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before a
Joint Subcommittee Hearing: Subcommittee on Domestic and International Monetary Policy, Trade and Technology (FSC) and the Subcommittee on Terrorism, Nonproliferation and Trade (HCFA)

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Mr. Chairman and Committee members, it is a privilege to have this opportunity to testify before this joint hearing entitled "Punishing the Proliferators and Sponsors of Terror: Using Financial and Economic Sanctions to Change Regime Behavior." I am President & CEO of Conflict Securities Advisory Group, Inc. (CSAG), an independent, impartial research provider specializing in the field of global security risk management and the implementation of terror-free investing strategies. In the way of background, I am an international banker by training, having served as a Vice President in the International Department of the Chase Manhattan Bank with responsibility for Chase's loan portfolios in the former Soviet Union, Eastern and Central Europe and Yugoslavia. I also served as a personal assistant to former Chase Chairman David Rockefeller. In government, I held the post of Senior Director of International Economic Affairs at the National Security Council from March 1982 to September 1985 and later served as Chairman of the Congressional U.S.-China Economic and Security Review Commission until January 2006.

Established in the fall of 2001, CSAG maintains the world's most comprehensive database on every publicly traded company globally with business ties to Iran, Sudan, Syria and North Korea as well as public firms that have been associated with WMD and ballistic missile proliferation. These countries have each been designated by the U.S. Department of State as official sponsors of terrorism. In this connection, our *Global Security Risk Monitor* online service identifies some 450 mostly foreign companies with business ties to these countries, roughly 340 of which have ties to Iran.

CSAG provides data to scores of asset managers, pension systems and state and federal entities, including the Securities and Exchange Commission's Office of Global Security Risk[*]. CSAG has also coordinated extensively with those officials overseeing public funds, including from the state of Missouri, as well as private fund managers in structuring and implementing "terror-free" investment portfolios.

At the outset, I would like to make clear that CSAG, as an impartial research firm, takes no position on legislation or U.S. policy initiatives, nor does it take a position on the use of our data by clients. That said, we are prepared to share our professional views on the feasibility of "terror-free" or "Iran-free" investment policies and screens and other technical issues of potential interest to the Committee. In making observations on the Iranian economy and non-technical issues, the views expressed herein are my own and do not necessarily reflect the views of Conflict Securities Advisory Group, Inc.

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[*] Global security risk is defined by the SEC and others as the risk to share value and corporate reputation of companies with business ties to U.S.-sanctioned countries, including the terrorist-sponsoring nations.

Corporate Activity in State Sponsors of Terrorism

Not surprisingly, the majority of companies with ties to terrorist-sponsoring states – some 60% – are engaged in various dimensions of the energy sector, particularly with respect to the oil-producing states (i.e., Iran, Sudan and Syria). In addition to large energy firms involved in major oil and gas projects like Total, ENI, Sinopec, Gazprom and Shell, there are also a number of companies engaged in downstream operations.

It is no exaggeration to assert that were these public companies to curtail their activities in such countries, particularly in Iran and Sudan, energy-related exports would plummet and economic/financial crises would likely ensue. Indeed, it is fair to say that publicly traded companies provide, wittingly or unwittingly, vital life-support to these regimes in a number of sectors beyond energy, including telecommunications, electric power generation and manufacturing. In some cases, this support takes the form of sales of advanced equipment and technology (some of it "dual use") as well as the supply of know-how and often large-scale revenue streams.

As your Committees are aware, U.S. sanctions under the Iran Sanctions Act, and its predecessor legislation, the Iran-Libya Sanctions Act, have been consistently waived by the Executive Branch and have therefore only been of nuisance value. The Bush Administration's financial sanctions against Iran and North Korea, however, have had a chilling effect on the willingness of international financial institutions to continue doing business with these states, including certain of Iran's major banks (notably Bank Saderat and Bank Sepah). The cut-back in the availability of official credit guarantee and insurance programs by certain U.S. allies, like Japan, has also had a material, negative impact on the ability of Iran to attract needed financing for larger-scale projects and transactions.

These official sanctions have been accompanied by what is becoming an even more important inhibitor to the ability of terrorist-sponsoring states to fund themselves and their malevolent activities, specifically security-minded shareholder activism and global security risk management in the private sector.

Enter Global Security Risk

In May 2001, the Securities and Exchange Commission (SEC) determined that publicly traded companies that do business in U.S.-sanctioned countries, such as Iran, are exposed to "global security risk," even if such activities are legal and commercial in nature. Such risks can be material and impact adversely on share value and corporate reputation. Among the risks to which companies doing business in terrorist-sponsoring states are exposed include: new U.S., U.N., or other official sanctions that affect a company's operations; sanctions violations; negative publicity; law suits by victim's rights and other groups; and opposition-oriented shareholder activism, including divestment campaigns. This financial risk can be compounded by firms doing business in more than one terrorist-sponsoring state and/or in sectors of these economies that have a record of the diversion of commercial equipment, technology and revenues to military-related purposes.

As a result of this heightened financial risk profile, a number of fiduciaries that have contacted CSAG have indicated a desire to exercise greater caution with respect to investing in companies with operations in the terrorist-sponsoring states. This established financial risk is also what differentiates "global security risk" from other categories of values-based or socially responsible investing (e.g., environment, tobacco, Burma, guns, alcohol, etc.). In short, even if a fiduciary does not share the moral, ethical or security-related concerns of other investors, in the protection of portfolio value, it is only prudent to account for this risk category.

Terror-Free Investing

Terror-free investing is defined as excluding from portfolio some or all of the approximately 450 publicly traded companies with business ties to, or operations in, State Department-designated terrorist-sponsoring states, specifically Iran, Sudan, Syria and North Korea. Typically, the fiduciary determines the threshold or "bright-line" for what scope or type of corporate activity in these countries would merit exclusion from investment portfolios and be determined non-compliant under a new investment policy adopted by the fiduciary.

For actively managed stocks, maintaining "terror-free" compliance is quite straightforward and inexpensive. With the specific threshold in hand, CSAG can determine which companies in our database would be non-compliant and off-limits to the fund manager or fiduciary. Once that list of non-compliant companies is developed, the manager sells the shares of current holdings that are non-compliant (perhaps over a period of time). Thereafter, the manager maintains the screen (or a "do not buy" list) provided by an independent research firm, like CSAG, and certifies to their client that they are in compliance with the new investment policy on a quarterly basis.

The greater challenge lies in passive investments, such as an index. If index providers offered "terror-free" indexes, as will soon occur, fiduciaries or their asset managers could invest in such certified products in order to comply with a given terror-free or Iran-free investment policy. Regrettably, this is the "chicken and egg" issue facing several states that wish to exclude companies with business ties to one or more of these countries. The simple fact is that indexes are pools of stocks available to many clients. Fiduciaries cannot merely ask that non-compliant companies be removed. Rather, entirely new "terror-free" indexes need to be built. In that sense, state legislative initiatives can "drive the market."

In the case of Illinois' legislated divestment of companies with Sudan ties, the state's asset managers took the step of requesting prominent index managers (notably from Northern Trust and Barclay's Global) to create new "Sudan-free" funds to which index-invested assets of the State's pension funds could be moved. The business logic for these firms was compelling because demand for such new investment products was established by the legislation. Such "Sudan-free" products could also serve as a differentiator for these firms in the markets. As it turned out, this approach proved successful and the first index-managed fund providers attracted billions of dollars to their new "Sudan-free" products in a relatively short period of time.

In sum, by defining a list of companies in which asset mangers cannot invest and then requiring them to certify that they are compliant with this list, the likely effect would be to create a compelling financial incentive for financial firms to produce indexes and similar pooled investment vehicles. The Illinois example makes clear that asset mangers will respond to these kinds of legislative initiatives. It is also our understanding that the entire divestment process in Illinois with respect to Sudan required no new layers of bureaucracy or cost to the state. The modest costs involved were borne by the state's external fund managers. The important corollary benefit of the creation of these new investment vehicles was their availability to individual investors throughout this country. Due to the market influence of Illinois' public assets, individual Americans were presented with passive investment options that otherwise would have been unavailable had the state not taken these actions.

Municipal, State and Private Sector Shareholder Activism

New York City public pension systems were the first in the nation to react to global security risk, specifically the city's firefighter and police pension systems. New York City Comptroller Thompson, with the database provided by our firm, has made global security risk concerns a top corporate governance priority for the past several years. Under Comptroller Thompson's leadership, several U.S. firms doing business with terrorist-sponsoring states through their overseas subsidiaries were persuaded, via the City's registering of shareholder resolutions, to exit these countries once existing contracts were concluded (e.g., Halliburton, ConocoPhillips, GE, Cooper Cameron and Aon Corporation). New York City has likewise been in communication with scores of other portfolio companies requesting explanations for their business activities in these countries.

After the airing of a "60 Minutes" segment entitled "Doing Business with the Enemy" twice in 2004, a number of states, as well as average investors became alert to this risk category and began to take action. Today, some eight states have introduced divestment legislation with respect to companies doing business in one or more of these countries, including California, Florida, Georgia, Maryland, New Jersey, Texas, Ohio and Pennsylvania. Ohio's Iran divestment legislation is of particular interest as it is the most hotly contested between those seeking to defeat this legislation, including Ohio's public pension systems, and those that believe this is an appropriate response to elevated financial risk and the values of Ohio's public employees. Several other states have already passed legislation divesting from some, if not all, companies with business operations in genocide-sponsoring Sudan. The first public fund to go "terror-free" was the Missouri Investment Trust under the leadership of State Treasurer Sarah Steelman who is with us today. That fund, administered by State Street Global Advisors, was screened and certified by CSAG.

In the private sector, Nationwide Financial has made a terror-free mutual fund available on its 401(k) platforms to some 50,000 corporate and public entity clients. The Roosevelt Investment Group in New York was the first fund manager in America to introduce a terror-free mutual fund (certified by CSAG) – the Roosevelt Anti-Terror Multi-Cap Fund (www.anti-terrorfund.com). There are also a number of "terror-free" products and services expected to come to market in the next several months, including a family of mutual funds, index-managed funds, Exchange Traded Funds and separately managed accounts.

These public and private sector developments, including two ongoing Federal legislative initiatives with respect to Iran divestment, all point to the fact that institutional and individual investors now have a choice with respect to whether or not to screen out some or all portfolio companies with ties to terrorist-sponsoring regimes.

Implementation, Costs and Performance

The primary argument against divestment and terror-free investing screens is the prospect of reduced investment returns. Given the exposure of these companies to global security risk, however, there is a valid argument to be made that continuing to hold certain of these companies in portfolio could actually harm performance. In fact, those investors that have now successfully structured "terror-free" portfolios have outperformed their benchmarks. Moreover, the "Sudan-free" index-managed funds referenced earlier have reportedly performed quite well for Illinois.

With respect to costs, it would likely be helpful to evaluate the experiences of other states. For example, Illinois' succeeded in having some 15 statewide pension systems and scores of asset managers divest form roughly 150 companies with ties to Sudan with minimal disruption or impact on state investments and at no apparent cost to the state of Illinois. This is largely because Illinois placed the implementation requirement on the state's external asset managers and, by statute, required that they absorb the modest costs involved.

In the case of index products, the movement of assets to new funds that are certified to meet various legislated investment policies would be required. Nevertheless, it is not necessarily the case that such adjustments would require significant costs or losses for the state. Indeed, there are precedents indicating that this is not the case. The reality is that if a state pension system were to request a "terror-free" index, given its market leverage, investment managers would almost surely respond. Furthermore, we would be perplexed by arguments suggesting that their fees would increase significantly if they did so. If a manager is going to gain a mandate to manage a sizable portfolio, why would such a firm *upcharge* for the "terror-free" component?

Returning to performance, the Missouri Investment Trust, as mentioned, recently worked with our firm to become the first public fund in the country to invest "terror-free." Although CSAG is not an investment advisor or manager, we understand that the results have been impressive. To briefly review how this came to pass, MIT worked with CSAG in the manner described above to use its "terror-free" policy to establish a "do not buy" list that was then sent to its manager, State Street Global Advisors. State Street then removed non-compliant companies from its index benchmark, rebalanced the portfolio and, on a quarterly basis thereafter, ensured that the portfolio excluded companies on the "do not buy" list.

As Treasurer Sarah Steelman will likely testify, the seven-month returns have recently been made public. Over this period, the "terror-free" portfolio has outperformed its benchmark by a significant margin. This experience may not be representative of the results of terror-free investing for other funds, but it certainly is evidence that: 1) terror-free investing is possible at a modest cost; and 2) it may not have the type of negative performance forecasted by detractors.

Conclusion

There are now a number of concrete indicators that, over time, global security risk (which underpins "terror-free" investing) will likely become a standard, "boiler-plate" component of most larger-scale investment policies, corporate governance deliberations and due diligence risk assessments here and abroad. There was also a recent national poll conducted by the firm Luntz, Maslansky Strategic Research that indicated that a large majority of American investors care about this issue and are prepared to react to these corporate involvements in their individual investment decisions and those made on their behalf by institutional investors.

Accordingly, the process of excluding certain categories of companies due to the nature and scope of their business operations in terrorist-sponsoring states like Iran appears to be rapidly gaining traction. As the precedents for successful terror-free investing multiply and more index-managed funds and similar "passive" investment products are made available, the task of going terror-free or Iran-free, which is already rather straightforward and inexpensive, will get easier still.

Although public pension systems are legitimately concerned about the "slippery slope" of social issues increasingly restricting their investible universe, the financial risk elements associated with the activities of public companies in Iran and other terrorist-sponsoring states can be legitimately taken into account by state legislators and public and private sector fund managers in a manner consistent with their oversight and fiduciary responsibilities.

The bottom line is that "terror-free" investing is now a matter of choice, without the past implementation burden. To the extent that average Americans wish to react to these risk elements or screen against such corporate ties as an expression of their values, terror-free investing is an option that is likely here to stay.