Iranian Banks, and in September 2002, as part of an overall review of the Iranian USD payments business, the Director of Lloyds' GFC unit requested that Lloyds' IPPU and FI personnel evaluate the risks of these payment practices. Lloyds IPPU continued to express concern about the payment practices while FI maintained that Lloyds should continue to provide the U.K. Iranian Banks with USD payment processing services on the mistaken belief that because Lloyds is a U.K. institution it was not subject to OFAC regulations for such processing activity. This internal debate continued into 2003.

30. In March 2003, the GFC Director instructed a senior GFC staff member to conduct a sampling analysis of Iranian USD payments. The results of the analysis noted that, prior to July 2002, a dedicated team of Lloyds' IPPU staff manually reviewed and

removed any references to Iran from SWIFT messages submitted by the U.K. Iranian Banks. Shortly after the GFC concluded its analysis, the executive director of Lloyds' Group Risk Management (the overall business unit in which GFC was located) advised the executive director of the W&IB division that regardless of whether the OFAC regulations applied to the USD payment services, they should either operate on a fully transparent basis or be terminated. At its meeting on April 1, 2003, the GEC received a risk report from Group Risk that mentioned the existence of the USD payment processing services provided to the U.K. Iranian Banks. The GEC expressed concerns over the continuance of the business and directed that it receive further information and analysis as a matter of urgency. A week later on April 9, 2003, the GEC received a more detailed analysis that described the systematic removal of Iranian-related information from SWIFT messages and recommended that the GEC terminate the USD correspondent banking accounts held for the Iranian Banks on reputational grounds. The GEC decided that the USD correspondent accounts of the Iranian Banks should be terminated.

31. On May 22, 2003, the Executive Director of W&IB instructed FI to exit the business. FI relationship managers informed their contacts at the U.K. Iranian Banks that Lloyds was exiting the business. Activity through the accounts was wound down over the ensuing months and all of the USD correspondent accounts maintained by the U.K. Iranian Banks with Lloyds in the United Kingdom were closed by April 2004.

Transaction Value of Stripping Conduct

32. From 2002 to 2004, Lloyds processed approximately three hundred million dollars in outgoing USD payment transactions on behalf of the U.K. Iranian Banks that terminated either at banks located inside the United States or at U.S. banks located outside the United States. The payment messages related to these transactions

were busted out and processed as described herein to allow them to be processed through U.S. banks in New York and elsewhere without detection by OFAC filters.

33. From August 2002 to September 2007, Lloyds processed more than twenty million dollars in outgoing USD payment transactions on behalf its Sudanese bank customers through its U.S. correspondent banks in a manner that prevented the U.S. banks from identifying their Sudanese origin.

34. From August 2002 to April 2004, Lloyds processed approximately twenty million dollars in outgoing USD payment transactions on behalf of a Libyan customer through its U.S. correspondent banks in a manner that prevented the U.S. banks from identifying their Libyan origin.

Actions Taken by Lloyds

35. Throughout the course of this investigation Lloyds' cooperation has provided substantial assistance to DANY and DOJ. Lloyds' prompt and substantial cooperation has included the following:

- Committing substantial resources to conducting an extensive internal investigation into the provision of USD clearing services to the Iranian banks, their U.K. subsidiaries and branches, and banks from other OFAC-sanctioned countries including Sudan and Libya.
- Conducting a review of its operations in the United Kingdom and around the world to determine the existence of USD correspondent accounts held for banks in OFAC-sanctioned countries and confirming the closure of all such accounts.

- Conducting a detailed forensic review across various accounts related to OFAC-sanctioned countries, including an analysis of underlying SWIFT transmission data associated with USD activity for accounts of banks in OFAC-sanctioned countries.
- Conducting a screening of payments cleared through the United States between August 2002 through the closure of those accounts that were processed through vostro accounts held by banks of OFAC-sanctioned countries against names on contemporaneous OFAC terrorist and weapons of mass destruction watch lists. Lloyds found no confirmed matches to any names on such lists.
- Providing regular and detailed updates to DANY and DOJ on the results of its investigation and forensic SWIFT data analyses and responding to additional specific requests of DANY and DOJ.

36. Lloyds has also agreed, as part of its cooperation with DANY and DOJ, to undertake the further work necessary to enhance and optimize its sanctions compliance programs. The full scope of Lloyds' continued efforts and commitments, including its look-back review of payment messages, are outlined in the DPAs and the Factual Statement. Lloyds has also agreed to cooperate in DANY and DOJ's ongoing investigations into these banking practices. Furthermore, Lloyds has agreed to be in compliance with the Wolfsberg Anti-Money Laundering Principles of Correspondent banking.