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U.S. FINANCE INDUSTRY & NATIONAL SECURITY: A SOURCE OF BOTH STRENGTH AND VULNERABILITY

FINANCE INDUSTRY STUDY
GROUP PAPER

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Executive Summary

In an era of Great Power Competition and the rise of the People's Republic of China (PRC), this paper explores the intersection of the U.S. financial industry and national security. The finance industry study focused on three lines of effort: trends in capital markets, financial innovation, and financial statecraft. The research explores how the U.S. finance industry can advance national security in the face of legal, political, practical, and geopolitical challenges.

The United States has held a dominant position in the global economic order for decades, owing in part to the strategic foresight that established the Bretton Woods system. However, this dominance is now being tested by the economic rise of the PRC and a shift toward multipolarity. The PRC's economic maneuvers, characterized by predatory investments and coercive measures, are challenging the norms and standards set by the United States. Simultaneously, domestic challenges including political polarization, high debt levels, and economic inequality threaten the U.S.' internal stability and global economic leadership.

U.S. capital markets, a cornerstone of the country's economic strength, play a pivotal role in national security. They enable efficient capital allocation, foster innovation, and drive economic growth. Additionally, capital markets empower the U.S. to exert international influence through economic policies and tools like sanctions and trade policies. However, the evolving nature of these markets—characterized by a decline in public listings and a shift toward private capital—suggests potential obstacles in maintaining economic dominance and leveraging these markets for national security.

This paper argues for a more purposeful Department of Defense (DoD) approach in leveraging U.S. financial strengths to bolster national security. This includes enhancing the DoD's strategies around economic statecraft to effectively use financial tools for national security ends, particularly focusing on technological innovations and capital deployment to counter adversarial economic tactics. Additionally, the paper advocates for including diverse human capital in shaping the finance industry to ensure that economic policies and national security objectives are well-aligned. The paper also recommends adjusting regulatory measures to mitigate vulnerabilities in capital markets that adversaries might exploit, particularly in cybersecurity and illicit finance. Finally, the paper encourages closer collaboration between the public and private sectors to align national security objectives with financial and economic activities.

As the global economic landscape becomes more competitive and complex, the United States must strategically adapt its approaches to maintain its leadership role. This involves reinforcing its financial markets' domestic foundations while proactively engaging in global economic governance to shape outcomes that secure national interests against emerging threats. This paper offers a blueprint for integrating economic power with national security strategy in an era of significant geopolitical flux, while acknowledging the rapidly evolving technological, legal, and geopolitical environments.

The United States is at a critical juncture and must recalibrate its tools of economic influence to address and navigate the challenges of modern geopolitical competition effectively. The recommendations ensure that the United States will continue to harness its economic prowess to support robust national security strategies, thus maintaining its status as a global leader amid changing international dynamics.

I. Introduction

The last three decades have witnessed unprecedented global economic growth. This growth has lifted billions of people out of poverty and enabled technological breakthroughs and innovation, fostering a globally connected network of individuals, communities, states, and non-state actors. The United States has played a key role in enabling this remarkable growth, both in providing capital and the vast markets necessary to facilitate economic productivity, and having the foresight at the end of World War II to establish rules-based global organizations (known as the Bretton Woods system) to focus on economic stability, development, and growth.[1] The United States intentionally established itself at the center of this global financial system to ensure the economic order supported U.S. national security objectives with aspirations that "stronger international economic coordination would prevent another world war."[2] The synchronization of economic and security interests in the post-World War II order cemented U.S. primacy and catapulted the U.S. financial system into unquestioned dominance for several decades. This dominant role, however, is beginning to recede, as unipolarity gives way to Great Power Competition and diverging spheres of influence around the globe.[3] This paper will explore the connective tissue between the U.S. capital market structure and national security in the context of a rising PRC and renewed Great Power Competition. The paper will also address the ways in which the U.S. finance industry seeks to advance national security objectives through its capital

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[1] The original Bretton Woods conference established the International Monetary Fund (IMF) and the predecessor to today's World Bank. Current organizations that have propagated from this agreement include the IMF, World Bank, World Trade Organization, International Courts of Arbitration and Justice, Financial Action Task Force, and several other financial, legal, and enabling organizations that facilitate and support international economic activity.

[2] "Bretton Woods 2.0 Project," *Atlantic Council* (blog), accessed May 6, 2024, https://www.atlanticcouncil.org/programs/geoeconomics-center/bretton-woods-2-0-project/.

[3] "The world's economic order is breaking down," *The Economist*, May 8, 2024, https://www.economist.com/briefing/2024/05/09/the-worlds-economic-order-is-breaking-down, and "The global financial system is in danger of fragmenting: The American-led financial order is giving way to a more divided one," *The Economist*, May 8, 2024, https://www.economist.com/special-report/2024/05/03/the-global-financial-system-is-in-danger-of-fragmenting.

markets and economic statecraft initiatives while contending with the geoeconomic dynamics of the past three decades that help or, more often, hinder those efforts. This paper will argue the United States and the DoD should take a more purposeful approach to the finance industry by leveraging human capital from a more diverse set of backgrounds to shape both domestic and international agencies that oversee this tremendous resource. This paper will also provide policy recommendations that can posture the DoD to build, support, and take advantage of the powerful U.S. economic instrument to advance national security. This is the best way to ensure alignment across all elements of U.S. power to achieve national security objectives.

II. Strategic Landscape

The resurgence of Great Power Competition requires a coordinated and integrated use of all instruments of power (IoP) to pose strategic dilemmas to the U.S.' strategic competitors and potential adversaries. The formidable array of global challenges combined with the increasing capacity of adversarial nations reflect the tremendous task to those seeking to advance U.S. national security interests. The 2022 National Security Strategy (NSS) identifies the PRC as "the only competitor with both the intent to reshape the international order and, increasingly, the economic, diplomatic, military, and technological power to advance that objective" while reiterating the ongoing threats presented by Russia, Iran, and North Korea.[4] Additionally, the strategy highlights the unique threats presented by violent extremists, transnational criminal organizations, cyber threats, and climate change.[5]

[4] "National Security Strategy," The White House, October 2022, https://www.whitehouse.gov/wp-content/uploads/2022/10/Biden-Harris-Administrations-National-Security-Strategy-10.2022.pdf.
[5] "National Security Strategy."

The PRC's assertive behavior, predatory investments, and coercive economic measures have betrayed its stated intent to pursue a harmonious relationship with all countries. In 2023, Chinese Communist Party (CCP) Chairman Xi Jinping stated, "countries taking the lead in economic development should give a hand to their partners who are yet to catch up. We should treat each other as friends and partners, respect and support each other, and help each other succeed."[6] Meanwhile, the PRC, despite reaping economic advantages from the existing order, has demonstrated a willingness to wield its rejuvenated financial and economic clout as a tool for both material and political gain, often to the detriment of the standards and rules established under the Bretton Woods system.

The 2022 National Defense Strategy (NDS) expresses a sense of urgency to leverage industry, and thus the underlying economic power, to "ensure that we produce and sustain the full range of capabilities needed to give U.S., allied, and partner forces a competitive advantage."[7] Given the complexity of the geopolitical landscape, the strategy encourages coordination across all IoPs to close any potential seams in addressing these challenges.

The U.S.' economic dominance, technological superiority, and robust alliances and partnerships represent an enduring advantage that can help address global threats and outcompete the PRC. This economic IoP provides a significant advantage to the United States; it can deploy economic policies to project power internationally and influence behavior on the global stage. This center of gravity is empowered by the U.S. Dollar (USD) acting as a global reserve currency and the attendant impact that has on activities such as sanctions, trade policy,

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[6] "(BRF2023) Full Text of Xi Jinping's Keynote Speech at 3rd Belt and Road Forum for Int'l Cooperation," Xinhua, October 18, 2023, https://english.news.cn/20231018/7bfc16ac51d443c6a7a00ce25c972104/c.html.

[7] "2022 National Defense Strategy of the United States of America," U.S. Department of Defense, October 27, 2022, https://media.defense.gov/2022/Oct/27/2003103845/-1/-1/1/2022-NATIONAL-DEFENSE-STRATEGY-NPR-MDR.PDF.

investment in foreign aid, and membership in key global financial systems like the Society for Worldwide Interbank Financial Telecommunication (SWIFT).[8] The United States has historically employed these tools to influence international events, support allies and partners, and deter adversaries. While the United States is currently on track to remain an economic superpower with substantial influence over global financial markets and institutions into the future, there are several formidable challenges the country needs to address.[9] For instance, the rise of other economies, particularly that of the PRC, poses a significant challenge to U.S. dominance in global economics.[10] Figure 1 depicts global Gross Domestic Product (GDP) by country and highlights the relative strengths of both the U.S. and Chinese economies. Additionally, debt levels, inequality, and political polarization may impact the U.S.' economic stability and, therefore, its ability to leverage economic power globally. Furthermore, increased economic interdependency complicates using economic tools without affecting other U.S. interests.

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[8] Juan C. Zarate, *Treasury's War: The Unleashing of a New Era of Financial Warfare* (New York/N.Y: Public Affairs, 2013), 20.

[9] For a brief synopsis of the financial interdependence and associated power dynamics between the United States and the PRC, see Brad Setser, "Power and Financial Interdependence," *Ifri Papers*, Ifri, May 2024, accessed May 13, 2024, https://www.ifri.org/sites/default/files/atoms/files/ifri_setser_power_financial_interdependence_2024.pdf.

[10] Ilaria Mazzocco, "Unpacking Linkages Between the Chinese State and Private Firms," Big Data China, March 21, 2024, https://bigdatachina.csis.org/unpacking-linkages-between-the-chinese-state-and-private-firms.

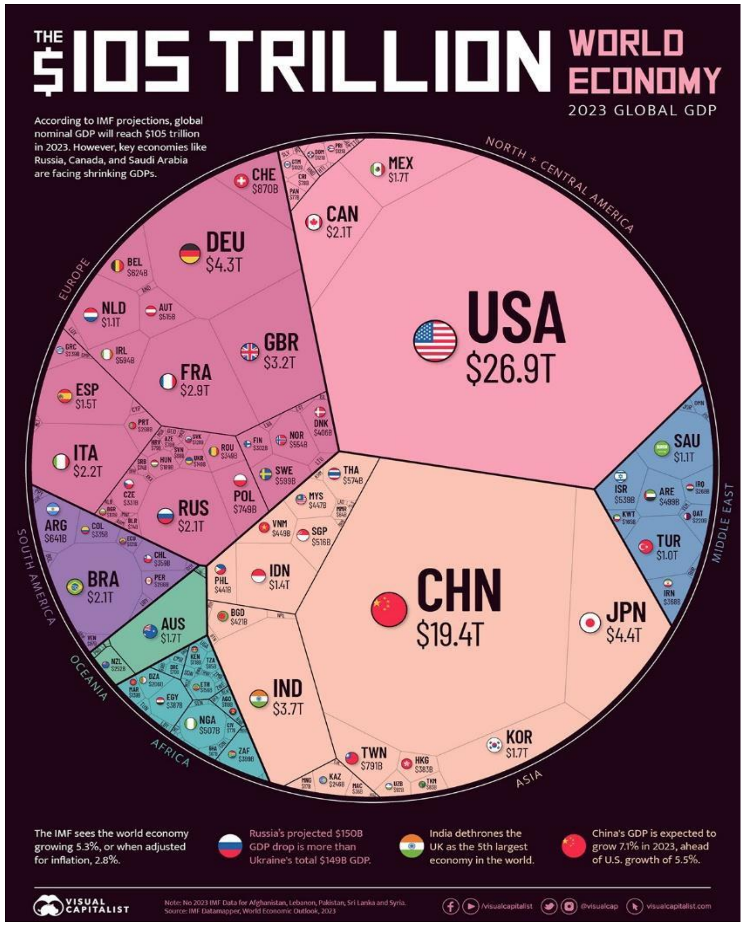


Figure 1. Source: https://www.visualcapitalist.com/visualizing-the-105-trillion-world-economy-in-one-chart/

The challenges highlighted in the NSS require vigilance and determination. Previously, the United States leveraged its capabilities to establish international financial institutions that generated massive wealth, raised the living standards of billions, produced technological breakthroughs, enabled the DoD to support international alliances against common threats, and ultimately prevented the Cold War from ending in global conflagration. The current strategic environment calls for the same level of effort to address changing geoeconomic circumstances.[11] To maintain global stability and achieve its national security objectives, the United States must

[11] The PRC arguably presents a greater challenge to the U.S. than the Soviet Union did during the Cold War, particularly in the economic sphere where the PRC is enmeshed into the global finance ecosystem in a way the Soviet Union never achieved. For additional background, see https://www.youtube.com/watch?v=YIJRKfTtfSc.

once again find a way to optimize and leverage its financial strength, massive capital markets, and financial statecraft policies towards those ends.

III. U.S. Capital Markets

The financial industry affords U.S. policymakers the ability to use rules, regulations, and oversight to shape public and private market activity to advance core national security interests. At their best, these markets ensure efficient allocation of capital, driving innovation and economic productivity growth, and facilitate targeted investment in sectors vital to national security, while simultaneously preventing and disrupting illicit capital flows. The strength of these markets provides opportunities, but there are bureaucratic and structural impediments to fully leveraging this uniquely American capability. The following section will provide an overview of U.S. capital markets, discuss how current U.S. policy attempts to instrumentalize these markets to advance national security, and highlight several factors that create tension as policymakers seek to address the challenges outlined above.

Capital Markets Overview

Following the establishment of the Bretton Woods system, U.S.-based capital markets spearheaded global economic integration and growth, supporting U.S. national security objectives and opportunities for significant wealth accumulation. The free-market system that evolved provides the underlying structure that has powered the global economy in recent decades. This system engenders trust among market participants by establishing a benchmark against which non-participants must compete, ultimately building a network that relies on U.S. leadership for the underlying global economic architecture. The international financial order is undergirded by the disclosure-based U.S. system; premised on reasonable but not absolute supervision and oversight. This oversight stems not only from government regulators but also from significant stakeholder participation. Large financial firms like BlackRock and Goldman Sachs have a vested financial interest in managing their business in a responsible manner that engenders and maintains this critical confidence and trust.[12]

Through registration and disclosure regimes, U.S. oversight mechanisms ensure capital markets are dynamic, transparent, and predictable without being overly prescriptive or cumbersome. Entities within the U.S. Treasury and Commerce departments, the Securities Exchange Commission (SEC), and self-regulating organizations such as U.S.-based exchanges and the Financial Industry Regulatory Authority (FINRA), combine to establish common practices that foster trust and support economic vitality.[13] Some argue these policies have "engendered a new era of corporate transparency and financially sound valuations that make the market more efficient."[14] Others express concerns about the potential for increased oversight to generate negative effects. Securities Industry and Financial Market Association (SIFMA) President and CEO Kenneth E. Bentsen testified before Congress about what he deems as excessive SEC intrusion, noting "it is critical that any changes to the rules governing our capital markets are thoughtfully considered, or we risk damaging our markets' preeminent global status and harming investors."[15] The United States has historically found a balance to limit obstructive

[12] Capital markets that include reliable, credible, and enforceable regulations help to build investor confidence, lower the cost of capital and are ultimately profitable for the industry. For additional information, see Hans B. Christensen, Luzi Hail, and Christian Leuz, "Capital-Market Effects Of Securities Regulation: Prior Conditions, Implementation, And Enforcement," *National Bureau of Economic Research*, January 2011, https://www.nber.org/system/files/working_papers/w16737/revisions/w16737.rev3.pdf.

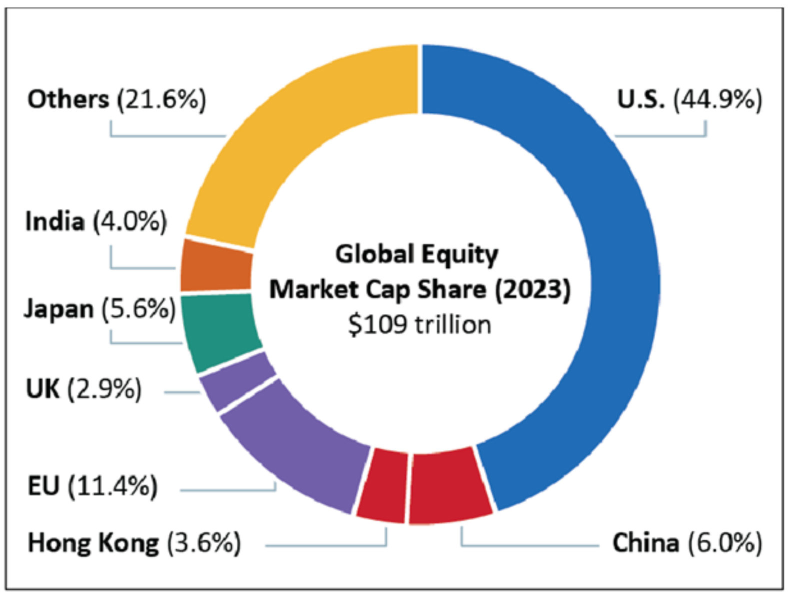
[13] See Appendix 1 for a list of major entities in the U.S. financial industry regulation and oversight ecosystem.

[14] Ryan Kish, "The Capital Allocation and Agency Problems with Index Funds," April 21, 2021, https://deepblue.lib.umich.edu/bitstream/handle/2027.42/169234/The%20Capital%20Allocation%20and%20Corporate%20Governance%20Issues%20With%20Index%20Funds.pdf?sequence=1.

[15] Katrina Cavalli, "SIFMA Testimony at House Subcommittee Highlights Negative Consequences of SEC Rulemaking," SIFMA, November 2, 2023, https://www.sifma.org/resources/news/sifma-testimony-at-house-subcommittee-highlights-negative-consequences-of-sec-rulemaking/.

regulation with the need to target seams that adversaries can exploit. SIFMA's reaction to proposed regulation underlines the importance of this balancing act.

The liquidity and structure of the public U.S. capital market, and investor confidence in the U.S. financial system, reflect an enviable economic dominance for the foreseeable future. The U.S.' high proportion of global equity market share reflects this reality. SIFMA estimates the global stock market valuation at $109 trillion, and the U.S. represents approximately 45% of that value (See Figure 2).[16] According to SIFMA, "The U.S. equity markets are the largest in the world and continue to be among the deepest, most liquid, and most efficient."[17] The prestige and wealth of U.S. capital markets represent an overwhelming advantage for U.S. policymakers.



Source: CRS, with data from the Securities Industry and Financial Markets Association (SIFMA)

Figure 2. Source: https://crsreports.congress.gov/product/pdf/IF/IF11803

[16] Dorothy Neufeld, "The $109 Trillion Global Stock Market in One Chart," *Visual Capitalist*, September 27, 2023, https://www.visualcapitalist.com/the-109-trillion-global-stock-market-in-one-chart/.
[17] "Research Quarterly: Equities," SIFMA, April 12, 2024, https://www.sifma.org/resources/research/research-quarterly-equities/.

The U.S. system of balanced regulation has supported efficient capital allocation to drive innovation and economic growth and has cemented the perception that the U.S. market is the safest place to store money, even in times of economic crisis. The primacy of U.S. public markets serves national security interests by underwriting innovative firms, building international support, and supporting the role of the USD as a global reserve currency. Additionally, the DoD uses publicly traded companies to support many of its acquisition and sustainment efforts for key warfighting capabilities; this represents another crucial link between U.S. capital markets and national security.

While the U.S. dominance in the equity industry is unquestionable, the ecosystem remains competitive globally. Advanced technology and changing market structures require policymakers to address the growing trend away from more regulated publicly traded venues toward private capital markets. According to Forbes, the United States has been experiencing a decline in publicly traded Initial Public Offerings (IPOs) since the 2010s, as companies opt to raise capital through strategic partnerships in private markets as opposed to "going public" and submitting to disclosure and compliance requirements.[18] Figure 3, current through May 2024, depicts this general downward trend in IPOs.

[18] Giri Devanur, "Council Post: The Current IPO Market: Factors In Its Decline And Reversing The Trend," *Forbes*, February 1, 2023, https://www.forbes.com/sites/forbesbusinesscouncil/2023/02/01/the-current-ipo-market-factors-in-its-decline-and-reversing-the-trend/?sh=4153c132c31a.

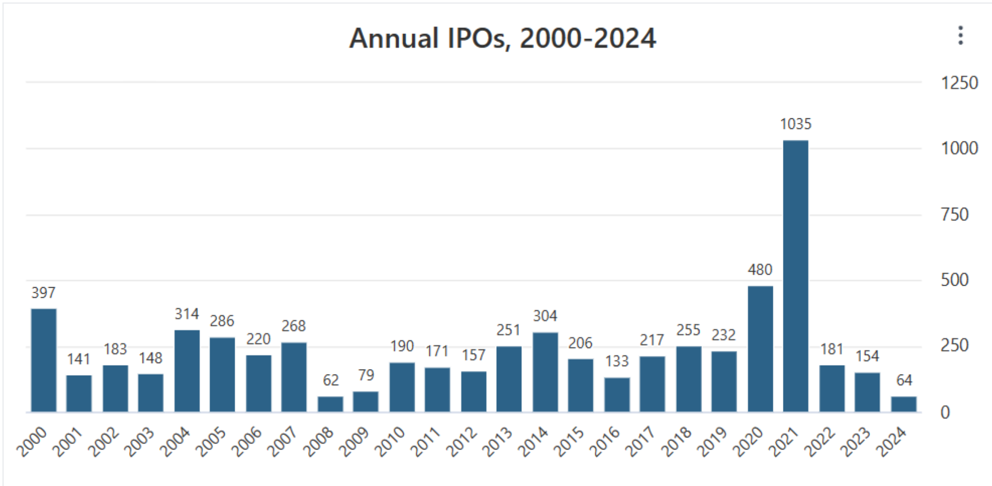


Figure 3. Source: https://stockanalysis.com/ipos/statistics/

Additionally, according to the Wall Street Journal, venture capitalists provide companies unique opportunities, as these investors understand the tensions in the current geopolitical landscape and are increasingly funding defense technologies in search of maximized investor returns.[19] While IPO activity has declined significantly in recent years, the private financing ecosystem affords DoD an alternative avenue to accelerate critical technology development and drive the targeted investments required for national security objectives.[20] Secretary of Defense Lloyd Austin recognized the need to leverage the private capital market and noted, "private capital is a vital resource for the Department and a key source of U.S. comparative advantage in technology competition. Therefore, working with [an array of] capital providers is a national security imperative."[21]

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[19] Marc Vartabedian, "Venture Investor on What It Takes to Succeed in Defense Tech," *Wall Street Journal*, March 4, 2024, https://www.wsj.com/articles/venture-investor-on-what-it-takes-to-succeed-in-defense-tech-fabb4d8b.

[20] "NATSEC 100: 2023 Edition," *Silicon Valley Defense Group*, July 24, 2023, accessed May 13, 2024, https://static1.squarespace.com/static/5f82250a85dd3125aeba053d/t/64c1391012ab1e548d9ed522/1690384657016/SVDG+NatSec100+2023+Report+%28Public+Release+v4%29.pdf.

[21] "Investment Strategy for the Office of Strategic Capital," U.S. Department of Defense, March 2024, https://www.cto.mil/wp-content/uploads/2024/03/FY24_Invest_Strat_OSC.pdf.

For DoD, U.S.-based capital markets offer a tremendous competitive advantage when addressing the current geopolitical environment. The depth, breadth, and liquidity of U.S.-based markets have all grown substantially under the global architecture established by the Bretton Woods system. This trend gained momentum during the deregulation of the 1980s as the Washington Consensus took hold across the political-economic landscape, and the fall of the Soviet Union further accelerated the transition of global economies toward the U.S. sphere of influence. It was during this period of rapid acceleration of U.S. economic power, however, that this lever began to diverge from its alignment with national security objectives and began a steady march toward focusing on near-term shareholder profitability, regardless of the impacts to other stakeholders. Identifying this concerning trend, the 2024 Department of Treasury National Risk Assessment states:

> The size of the U.S. financial system, the centrality of the USD in global trade, and the role of U.S. manufacturers in producing military and proliferation-related technology (including dual-use items) continue to make the United States a target of exploitation…These structural vulnerabilities are mitigated by a strong culture of compliance with U.S. law by U.S. financial institutions and other private sector actors, though some gaps remain.[22]

Areas for Concern in Capital Markets

It is no longer true that U.S. capital markets work seamlessly in tandem with other elements of national power in pursuit of U.S. security interests. The strength and structure of U.S. capital markets have traditionally supported efficient capital allocation to drive global economic growth and stimulated a system that relies on the USD as the global reserve currency, providing U.S. policymakers with exorbitant privilege in wielding tools of economic statecraft. In the last three decades, U.S. economic and financial decisions have allowed a great number of

[22] "2024 National Proliferation Financing Risk Assessment," U.S. Department of the Treasury, February 2024, https://home.treasury.gov/system/files/136/2024-National-Proliferation-Financing-Risk-Assessment.pdf.

individuals to benefit from access to market activities, but these policies have created a schism between U.S. national security interests and the underlying economic structure.

Several factors create tension between capital market activity and national security objectives. Market structure, including the role of public versus private capital, the passive methods through which investors participate, the role of institutions that manage large portfolios on behalf of those investors, and shifting international dynamics, all shape the ways in which U.S. policymakers can derive policy options to support national security. Trends in corporate governance and shareholder activism can either propel or undermine policies and activities that support national security objectives. Legislation and regulation that seeks to change market behavior towards a more 'patriotic' approach risk hampering the economic vitality of U.S. markets.[23] These factors have the potential to undermine the mechanisms through which the United States can derive national security benefits from its leading position in global capital markets.

Recent trends that have led to modified market structure are significant: "Over the last decade, more than 80% of all assets flowing into investment funds have gone to the Big Three."[24] The Big Three refers to the three largest institutional investors – BlackRock, Vanguard, and State Street – which now manage over $22 trillion on behalf of their clients, representing more than three-quarters of U.S. GDP.[25] These three asset managers' indexed investing strategies

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[23] For an example of how some firms are attempting to execute this strategy, see the vetting process used by National Security Index, https://www.nationalsecurityindex.com/. The SEC's staff bulletin regarding foreign issuers who are manipulating small-cap and limited public float public offerings provides an example of how regulators are attempting to manage some of these risks. This bulletin does not create new legal or regulatory requirements or new interpretations of existing requirements, nor does it relieve firms of any existing obligations under federal securities laws and regulations, but it does provide warning to the public about potential threats, https://www.sec.gov/tm/risks-omnibus-accounts-transacting-low-priced-securities.

[24] Lucian Bebchuk and Scott Hirst, "The Specter of the Giant Three," *Boston University Law Review* 99 (n.d.).

[25] Dan Romito, "The Top 15 Anticipated ESG-Related Considerations That Will Influence Strategy in 2023," *The Harvard Law School Forum on Corporate Governance* (blog), December 31, 2022,

threaten to impact several areas of concern to U.S. national security. While indexation and influential institutional investors do not, in and of themselves, undermine the U.S.-centric Bretton Woods system, they do impact how the international economic system operates and shape the extent to which the United States is able to extract positive security benefits from the system. This new market structure has potential to undermine innovation and economic growth by failing to efficiently allocate capital, fund firms that are directly or indirectly influenced by adversarial governments, and fail to address negative externalities like climate change.

Transparency issues represent another glaring seam in capital markets. Disclosure requirements are an example of a dilemma that market regulators must contend with when trying to address national security concerns. With an intent to stimulate the startup ecosystem, the 2012 JOBS Act eased reporting requirements for some small companies that met specific requirements (i.e., fewer than 2000 shareholders).[26] While this fostered the rise of large privately held companies (the so-called Unicorn companies), it did not stimulate an increase in associated public offerings for smaller companies. This trend has enabled companies to stay private and, in some cases, avoid SEC reporting requirements, depriving regulators, investors, and national security practitioners of critical information. For example, private companies do not face the same climate disclosure requirements as public companies, an area highlighted by the DoD as a national security priority.[27]

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https://corpgov.law.harvard.edu/2022/12/31/the-top-15-anticipated-esg-related-considerations-that-will-influence-strategy-in-2023.

[26] The JOBS Act was successful in stimulating entrepreneurial activity partially by fostering the private IPO of so-called Unicorn companies. These companies have had the flexibility to avoid public markets and remain non-reporting entities for SEC registration purposes due to the size of the private institutional market that funds them. Section 12 of the Exchange Act does still require private companies that meet certain thresholds to register and report on their business. For additional information see https://www.sec.gov/education/smallbusiness/goingpublic/exchangeactreporting.

[27] Alperen Gözlügöl and Wolf-Georg Ringe. "Private Companies: The Missing Link on The Path to Net Zero." *Journal of Corporate Law Studies* (2023). European Corporate Governance Institute - Law Working Paper No. 635/2022, SAFE Working Paper No. 342, March 22, 2022. Available at SSRN: https://ssrn.com/abstract=4065115.

Some of the transparency issues associated with beneficial ownership were addressed in the 2021 Corporate Transparency Act (CTA), which required disclosure of ownership for various types of corporate structures. This legislation, which was set to begin implementation in January 2024, is currently on hold pending continued litigation after it was deemed unconstitutional in a lower U.S. District court.[28] Additionally, in November 2023 the White House issued a press release regarding investments that benefit the PRC by financing companies beholden to its national policy of civil-military fusion. The release noted, "The President found that the PRC is exploiting U.S. capital to resource and enable the development and modernization of its military, intelligence, and other security apparatuses."[29] The House Select Committee on Strategic Competition with the CCP found that "American investors wittingly and unwittingly support the PRC's defense industry, emerging technology companies, and human rights abusers."[30] The structure of the U.S. capital market likely facilitates the PRC's strategy to subvert the United States through economic measures, allowing opaque companies an opportunity to raise capital in U.S. based markets.[31] The full national security impact of the CTA ruling is not yet known as the

[28] Satish Kini, Aseel Rabie and Jonathan Steinberg, "Corporate Transparency Act Ruled Unconstitutional, but Scope of Judgment Is Limited," Harvard Law School Forum on Corporate Governance, April 2, 2024, https://corpgov.law.harvard.edu/2024/04/02/corporate-transparency-act-ruled-unconstitutional-but-scope-of-judgment-is-limited/.

[29] "Press Release: Notice on the Continuation of the National Emergency With Respect to the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China," The White House, November 3, 2023, https://www.whitehouse.gov/briefing-room/statements-releases/2023/11/03/press-release-notice-on-the-continuation-of-the-national-emergency-with-respect-to-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/.

[30] "Reset, Prevent, Build: A Strategy to Win America's Economic Competition with the Chinese Communist Party," The Select Committee on the CCP, December 12, 2023, http://selectcommitteeontheccp.house.gov/media/policy-recommendations/reset-prevent-build-strategy-win-americas-economic-competition-chinese.

[31] Heather Somerville, "As Silicon Valley Pivots to Patriotic Capital, China Ties Linger; Investors with Connections to China are Backing Startups Developing Tech that the U.S. Wants to Counter Beijing," *Wall Street Journal (Online)*, May 12, 2024, accessed May 13, 2024, https://login.nduezproxy.idm.oclc.org/login?url=https://www.proquest.com/newspapers/as-silicon-valley-pivots-patriotic-capital-china/docview/3053789190/se-2.

court's ruling was limited in scope and provided specific views on how Congress could amend the legislation to ensure constitutionality.[32]

The finance industry's pursuit of short-term profits can pose significant risks, including jeopardizing longer-term national security objectives. For instance, a myopic focus on quarterly profits can result in underinvestment in areas crucial to national security, such as infrastructure and advanced technology.[33] Financial strategies prioritizing cost reduction and profit maximization often lead to offshoring and outsourcing, weakening domestic industrial bases critical for national security. Moreover, financial institutions occasionally support activities that circumvent or undermine financial regulations designed to enhance national security.[34] Other factors, such as growing concerns about the Environmental, Social, and Governance (ESG) impacts of firms, have influenced the finance industry in a way that impacts national security by shaping investment priorities across different participants in the ecosystem.[35] Corporations and investors in the United States also cannot ignore the tremendous opportunities presented in the Chinese market.[36] Without U.S. government intervention, these profit opportunities drive actors to ignore or underestimate the impact of legitimate national security concerns. Unfortunately, the U.S. government must contend with increasing fiscal pressures that place limits on its ability to influence the private sector to adjust its focus away from these profit driven motivations.

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[32] See Richard Manfredi, "The Corporate Transparency Act Declared Unconstitutional: What It Means for You," *Gibson Dunn* (blog), March 18, 2024, https://www.gibsondunn.com/corporate-transparency-act-declared-unconstitutional-what-it-means-for-you/ and Crowell Insights, https://www.crowell.com/en/insights/client-alerts/federal-district-court-rules-corporate-transparency-act-unconstitutional.

[33] Various lectures, National Defense University, Finance Industry Study, Academic Year 2023-2024. An alternative viewpoint is that the post-industrial U.S. economy requires a different type of capital expenditure than industrialized economies to ensure sustained growth. For an example of this counterargument, see https://jbs-ojs-shsu.tdl.org/jbs/article/view/452.

[34] Katja Langenbucher, "Regulatory Arbitrage: What's Law Got To Do With It?," *Accounting, Economics, and Law: A Convivium* 11, no. 2 (July 1, 2021): 91–117, https://doi.org/10.1515/ael-2019-0054.

[35] Various lectures, National Defense University, Finance Industry Study, Academic Year 2023-2024.

[36] From a national security perspective, the associated risks of an investment in a company with ties to the PRC can often be viewed similarly to a joint venture between U.S. and PRC based firms.

Despite these structural, bureaucratic, and incentive-based factors, U.S. policymakers are actively attempting to leverage the financial industry to further national security objectives. The following section will outline some of the ways in which the U.S. government is trying to actively use the industry to advance innovation and support national security.

Current Efforts to Leverage Capital Markets for National Security

Targeted Investment

The national security establishment, recognizing that financialized firms have underfunded research, development, and other long-term investments, is strategically intervening with various tools to align financial activities with broader national security objectives. Initiatives such as publishing the National Defense Industrial Strategy (NDIS), establishing the Office of Strategic Capital (OSC), and passing the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act, are prime examples of how the U.S. government is integrating national security concerns into the fabric of the nation's industrial and technological bases through the finance sector. These efforts are designed not only to mitigate the risks associated with global financial interdependencies but also to improve the U.S.' posture and resilience against peer/near-peer and emerging threats and to ensure economic resilience and technological sovereignty.

The NDIS is designed to bolster the U.S. defense industrial base, which is integral to national security and readiness, through a "strategic vision to coordinate and prioritize actions… fully aligned with the NDS."[37] This strategy addresses the vulnerability of supply chains, the need for the U.S. to sustain and advance its manufacturing capabilities in critical areas, and

[37] "Fact Sheet: National Defense Industrial Strategy," U.S. Department of Defense, January 2024, https://www.businessdefense.gov/docs/ndis/NDIS-Fact-Sheet_JAN24.pdf.

recognizes the need to leverage the expertise of the private sector to strengthen the defense industrial base. The strategy identifies four priorities: Flexible Acquisition, Economic Deterrence, Workforce Readiness, and Resilient Supply Chains.[38] Financial institutions play a crucial role in this strategy, providing essential capital for defense-related projects with investments from banks, venture capital firms, and other financial entities driving research, development, and production of defense technologies. Additionally, financial support is pivotal for building a resilient workforce through development programs and public-private education initiatives, essential for achieving the NDIS workforce readiness goals. The NDIS relies on the finance industry's ability to mobilize large-scale investments necessary to maintain and enhance technological superiority on a global stage. To that end, Secretary of Defense Austin established the OSC to accelerate partnerships with the private capital markets, focusing on critical areas of need for DoD.

The OSC's strategy is to facilitate significant investments in critical technologies (CTs) deemed essential for national security but considered too risky or costly for the private sector to invest in without additional incentives. It follows, therefore, that the DoD needs to maintain public-private funding for CT projects to sustain an ecosystem of both CT financing and development. The OSC Investment Strategy also makes clear the need to align CT companies' and investors' incentives (to make money) with DoD's objective (to ensure national security) by focusing on shared use technologies. The Strategy states that OSC will focus its investments on "component-level technologies with broad commercial application that are also relevant to the national security of the United States and its allies and partners."[39] It further refines its

[38] "National Defense Industrial Strategy," U.S. Department of Defense, November 13, 2023, https://www.businessdefense.gov/docs/ndis/2023-NDIS.pdf.
[39] "Investment Strategy for the Office of Strategic Capital."

investment focus by defining “strategic capital needs,” namely, companies developing CT vital to national security that are underfunded or underdeveloped due to the high cost of capital, long timelines for repayment, or the technical challenges being too risky for the commercial market to take on alone.[40] Secretary of Defense Austin gave OSC a mandate to both address these investment gaps and add new “financial tools and approaches” complementing existing DoD programs. The OSC investment strategy states its intent to meet the mandate by attracting and “crowding in” private capital.[41] This initiative represents an additional step toward strategic alignment between government priorities and private capital, aiming to bridge funding gaps and accelerate the development of CTs.

In another effort to achieve synergy between the financial sector and national security aims, the CHIPS and Science Act was signed into law on August 9, 2022. This pivotal legislation is designed to ensure resilience and a technological edge through the strategic reconstitution of a more self-reliant industrial base in the semiconductor industry. It aims to reverse the erosion of U.S. domestic semiconductor capacities and reinvigorate national capabilities in this critical sector. Although the CHIPS and Science Act provides foundational government funding, the capital requirements to fully scale semiconductor manufacturing and research and development efforts into the future will significantly surpass the initial allocation (See Figure 4).

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[40] “Investment Strategy for the Office of Strategic Capital.”
[41] “Investment Strategy for the Office of Strategic Capital.”

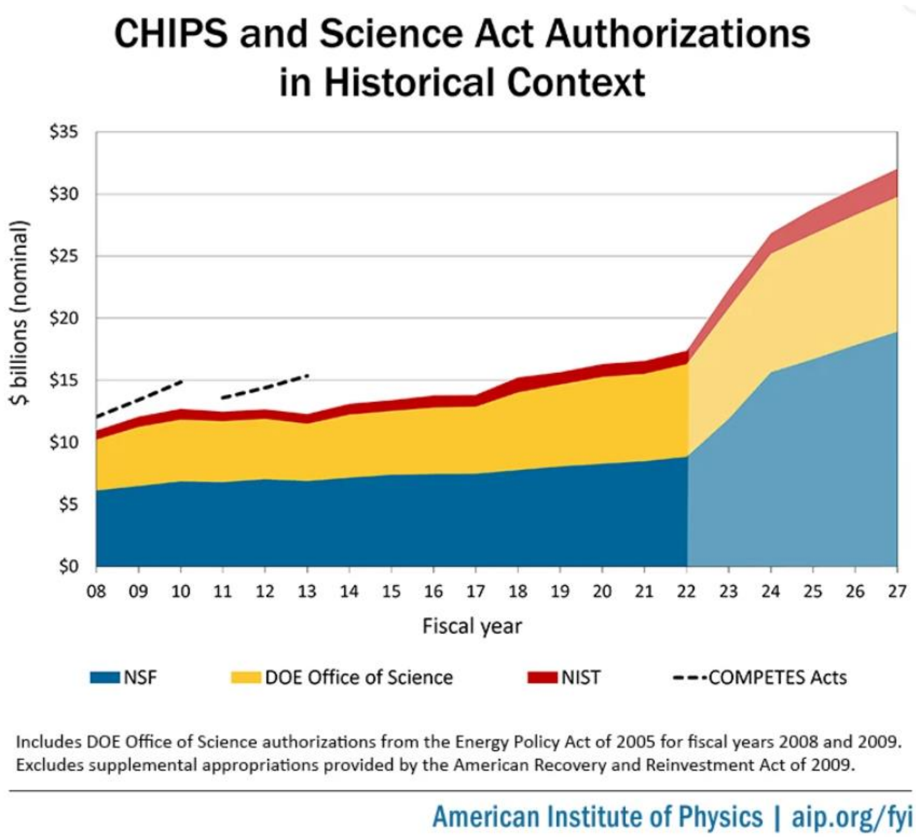

Figure 4. Source: https://ww2.aip.org/fyi/2022/congress-urged-meet-budget-targets-chips-and-science-act

Critical to these efforts is the cultivation of collaborative partnerships spanning academia, industry, and government to advance research and development skills for semiconductor design and production. Thus, the Act's success hinges on the finance and private sectors playing a crucial role in enabling effective resource allocation and driving innovation forward.

Corporate Social Responsibility

These initiatives underline the national security establishment's recognition of the critical need to align national security objectives with capital market demands. This alignment is facilitated by active participation from public and private sectors, including academia and the financial community. In addition, a crucial component in all the aforementioned initiatives involves expanding the definition of Corporate Social Responsibility (CSR) to include advancing national security, including prioritizing education centered on CTs, ensuring long-term sustainability, and fostering a workforce capable of sustaining innovation and competitiveness in CTs sectors. This approach could ensure that commitments not only address social responsibilities but also support economic objectives by bolstering the U.S. capacity for innovation and growth in critical technologies—a potent force multiplier for aligning with national priorities.

CSR initiatives reflect corporate America and the finance industry's stated commitments to sustainable development and ethical business practices. These initiatives are increasingly important in shaping investment strategies that align with broader societal goals, including sustainability and social welfare. The national security establishment must acknowledge the critical nature of these efforts as they not only enhance the reputation of the finance industry but also contribute to long-term value creation by fostering a stable and just society – a pillar of a robust and vibrant economy essential to national security.

Addressing Illicit Finance

While these initiatives seek to leverage the U.S. financial sector for the benefit of national security objectives, U.S. markets also represent a threat to national security. To eliminate flows of U.S. capital to illegal activities, there have been numerous updates to Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) policies and regulations. Some key updates include enhancing reporting requirements for financial institutions, tightening controls on international wire transfers, and expanding the scope of entities required to maintain robust anti-money laundering programs. Additionally, the U.S. government has emphasized the need for increased cooperation with international partners to effectively address the global challenge of money laundering. Organizations like the international Financial Action Task Force (FATF) review the financial practices of participating countries and provide recommendations on how to improve oversight to prevent illicit finance activities (See Figure 5). These measures aim to cut off financial resources to illicit actors and, consequently, reduce their capacity to undermine U.S. interests. This comprehensive approach underscores the crucial role of financial regulations and international collaboration in safeguarding the integrity of the global financial system.

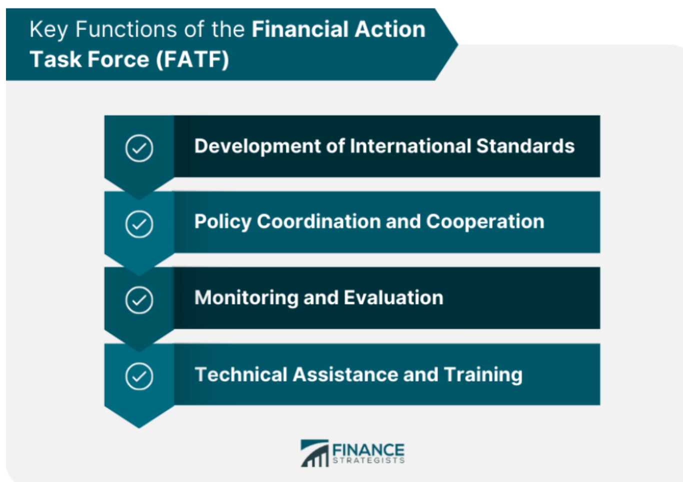

Figure 5. Source: https://www.financestrategists.com/banking/financial-action-task-force-fatf/

Export controls are another tool the United States has used successfully in conjunction with allies and partners to advance national security objectives. Together with outbound investment screening, they help the United States protect both its intellectual property (IP) and its position of technological prominence by slowing the progress the PRC could otherwise make through purchasing technology, requiring turnover of IP to produce goods in the PRC, or capital investment in its own technology development. The United States and Europe have imposed a variety of economic tools in response to the PRC's economic and technological growth. These include tariffs on some Chinese goods, technology restrictions, and investment screening mechanisms aimed to slow the PRC's momentum on the global stage. These efforts are an attempt to allow the U.S. and allies and partners to protect their vital national security interests and limit the PRC's influence.

Congress passed the Export Control Reform Act (ECRA) of 2018, giving the President authority to control dual-use exports for national security and foreign policy reasons. The Department of Commerce's Bureau of Industry and Security (BIS) administers these controls, which include increased monitoring and penalties for violation. Non-financial firms conducting business and trade with listed entities bear the burden of compliance but rely heavily on the financial industry for advice and support. Along the same lines as export control, Congress has begun to propose laws regulating outbound investments into the PRC. Several recent pieces of legislation such as the National Critical Capabilities Defense Act of 2023, the Outbound Investment Transparency Act of 2023, and the Preventing Adversaries from Developing Critical Capabilities Act of 2023 all contain language to limit investments involving "national critical capabilities" in the PRC.[42] In August 2023, President Biden signed Executive Order 14105, tasking the Department of Treasury to develop regulations restricting outbound investment to the PRC.[43] Full implementation of these efforts will be dependent on the results of multiple rounds of negotiation and likely litigation between regulators and those affected by the proposed new rules. Given the large economic interdependency between the United States and the PRC, these efforts attempt to find a balance between a full decoupling and targeted restrictions, part of the United States' so-called "de-risking" effort.[44] Also referred to as a "reverse Committee on

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[42] Cathleen D Cimino-Isaacs and Karen M Sutter, "Proposals to Regulate U.S. Outbound Investment to China," Congressional Research Service, April 8, 2024, https://crsreports.congress.gov/product/pdf/IF/IF12629.

[43] "Executive Order on Addressing U.S. Investments in Certain National Security Technologies and Products in Countries of Concern," The White House, August 9, 2023, https://www.whitehouse.gov/briefing-room/presidential-actions/2023/08/09/executive-order-on-addressing-united-states-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern/.

[44] "Executive Order 14,105 Restricts U.S. Outbound Investment into Sensitive Technology Sectors in China.," Harvard Law Review, March 12, 2024. https://harvardlawreview.org/print/vol-137/exec-order-no-14105/.

Foreign Investment in the United States (CFIUS)", these rules seek to impede PRC's ability to use U.S. capital markets for their own geopolitical benefit.

Both economic tools, export controls and outbound investment restrictions, rely and will rely heavily on the finance and banking industry to be successful. These firms serve as the linchpin in implementing and enforcing any controls through compliance monitoring, transaction reviews, and financial services to support trade. Additionally, banks provide expert advice to help firms maneuver the new landscape to ensure firms understand their legal obligations. Financial institutions will be responsible for reporting potential violators of outbound investment restrictions to the Financial Crimes Enforcement Network (FinCEN). The BIS and FinCEN have released a list of potential "red flags" based on the recent legislation although many of them should be part of the finance industry's normal day-to-day operations for other financial crimes.[45] These functions will prove vital to maintaining the integrity of the export and outbound investment controls.

Cybersecurity

Cybersecurity is an example of private industry successfully coordinating and collaborating with the public sector to address threats and protect critical infrastructure.[46] Capital markets and financial infrastructure represent a point of vital national security and are highly vulnerable to exploitation, hence business and federal government's shared interest in cybersecurity and infrastructure resilience. The Cybersecurity Infrastructure Security Agency

[45] Jacob Atkins, "US Deepens Banks' Role in Detecting Export Control Violations," Global Trade Review, November 8, 2023, https://www.gtreview.com/news/americas/us-deepens-banks-role-in-detecting-export-control-violations/.

[46] "Partnerships and Collaboration," Cybersecurity and Infrastructure Security Agency, accessed April 23, 2024, https://www.cisa.gov/topics/partnerships-and-collaboration.

(CISA) has built trusted partnerships, such that businesses and government share threat information, co-develop security protocols, and implement best practices for safeguarding digital and physical assets against evolving threats.[47] SEC and FINRA rules that subject financial services firms to business continuity testing and contingency planning establish resilience and reinforce investor confidence. By pooling resources and expertise, such collaboration can significantly reduce vulnerabilities in critical infrastructure and cyber domains, serving as a robust mechanism to help guard against both conventional and asymmetric threats. According to CISA, "this mutual commitment to information sharing through our trusted partnerships is essential to the protection of critical infrastructure and to furthering cybersecurity for the nation."[48] These partnerships exemplify the benefits of cultivating areas of shared interest between business and the federal government and can serve as a model for a way to leverage the strengths and resources of both public and private sectors to achieve national security objectives.

Impediments to Leveraging Capital Markets for National Security Objectives[49]

Shareholder vs Stakeholder Capitalism

Shareholder capitalism prioritizes shareholder returns above all else, aligning with the notion that businesses should focus on profit maximization as their primary responsibility.[50] This

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[47] "Partnerships and Collaboration."
[48] "Partnerships and Collaboration."
[49] This section outlines several of the dynamics that shape how the finance industry may/may not be able to address national security concerns. It is not all inclusive. Some additional factors that must be considered include U.S. fiscal policy, and the associated budget authority that may limit the capability to pursue some or all the targeted investment opportunities listed above in future years. Another consideration not addressed in this section relates to registration requirements for entities like the OSC. SEC registration is highly regulated and is required for those pursuing equity stakes in public and private corporations. These regulations highlight conflicts of interest with government as a factor in determining fiduciary credibility. These and other factors shape the ability for the U.S. government, and DoD in particular, to leverage capital markets for national security purposes.
[50] Garnet Roach, "'A Tension between Purpose and Profit Persists': NYU Report Calls for ESG Rethink," IR Magazine, November 10, 2023, https://www.irmagazine.com/esg/tension-between-purpose-and-profit-persists-nyu-report-calls-esg-rethink.

is currently the dominant model in the United States. In contrast, stakeholder capitalism advocates for a broader view wherein companies consider the impact of their decisions on all stakeholders, including employees, communities, the society, the nation, and the environment, beyond just financial shareholders.[51] Over the past several decades, the limitations of the shareholder model have called into question its value, and there are growing calls for a broader stakeholder focus.[52] Although this change started to take hold in the form of firms focusing on overall societal well-being, so-called CSR and ESG initiatives, the approach is still evolving. This evolving approach does not yet formally include a business focus on the tradeoffs between national security and profit maximization, but there are increasing calls for this dialogue.

It should be noted that prior to the invasion of Ukraine, approximately 1,400 U.S. based companies were doing business in Russia, despite the Russian leadership's open calls to upend the international order.[53] The recent global experience of Russia weaponizing its role in the energy, commodities, and food markets resulted in global inflation, rising interest rates, and a subsequent decline in stock valuations.[54] Despite this, and the national security-based impetus for companies to fully divest from Russia, and the associated public pledges to do so, many are still operating successfully in the country.[55] This highlights the on-going tension between national security imperatives and shareholder returns. Prior to Russia's invasion of Ukraine,

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[51] Roach, "A Tension between Purpose and Profit Persists."

[52] For an example of these shifting dynamics see the UN-chartered "The Global Compact: Who Cares Wins – Connecting Financial Markets to a Changing World," 2004, https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf.

[53] Jackie Northam, "Many American companies that waited to exit Russia are now struggling to leave," National Public Radio, April 19, 2023, https://www.npr.org/2023/04/19/1170919522/many-american-companies-that-waited-to-exit-russia-are-now-struggling-to-leave.

[54] Lotanna Emediegwu, "Update: how is the war in Ukraine affecting global food prices?" *Economics Observatory*, February 23, 2024, https://www.economicsobservatory.com/update-how-is-the-war-ukraine-affecting-global-food-prices.

[55] "Companies Failing to Keep Promises to Leave Russia," Yale School of Management, July 2023, https://www.yalerussianbusinessretreat.com/companies-reneging-on-leaving-russia.

many corporate initiatives led firms to distance themselves from investments in companies critical to national security, but the invasion "reignited a debate about whether such companies are ESG-friendly investments."[56] The ensuing debate highlights some of the limitations and hypocrisy associated with corporate initiatives that cater to one set of stakeholders at the expense of stakeholders with differing opinions.[57] The tension between maximizing immediate financial returns and considering broader societal impacts reflects the core of the shareholder-stakeholder debate.[58]

2022 was an inflection point for stakeholder capitalism, as a new type of political backlash rose to prominence that will likely shape the 2024 U.S. election and subsequent regulatory environment. This backlash paints aspects of basic CSR and ESG initiatives as too "woke" and is forcing firms in the finance industry to assess the costs and benefits of their investment strategies more holistically. Certain large investors, including state pension funds and university endowments, are pressuring the finance industry to address these concerns by modifying their investment strategies, while certain state legislatures are considering bills that will shape the regulatory environment. According to research from Plural, 156 bills that sought to undermine ESG investing or contracting were introduced in 37 states and the U.S. Congress in

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56 Polly Bindman, "Why ESG funds are full of weapons," *Capital Monitor*, July 20, 2022, https://capitalmonitor.ai/strategy/responsilbe/how-exposed-are-esg-funds-to-weapons/.

57 Timothy Ash, "How has the ESG investing landscape changed one year on from the Russian invasion of Ukraine?" RBC Global Asset Management, March 2, 2023, https://institutional.rbcgam.com/en/us/research-insights/article/how-has-the-esg-investing-landscape-changed-one-year-on-from-the-russian-invasion-of-ukraine/detail.

58 For an example of how prime DoD contractors address the primacy of shareholders by pursuing stock buybacks instead of reinvesting capital, see Valerie Insinna, "Defense companies keep up momentum on share repurchases, despite Navy leader's criticism," Breaking Defense, May 6, 2024, https://breakingdefense.com/2024/05/defense-companies-keep-up-momentum-on-share-repurchases-despite-navy-leaders-criticism/.

the first half of 2023.[59] This legislative pushback suggests a polarization regarding the role of corporate initiatives in investment and governance activities.[60]

Regulatory Arbitrage

The capital markets that serve as a source of strength for the U.S. can also be a source of vulnerability if they are not properly monitored and regulated. The strength of the U.S. market lies in regulation and transparency.[61] These regulations and subsequent enforcement make the U.S. capital markets safe for investment but vary significantly depending on how and where a company elects to conduct business. Regulatory arbitrage often surfaces in the context of innovative transactions or deal structures, and the current global landscape allows multi-national corporations with internationally based subsidiaries the opportunity to leverage jurisdictional differences to optimize their profitability and shirk efforts to regulate corporate responsibility.[62] The finance industry conducts significant business with, and generates revenue from, firms seeking to exploit the "discrepancies between the economic substance and the legal treatment" of their activities across a variety of different jurisdictions.[63] Efforts to overcome this dynamic would require government and private sector collaboration to address national security concerns and promote transparency. These efforts would likely come at a significant cost, fail to close all

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[59] Garnet Roach, "ESG Backlash Fails to Deter Investors, Research Finds," IR Magazine, accessed May 6, 2024, https://www.irmagazine.com/investor-perspectives/esg-backlash-fails-deter-investors-research-finds.

[60] Roach, "ESG Backlash."

[61] "The Anti-Money Laundering Act of 2020," FinCen, accessed May 6, 2024, https://www.fincen.gov/anti-money-laundering-act-2020.

[62] For examples of regulatory arbitrage see Josh McDermott, "The where and what of regulatory arbitrage," *Financial Times*, March 9, 2011, https://www.ft.com/content/763f1c99-8ddb-3cc9-9919-25f2701759ed and Katja Langenbucher, "Regulatory Arbitrage: What's Law Got To Do With It*?" Accounting, Economics, and Law: A Convivium*, July 16, 2020, https://www.degruyter.com/document/doi/10.1515/ael-2019-0054/html.

[63] Andrea Minto, Stephanie Prinz, and Melanie Wulf, "A Risk Characterization of Regulatory Arbitrage in Financial Markets," *European Business Organization Law Review*, August 2, 2021, https://link.springer.com/article/10.1007/s40804-021-00219-x.

regulatory gaps, and ultimately call into question the disclosure-based framework upon which the existing market structure was founded. The U.S.' ability to continue leveraging its economic IoP effectively in the future will depend on its ability to address the existing gaps between the finance industry's regulatory environment and broader national security concerns.

The Role of ESG in National Security

The DoD has highlighted environmental considerations as a core national security issue. In addition to the impacts to U.S. military installations and global population displacement, considerations for financing a green energy transition threaten to embolden our adversaries.[64] ESG proponents argue that ignoring ESG considerations can lead to environmental degradation and social unrest, with potential to pose significant national and global security risks. The current NSS, in line with these proponents, recognizes the importance of sustainable practices in critical sectors like energy, technology, and manufacturing.[65] Aligning corporate ESG goals with national security could potentially bolster resilience against these environmental threats and geopolitical instabilities, but gaining consensus across the finance industry is a challenge.[66]

The legislative scrutiny and debate around ESG investing underscores a deeper divergence within the finance industry and its alignment with national security. While some argue ESG investing might compromise economic stability by over-emphasizing non-financial factors, proponents believe sustainable practices are essential to long-term economic security.[67] Investor interest in ESG remains robust in Europe but investors in the United States diverge in

[64] The transition to renewable energy threatens to upend oil and gas markets, a key source of economic vitality around the globe. The PRC is currently leading investment in alternative energy efforts while Russia and Iran are key oil producers. Transition finance considerations will play a key geopolitical role in the coming decades.
[65] "National Security Strategy."
[66] "Banking on Climate Chaos," Fossil Fuel Finance Report 2024, accessed May 13, 2024, https://www.bankingonclimatechaos.org/wp-content/uploads/2024/05/BOCC_2024_vF.pdf.
[67] Garnet Roach, "ESG Backlash."

their ideas.[68] Issues such as greenwashing, where a company publicly claims it supports ESG efforts but fails to do so in practice, undermine the credibility of the movement.[69] For example, many of America's leading corporations quietly lobby against stricter government directed environmental policies while touting their own environmental policies.[70] Despite this, some investors and executives plan to increase ESG efforts, recognizing their long-term benefits and alignment with aspects of stakeholder capitalism.[71]

A new report by the nonpartisan research group Influence Map found 93% of American companies claim that they aim to achieve "net zero" climate effects but are only "weakly" aligned with the policies those companies and their trade groups promote (See Figure 6).[72] An original proponent of ESG principles, Larry Fink, CEO of BlackRock, has since tempered his thinking to a so-called "broader approach called transition investing."[73]

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68 Simon Jessop, Ross Kerber, and Isla Binnie, "Europe stands firm against US-driven ESG backlash," *Reuters*, April 12, 2024, https://www.reuters.com/sustainability/sustainable-finance-reporting/europe-stands-firm-against-us-driven-esg-backlash-2024-04-12/.

69 Several firms in the financial industry have been sued for greenwashing activities, see https://www.reuters.com/sustainability/us-sec-poised-ban-deceptive-esg-growth-fund-labels-2023-09-20/.

70 Saul Elbein, "Many Corporations Promote 'Net Zero' While Lobbying for Weaker Climate Action: Report," *The Hill* (blog), November 17, 2023, https://thehill.com/policy/energy-environment/4313429-many-corporations-promote-net-zero-while-lobbying-for-weaker-climate-action-report/.

71 Segal, "Investors, Businesses to Increase ESG Investment."

72 Elbein, "Many Corporations Promote 'Net Zero.'"

73 Jon McGowan, "BlackRock's Fink Calls for Energy Pragmatism, Omits ESG From Annual Letter," *Forbes*, March 27, 2024, https://www.forbes.com/sites/jonmcgowan/2024/03/27/blackrocks-fink-calls-for-energy-pragmatism-omits-esg-from-annual-letter/.

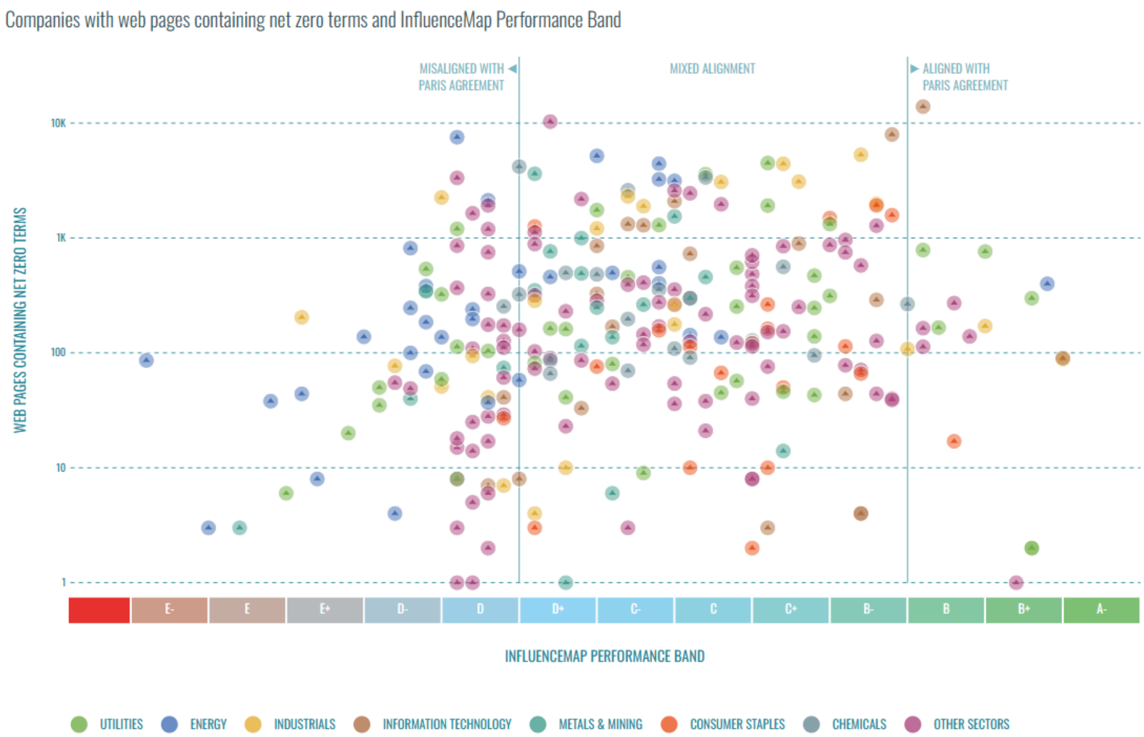

Figure 6. Source: https://influencemap.org/briefing/The-State-of-Net-Zero-Greenwash-24402

According to Fink, the term ESG has become contentious and somewhat tainted in the current socio-political climate. He expressed his reluctance to use the term, noting that it has been "weaponized by the far left and the far right," leading to a polarized debate that overshadows the underlying principles of ESG.[74]

This controversy stems from divergent views on how companies should integrate sustainability and ethical considerations into their business operations.[75] Critics argue that ESG mandates can be restrictive and are sometimes applied inconsistently, which can skew investment decisions.[76] This has led to significant backlash from various stakeholders, including

[74] Charles Creitz, "BlackRock's Larry Fink on Why He Won't Mention ESG Anymore: 'It's Been Weaponized by Left and Right,'" *Fox Business*, July 5, 2023, https://www.foxbusiness.com/media/blackrock-fink-wont-mention-esg-anymore-been-weaponized-left-right.
[75] Creitz, "BlackRock's Larry Fink on Why He Won't Mention ESG Anymore."
[76] Creitz, "BlackRock's Larry Fink on Why He Won't Mention ESG Anymore."

political figures and institutional investors, who either demand stricter adherence to ESG principles or oppose them as overly restrictive.[77] As a result, the term ESG has attracted criticism and skepticism, complicating discussions around its implementation and effectiveness in achieving balanced, sustainable investment outcomes. The DoD must contend with this fractious environment in trying to pursue its objectives in addressing climate change and other environmental issues. For the U.S. to effectively leverage its economic power and align the finance industry with national security goals, regulatory frameworks must ensure transparency and credibility, including efforts to reduce the risks of greenwashing and the divergent interpretations of appropriate responses.[78]

Market Structure Dynamics – Passive Investing

To further complicate the dynamics associated with the shareholder versus stakeholder debate, the rise of passive investing has significantly altered the structure of U.S. capital markets. Driven by the dominance of large institutional investors such as BlackRock, Vanguard, and State Street, passive investing involves investing in low-cost index funds that track a specific market index rather than actively selecting individual stocks.[79] This approach has gained popularity due to its lower fees, tax advantages, and the perception of superior returns. Passive investing has steadily increased over the last few decades, recently surpassing active investing.[80]

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[77] Creitz, "BlackRock's Larry Fink on Why He Won't Mention ESG Anymore."
[78] Mark Segal, "Investors, Businesses to Increase ESG Investment Despite Greenwashing Scrutiny & Political Pushback: Bloomberg Survey," *ESG Today*, November 13, 2023, https://www.esgtoday.com/investors-executives-to-increase-esg-investment-despite-greenwashing-scrutiny-political-pushback-bloomberg-survey/.
[79] Felipe Cambeiro and Shaun Bisman, "Big Three Institutional Investor Updates," The Harvard Law School Forum on Corporate Governance (blog), April 13, 2022, https://corpgov.law.harvard.edu/2022/04/13/
[80] Cambeiro and Bisman, "Big Three Institutional Investor Updates."

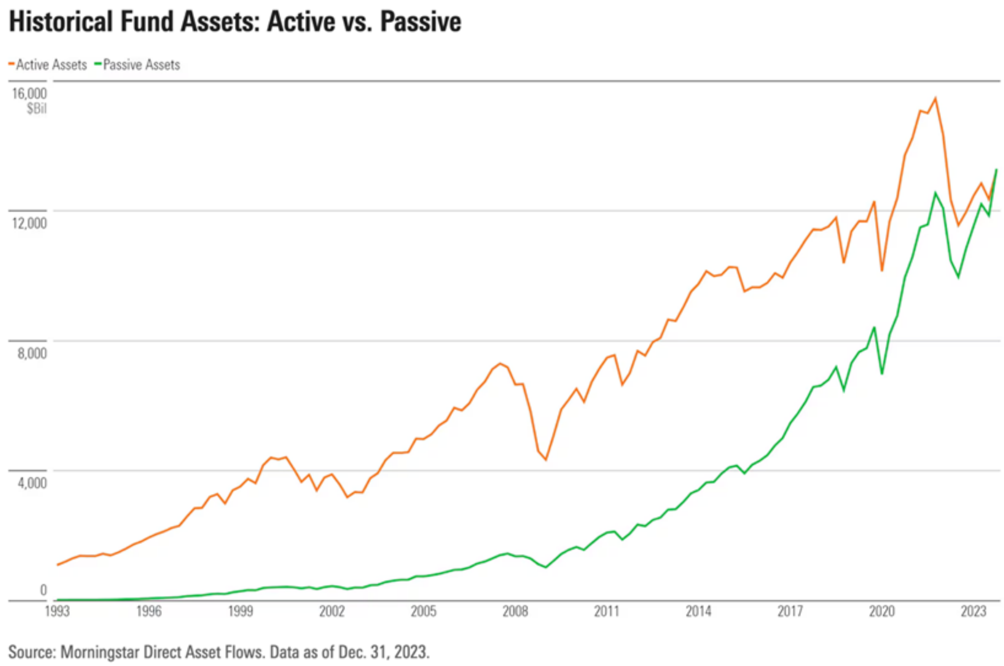

Figure 7. Source: https://www.morningstar.com/funds/recovery-us-fund-flows-was-weak-2023

The transition from active to passive investing strategies has increased steadily over the past several decades, resulting in passive funds surpassing the active equity market share in 2022.[81] These factors provide institutional investors, and specifically The Big Three, significant control over a large portion of the economy.[82] A primary concept that has enabled U.S. capital markets to become the most respected, liquid, and capitalized markets in the world is that its structure has ensured efficient capital allocation; flowing resources to the individuals and firms who will use it to provide a fair return to investors, thus driving both incremental and disruptive innovation.

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[81] Jackie Cook and Jasmin Sethi, "Asset Managers as Stewards of Sustainable Business: Implications of the Rise in Passive Investing, *MorningStar Blog*, October 9, 2019, https://www.morningstar.com/content/dam/marketing/shared/Company/LandingPages/EvolvingRoleOfAssetManagers/Asset_Managers_Oct9.pdf and Steve Johnson, "Passive fund ownership of US stocks overtakes active for first time," *Financial Times (Online)*, June 6, 2022, accessed May 15, 2024, https://www.ft.com/content/27b5e047-5080-4ebb-b02a-0bf4a3b9bc08.

[82]Cambeiro and Bisman, "Big Three Institutional Investor Updates."

Passive investing creates several challenges for maintaining an innovative ecosystem.[83] The concept undermines efficient capital allocation by failing to systematically account for the business fundamentals of the firms in which they invest, creating common ownership problems for board governance and corporate activities, and reducing opportunities for small and medium size companies to access public capital markets.[84] In addition to disrupting proper capital allocation, passive investing has potential to finance adversarial firms included in an index.[85] Despite these challenges, the benefits derived from passive investing, particularly to the individual investor, likely complicate potential policies that might seek to unravel current trends. The DoD must acknowledge the updated structure of U.S. capital markets and find ways to achieve its objectives despite the limitations imposed by these trends.

PRC's Market Allure

The PRC's domestic market is attractive to foreign firms due to its size and potential for revenue growth. Many U.S. companies view the PRC as a necessary market for long-term profitability despite the risks associated with doing business there.[86] The U.S. finance industry is crucial in facilitating investments in the PRC, providing essential services such as investment opportunities, capital management, and partnership facilitation. The industry also plays a significant role in implementing and enforcing export controls and outbound investment screening through compliance monitoring, transaction reviews, and by providing financial services that support trade. These measures aim to protect national security interests and limit the

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[83] Lu Wang, "Einhorn Says Markets Are Broken." *Bloomberg Online*, May 7, 2024, accessed May 13, 2024, https://finance.yahoo.com/news/einhorn-says-markets-broken-data-114725974.html?soc_src=social-sh&soc_trk=ma.
[84] Kish, "The Capital Allocation and Agency Problems with Index Funds."
[85] "Reset, Prevent, Build."
[86] Michael D Sutherland and Karen M Sutter, "U.S. Capital Markets and China: Issues for Congress," Congressional Research Service, March 5, 2024, https://crsreports.congress.gov/product/pdf/IF/IF11803.

PRC's influence on the global stage but are often in conflict with the allure of the PRC's market size and associated potential profits.

The U.S. government is actively seeking to shape the regulatory environment for both financial and non-financial firms to address the tension between the PRC's growing market and the implications for national security. Attempts to de-couple, or de-risk, U.S. capital markets from the economic opportunity presented by the PRC will face fiduciary, legal, and political issues. DoD should continue to highlight the challenges associated with how the PRC leverages its civil-military fusion for its own security objectives but must accept that the finance industry will have strong incentives to continue supporting economic interdependency with the U.S.' primary competitor.

Challenges in Digital Innovation

The finance industry has undergone a significant transformation in recent years, driven by digital innovations. The advancement of online banking, technology-based security trading, and the emergence of cryptocurrency are shaping the industry's future and creating new and unforeseen national security concerns. These technologies have already reshaped how financial services are delivered, accessed, and managed. While these have potential to be a source of strength for the U.S. economy, they also open new avenues of exploitation that can and are used for malign activity.

Government regulators from around the world have established digital sandboxes in which financial industry entities can experiment with the strengths and weaknesses of this digital transition.[87] The Global Financial Innovation Network seeks to build core competencies within the finance industry that permit the digital transition to provide maximum benefit while minimizing nefarious behavior by permitting "firms to apply jurisdictional scaling from day one," making it "more convenient for those firms which operate across jurisdictions."[88] Firms and regulators in the U.S. finance industry have the opportunity to participate, and many do so, but technological innovation is currently outpacing the rate of regulatory updates to mitigate potential threats.[89] Advocates for this type of experimentation argue that the United States should do more to address the fact that digital innovation provides alternative means through which illicit finance can flow.[90]

The DoD must recognize that the pace at which U.S. regulators develop, vet, approve, and often litigate the rules that govern this space is often much slower than that which technology becomes available to malign actors. The divergence between the U.S.' rule making timeline and the rate at which technology becomes available will continue to exist and impact national security. The U.S. government must continue to lead in the digital space with a combination of regulation, technological solutions, and industry best practices to proactively address the challenges and opportunities, rather than leaving a legal grey area that malign actors could exploit.[91]

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[87] Baker McKenzie, "A Guide To Regulatory Fintech Sandboxes Internationally," May 2020, https://www.bakermckenzie.com/-/media/files/insight/publications/2020/05/a_guide_to_regulatory_fintech_sandboxes_internationally_8734.pdf?la=en.

[88] "A Guide To Regulatory Fintech Sandboxes."

[89] "U.S. Financial Regulatory Agencies Join the Global Financial Innovation Network," Office of the Comptroller of the Currency, October 24, 2019, https://www.occ.gov/news-issuances/news-releases/2019/nr-ia-2019-122.html.

[90] Alessandra Carolina Rossi Martins, "A Sandbox for the U.S. Financial System," *The Regulatory Review*, August 19, 2021, https://www.theregreview.org/2021/08/19/rossi-martins-sandbox-for-us-financial-system/.

[91] This topic is becoming politicized in the United States. The 2024 election cycle will potentially shape the extent to which the U.S. Government moves forward on expansion of digital oversight. See Jasper Goodman, "Crypto is Trump's New Weapon Against Biden," *Politico*, May 10, 2024, accessed May 13, 2024, https://www.politico.com/news/2024/05/10/trump-crypto-biden-00157051.

The U.S. capital markets that have grown into a globally dominant force under the Bretton Woods system provide rich opportunities for policymakers to address national security concerns. Several market-based initiatives are currently underway to address the global challenges facing the United States. Unfortunately, as shown, there are several factors that impede the ability of the U.S. government to shape U.S. capital markets in such a way that it could derive additional decisive security benefits. Additionally, it is unlikely that policies which detract from the free, open, and transparent model of current market structure would allow the markets to continue operating at the pinnacle of the global economy. A significant benefit of the Bretton Woods system and the centrality of the U.S. finance sector to the global economy is the prominent role of the USD and the opportunities that fact affords to the United States. In addition to U.S. capital markets, policymakers are afforded the privilege to leverage the USD's dominant role in support of financial statecraft efforts to address national security concerns. The next section will address the finance industry's role in these efforts.

IV. Financial Statecraft

Financial statecraft refers to a government's use of financial sanctions and foreign assistance to influence the behavior of other countries.[92] Examples of negative financial statecraft – actual or threatened disincentives or punishments designed to change an actor or group of actors' actions to comply with U.S. interests – include, but are not limited to, sanctions,

[92] Leslie Elliott Armijo, "Financial Statecraft," *The Palgrave Handbook of Contemporary International Political Economy* (London: Palgrave Macmillan UK, 2019), 27–41, https://doi.org/10.1057/978-1-137-45443-0_2.

asset freezes, termination of bilateral investment treaties (BITs), and trade embargoes.[93] Examples of positive financial statecraft – incentives designed to encourage an actor or group of actors to align their actions with U.S. interests or reward similar behavior – include, but are not limited to, direct and indirect financial assistance, preferential terms for foreign investment, and subsidies. The use of each of these tools has direct and indirect implications for the U.S. finance sector, often related to oversight and compliance.

Overview of Statecraft Initiatives

The U.S. deploys various forms of negative and positive financial statecraft to advance its national security objectives and foreign policy goals. Given the United States is the world's largest economy; the size, strength, and liquidity of U.S. financial markets; and the USD's role as the dominant global reserve currency, the United States has great leverage to deploy the tools of financial statecraft.[94] Each of the tools of financial statecraft is imperfect, however, and there are legitimate policy debates about their costs and level of efficacy to advance U.S. national security objectives.

A review of multiple recent and current U.S.-led sanctions efforts highlights the promise and limitations of these tools. In 2011, as civil unrest in Libya demonstrated the potential to remove the anti-U.S. regime of Muammar Qaddafi, the United States used Executive Order

[93] Sanctions is an umbrella term for governmental actions, other than use of military force, which aim to stop, deter, or cause certain conduct by states, groups, or individuals. Sanctions include, but are not limited to, trade embargoes, restrictions on specific exports or imports, denial of foreign assistance, loans, or investments, locking foreign assets under the sanctioning entity's (or sender's) jurisdiction, and prohibiting transactions involving the sender's citizens or businesses. Sanctions can be classified in multiple ways: a specific sanction can 1) have a broad or targeted intended impact, 2) serve external or internal goals, 3) serve the primary function of influencing an actor's behavior or (in the case of secondary sanctions) serve the more indirect function of penalizing third parties whose actions undermine the intention of the primary sanction, and 4) be applied unilaterally or multilaterally.

[94] Anshu Siripurapu and Noah Berman, "The Dollar: The World's Reserve Currency," Council on Foreign Relations, July 19, 2023, https://www.cfr.org/backgrounder/dollar-worlds-reserve-currency.

13566 to freeze all assets owned by Qaddafi, his family, and his senior officials, resulting in an estimated $32 billion in frozen assets.[95] Weakened by the impact of the U.S.' action, Qaddafi lost his grip on power and was eventually ousted and killed later that year. During this same period, the U.S. advanced both broad and targeted sanctions against the nascent Iranian nuclear program; these efforts resulted in an estimated $60 billion in terminated energy projects, reduced global oil exports from Iran, and an 80% decline in the value of the Iranian rial.[96] Finally, the U.S. led efforts to sanction Russia in the wake of its 2022 full-scale invasion of Ukraine. This effort included targeted asset freezing, trade embargoes, and the removal of major Russian financial institutions from the SWIFT international payment messaging system, all designed to economically isolate Russia and undermine its financial system in an effort to weaken the Putin regime.[97] The associated impacts of these efforts include increased difficulty for Russia in engaging with global financial markets, temporary challenges finding markets for Russian-produced goods (i.e., fossil fuels), challenges finding parts and equipment used in the oil and gas sector, and a steady devaluation of the ruble since June 2022.

Beyond sanctions, additional statecraft options exist, to include severing previously agreed BITs, of which the United Nations Conference on Trade and Development reports there are 62 between Russia and other states.[98] "The Russian Central Bank reports that Russian investments into European countries make up to 83% of all Russian foreign investments, namely

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[95] Juan Zarate, *Treasury's War: The Unleashing of a New Era of Financial Warfare*, First Edition (New York/N.Y: Public Affairs, 2013).
[96] Zarate, *Treasury's War*.
[97] Christian Perez, "What Does Russia's Removal From SWIFT Mean For the Future of Global Commerce?," *Foreign Policy* (blog), May 16, 2024, https://foreignpolicy.com/2022/03/08/swift-sanctions-ukraine-russia-nato-putin-war-global-finance/.
[98] Oleksii Maslov and Nelli Kichigina, "Cutting-off Russia from ISDS: Another Tool to Consider?," Kluwer Arbitration Blog, March 26, 2022, https://arbitrationblog.kluwerarbitration.com/2022/03/26/cutting-off-russia-from-isds-another-tool-to-consider/.

$316 billion out of a total of $381 billion."[99] Currently, the United States has only one BIT in place with Russia though it is not in force.[100] Nonetheless, the number of BITs Russia shares with European countries emphasizes the need for the U.S. to cooperate with allies and partners to effectively employ its financial statecraft.

Negative Statecraft

In each of the above cases, the U.S.-led negative financial statecraft efforts were at least partially successful in having the intended impact, though an analysis of costs, secondary impacts, and risks highlights the complicated nature of each case. For example, as noted above, the U.S.' ability to engage in financial statecraft is largely due to its strong capital markets and the role of the USD as the global reserve currency. Today over half of all foreign exchange transactions include the USD and central banks around the world actively seek to hold USD, given the currency's strength and ubiquity.[101] The U.S. benefits in immeasurable ways from being at the center of this global system. However, if the U.S. overuses financial sanctions against adversaries it could have the unintended consequence of creating a bifurcated global financial system, in which alternative forms of engagement (i.e., non-SWIFT options) exist for targeted actors, creating an "axis of sanctioned countries," that could help create a non-U.S.-centered form of financial exchange.[102]

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[99] Maslov and Kichigina, "Cutting-off Russia from ISDS."

[100] "U.S. of America International Investment Agreements Navigator," UNCTAD Investment Policy Hub, accessed May 6, 2024, https://investmentpolicy.unctad.org/international-investment-agreements/countries/223/united-states-of-america.

[101] Sandra Kollen Ghizoni, "Creation of the Bretton Woods System | Federal Reserve History," accessed May 6, 2024, https://www.federalreservehistory.org/essays/bretton-woods-created.

[102] Reza Baqir and Saleha Mohsin "*Sanctions & the Dollar: Challenges to the World's Reserve Currency*," The Atlantic Council Interview at the International Monetary Fund, 2024, https://www.youtube.com/watch?v=3UlWNZMxZH8.

Countries faced with financial and currency limitations have employed counter strategies to defend their foreign policy autonomy. The PRC is currently seeking to build a network of international financial institutions that rivals the Bretton Woods system. These efforts include the Belt and Road Initiative (BRI), the Asian Infrastructure Investment Bank, the BRICS bank, and others, which are in some ways surreptitiously supported by stalled changes to improve Bretton Woods institutions.[103] The PRC uses the BRI, ostensibly a development project that aims to connect PRC with other countries in Eurasia and Africa through a land and maritime network, to assert its economic and political influence by creating economic dependencies on PRC – potentially swaying these countries' foreign policy stances. Russia and PRC have developed financial messaging systems – System for Transfer of Financial Messages (SPFS) and Cross-Border Interbank Payment System (CIPS), respectively – to bypass the SWIFT system.[104] PRC provided renminbi access to more than thirty countries by signing bilateral swap agreements with them and, as of 2014, launched the renminbi as a central bank digital currency. The digital yuan (e-CNY) and the petro-yuan (oil priced in yuan) are potential alternatives to the USD.

Sanctions can also lead to retaliatory countermeasures that negatively impact U.S. interests. For example, "in an attempt to retaliate, bolster its economy and stop [or delay] the exodus of foreign capital, Russia [took] various measures," including prohibiting or severely limiting transactions in foreign currencies and moving assets out of Russia, and nationalizing

[103] Hung Tran, "Understanding the debate over IMF quota reform," Atlantic Council (blog), March 28, 2024, https://www.atlanticcouncil.org/blogs/econographics/understanding-the-debate-over-imf-quota-reform/.
[104] Carla Norrlöf, "Economic Statecraft: Finance and Money," Atlantic Council (blog), November 30, 2021, https://www.atlanticcouncil.org/wp-content/uploads/2021/11/Economic-Statecraft-Finance-and-Money.pdf.

foreign assets located in Russia.[105] Clearly, negative financial statecraft initiatives have the potential to advance U.S. national security interests through imposing financial and time costs on their targets, though they are imperfect and complicated tools that also incur costs (i.e., compliance) and risks (i.e., retaliation and potentially undermining the centrality of the USD in the long-term) for the United States.

In April 2024, the United States enacted the Rebuilding Economic Prosperity and Opportunity for Ukrainians (REPO) Act, a bill that states "the President may seize, confiscate, transfer, or vest any Russian aggressor state sovereign assets, in whole or in part, and including any interest or interests in such assets, subject to the jurisdiction of the United States."[106] Time will tell if the decision of U.S. policymakers to confiscate foreign assets will provide a net gain or loss to national security efforts as other countries weigh their responses.[107]

There are additional challenges for the United States and its allies with respect to enforcing sanctions. International bodies aimed at restricting dual-use technologies, such as the Wassenaar Agreement, operate on a consensus basis. Russia remains part of the group, thus limiting the ability to restrict dual-use technologies to Russian markets.[108] Companies that operate across the globe have real economic incentives and profit from access to Russia's market

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[105] Valts Nerets and Artūrs Kazāks, "Concerns about Investment Protection in Russia during Its Invasion of Ukraine," Sorainen, March 18, 2022, https://www.sorainen.com/publications/concerns-about-investment-protection-in-russia-during-its-invasion-of-ukraine/

[106] Ingrid Brunk, "*The Controversial REPO Act Is Now Law*," Lawfare, April 25, 2024, https://www.lawfaremedia.org/article/the-controversial-repo-act-is-now-law.

[107] Ashley Deeks, Mitu Gulati, and Paul Stephan, "What Should the Biden Administration Do with REPO?" *Lawfare*, May 6, 2024, access May 13, 2024, https://www.lawfaremedia.org/article/what-should-the-biden-administration-do-with-repo.

[108] Steven Feldstein and Fiona Brauer, "Why Russia Has Been So Resilient to Western Export Controls," Carnegie Endowment for International Peace, March 11, 2024, https://carnegieendowment.org/2024/03/11/why-russia-has-been-so-resilient-to-western-export-controls-pub-91894.

and its ability to sell discounted oil, creating fragmentation in attempts to building a coalition to force Russia to the negotiating table.[109]

Positive Statecraft

In 2022, the Biden administration announced its Build Back Better World (B3W) initiative. B3W is an example of how the unparalleled financial power and access to resources allows the United States the opportunity to incentivize and reward actors aligned with U.S. national security interests.[110] Among the tools of positive financial statecraft, the United States is particularly equipped to mobilize capital markets to support the objectives of aligned actors. In addition to traditional development assistance that helps create pro-business and trade-enabling environments in targeted countries, the United States deploys international development finance through partial loan guarantees, direct loans, and limited equity investments.[111] It must be noted, however, that U.S. statecraft initiatives like B3W are not a panacea. Detractors argue that these efforts do not fully achieve the stated geopolitical goals and often do not actually deliver funding to the targeted country or organization. One scathing assessment bluntly addresses this issue stating:

> "The United States, the world's largest aid donor, directs its spending to just about everybody except the governments of developing countries. It pays the U.S. military to provide emergency relief services; subsidizes private firms to invest in infrastructure projects; funds NGOs to deliver aid in the health, education, and humanitarian sectors; and pays billions of dollars to private consulting firms within spitting distance of the White House to provide so-called technical assistance."[112]

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[109] Feldstein and Brauer, "Why Russia Has Been So Resilient."

[110] Conor M. Savoy and Shannon McKeown, "Opportunities for Increased Multilateral Engagement with B3W," Center for Strategic and International Studies, May 6, 2022, https://www.csis.org/analysis/opportunities-increased-multilateral-engagement-b3w.

[111] "Economic Growth and Trade," U.S. Agency for International Development, November 3, 2024, https://www.usaid.gov/economic-growth-and-trade.

[112] Charles Kenny, "Biden's Foreign Aid Is Funding the Washington Bubble," Foreign Policy (Blog), May 6, 2022, https://foreignpolicy.com/2022/05/06/us-foreign-aid-biden-build-back-better-world-development/.

Despite this concern, the U.S. International Development Finance Corporation (DFC) mobilizes private capital to advance projects that are mutually beneficial and reinforce the U.S.-led international system. For example, the DFC's deployment of partial loan guarantees and loan portfolio guarantees helps banks and other financial institutions lend their own private capital to targeted companies and sectors.[113] The United States typically assumes 50% of the risk associated with these investments and agrees to repay the private-sector lender if a default on principal occurs. The availability of this U.S-backed risk-sharing tool serves as one incentive for countries to remain aligned with U.S. national security interests. This innovative tool for positive financial statecraft is readily available to policymakers because of the Bretton Woods system that fosters global confidence in the USD and U.S. economy. Just as the PRC has advanced the BRI to strengthen economic and political ties around the world, the United States can drastically expand its positive financial statecraft for mutual gain, increasing and incentivizing private sector investment required for friend-shoring of critical supply chains and investing in education that increases the human capital of allies and partners.[114]

V. Conclusion and Policy Recommendations

The finance industry and U.S. national security concerns are inextricably linked, with broad implications for the international Bretton Woods system. Trends in U.S. capital markets have proven to be extremely beneficial for everyday investors and economic statecraft allows policymakers to act, or appear to act, tough on geopolitical rivals while minimizing the cost in

[113] "Debt Financing," U.S. International Development Finance Corporation, accessed May 6, 2024, https://www.dfc.gov/what-we-offer/our-products/debt-financing.
[114] "Friendshoring Brings Industrial-Sized Investment Opportunity," Capital Group NACG, February 29, 2024, https://www.capitalgroup.com/advisor/insights/articles/friendshoring-brings-industrial-sized-investment-opportunity.html

U.S. treasure and casualties. The last several decades of globalization and change, underpinned by the finance industry, have helped to lift income, build wealth, and drive economic activity around the world. U.S. policymakers who regulate and provide oversight to this industry must carefully consider the direct and indirect costs, benefits, and broad ramifications of both action and inaction.

The current global financial architecture was built with aspirations that "stronger international economic coordination would prevent another world war."[115] This underlying system was built to ensure the major facets of U.S. power worked together to deliver national security objectives, tying economic and financial tools to other diplomatic and military considerations and concerns. The ties that bound these facets of power together slowly began to erode under the Reagan administration's deregulation campaign in support of what would later be termed the Washington Consensus and progressed after the fall of the Soviet Union.[116] The National Economic Council was established as a separate and distinct cabinet level coordinating body from the National Security Council under the Clinton administration in 1993.[117] The Financial Stability Oversight Council (FSOC) was formed in 2010 under the Department of Treasury with the mandate to identify "risks to the financial stability of the United States, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system."[118] These changes to the oversight of the finance industry slowly drove participants away from policies that were designed to secure national security and shifted emphasis toward a

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[115] "Bretton Woods 2.0 Project," Atlantic Council (blog), accessed May 6, 2024, https://www.atlanticcouncil.org/programs/geoeconomics-center/bretton-woods-2-0-project/.
[116] John Williamson, "A Short History of the Washington Consensus," in *The Washington Consensus Reconsidered: Towards a New Global Governance*. ed Narcis Serra and Joseph Stiglitz. (Oxford University Press, Oxford, 2008).
[117] "National Economic Council," The White House, Accessed May 1, 2024, https://www.whitehouse.gov/nec/.
[118] "Financial Stability Oversight Council," U.S. Department of the Treasury, Accessed May 1, 2024, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc.

disaggregation of financial risks from geopolitical and security based risks. As the economic lever of U.S. power has grown, so too has the distance between military and economic considerations and concerns. Stakeholders at the nexus of U.S. capital markets, economic statecraft initiatives, and national security now operate without a full appreciation of how their recommendations and concerns are intertwined.

The interconnected nature of modern international relations and the significant role of the U.S. finance industry in national security concerns have highlighted the need to counter the erosion in the DoD's capability and capacity to incorporate geoeconomic considerations into its strategy. The military retains significant human capital and organizational structures to incorporate diplomatic and informational tools, but similar capabilities do not exist in the realm of economics and finance. This divergence and inability to align two globally influential elements of national power will at best undermine the efficacy of U.S. foreign policy and at worst will remove one or both tools from their global leading role. The financial ecosystem bleeds into the national security realm and better alignment is required between the two.[119] The DoD must find ways to not only use, but also help support the U.S.' dominant position in global finance as a tool for geopolitical influence, emphasizing the need for innovative approaches beyond stovepiped spheres of authority and centers of excellence.

Several institutions have argued for a reinvigorated Bretton Woods system, seeking to reform the global financial architecture to the realities of modern-day geopolitical considerations.[120] To step into a leading role in this much-needed effort, the United States needs

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[119] Courtney Degen, "House report says U.S. venture capital firms funded Chinese military interests," *Pension and Investments (Blog)*, February 9, 2024, https://www.pionline.com/venture-capital/house-report-says-us-venture-capital-firms-funded-chinese-military-interests.

[120] See for example, Otaviano Canuto, Hafez Ghanem, Youssef El Jai, and Stéphane Le Bouder, "The Reform Of The Global Financial Architecture: Toward a System that Delivers for the South," Atlantic Council, April 2024, https://www.atlanticcouncil.org/wp-content/uploads/2024/04/The-reform-of-the-global-financial-architecture-

to reinvigorate an interagency capacity to address interdisciplinary concerns like those listed in this paper. Financial oversight bodies should include members from across the government with the capability to inject and discuss these and other relevant geopolitical issues. The United States should take a more holistic view on the impact of its statecraft initiatives, with an emphasis on reestablishing itself as the global leader in setting the rules and standards necessary to facilitate economic vitality without undermining its own national security objectives. The following list of policy recommendations serve as examples of how the United States can once again leverage attributes of the financial industry to address the myriad of global challenges it faces.

Policy Recommendation 1 – Reinvigorate Global Financial Architecture to Address PRC Efforts

The PRC is a powerful country and a direct military conflict between the United States and the PRC will lead to catastrophe.[121] That said, the PRC has both the desire and means to alter the current international rules-based order, so the United States must find ways to manage and mitigate its global economic entanglement. The United States can take advantage of Chairman Xi Jinping's rhetoric regarding a cooperative economic model by calling on the PRC to specifically articulate its interpretation of "global cooperation," openly highlighting the extent to which it does or does not commit to transparency in its business transactions, agreements, and loans with other nations.[122] President Reagan's timeless mantra, "trust, but

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Toward-a-system-that-delivers-for-the-South.pdf and Wafa Abedin, Brahima S. Coulibaly, Hafez Ghanem, Eswar Prasad, and Marilou Uy, "Reforms for a 21st Century Global Financial Architecture," Global Economy and Development at Brookings, April 2024, https://www.brookings.edu/wp-content/uploads/2024/03/Reforms-for-a-21st-century-global-financial-architecture.pdf.

[121] Max Leshne, "China's Stunning Economic Turn," Michigan Journal of Economics, January 2, 2023, https://sites.lsa.umich.edu/mje/2023/01/02/chinas-stunning-economic-turn/

[122] "(BRF2023) Full Text of Xi Jinping's Keynote Speech at 3rd Belt and Road Forum for Int'l Cooperation-Xinhua."

verify," underscores the need for trust, openness, and honesty for partnership to succeed.[123]

To address the economic, political, and security challenges posed by the PRC's BRI, the United States, along with its allies and partners, must develop a well-defined strategy that recognizes the BRI as a long-term reality that provides economic benefits to millions of people around the globe. The strategy should involve adopting more innovative diplomatic, cognitive, economic, and military efforts to subtly influence the PRC's policies and international actions. A key element of this strategy is to enmesh BRI investments into the existing global financial architecture, ensuring the United States and its allies, through Bretton Woods style oversight, play a significant role in guiding the BRI's direction.[124]

Additionally, by deploying financial industry experts like bankers, lawyers, and auditors to developing countries engaged in the BRI, the United States can assist these nations in negotiating more favorable loan terms and agreements. This approach not only strengthens the financial and legal acumen of these countries but also enhances their bargaining power, ensuring that future BRI transactions are more equitable and sustainable for the recipient. Efforts to address the inconsistencies and deleterious effects of harmful investment practices do exist, but their impacts are still uncertain.[125] A broader incorporation of finance industry experts into these

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[123] Bob Whipple, "Trust but Verify," *Leadergrow* (blog), accessed May 6, 2024, https://leadergrow.com/articles/trust-but-verify/.

[124] There are examples of limited interaction between Western dominated institutions and newer PRC-led organizations, but more effort is required. It is also noted that previously the United States eschewed opportunities to join PRC-backed institutions and thus has been unable to shape their policies from within the organization. See https://www.dfc.gov/media/press-releases/building-transatlantic-partnership-dfc-and-eib-sign-agreement-collaborate and https://www.aiib.org/en/news-events/news/2024/AIIB-World-Bank-Strengthen-Cooperation-on-Infrastructure-Development-and-Sustainable-Development-Goals.html.

[125] The Blue Dot Network is a global certification framework for quality infrastructure investment, https://www.state.gov/blue-dot-network/. The Three Seas Initiative is a geopolitical joint project between twelve European countries that aims to strengthen trade, energy, infrastructure, and political cooperation, https://3seas.eu/. The Clean Network Initiative aims to create a communication network free from untrusted vendors, https://2017-2021.state.gov/the-clean-network/. Finally, the G20 Common Framework seeks to address fundamental debt sustainability concerns in low-income countries through rescheduling and debt relief, https://www.hks.harvard.edu/centers/mrcbg/programs/growthpolicy/modified-common-framework-restructuring-sovereign-debt.

efforts would improve the efficacy of these initiatives and more closely tie the industry to national security objectives. Simultaneously, this allows the U.S. to indirectly influence the BRI's expansion and ensure that it aligns with broader global economic standards and practices, all while fostering stronger ties with these nations. This initiative, built on a foundation of cooperation, could also make significant strides in addressing global challenges like climate change and transnational criminal activity.

Policy Recommendation 2 – Lead the Shift to and Regulation of Digital Currencies

In a discussion held at the Eisenhower School in early 2024, a prominent financial consulting firm discussed how Chainalysis, a crypto analysis tool, can be used to trace crypto flows and spot illicit activity.[126] Figure 8 depicts an example of the user interface deployed by Chainalysis to monitor and investigate transactions, visually displaying a digital wallet's connections with potential bad actors and tracking the flow of money.[127]

[126] Chainalysis Lecture, National Defense University, Finance Industry Study, Academic Year 2023-2024.
[127] "The Blockchain Data Platform," Chainalysis, accessed May 6, 2024, https://www.chainalysis.com/.

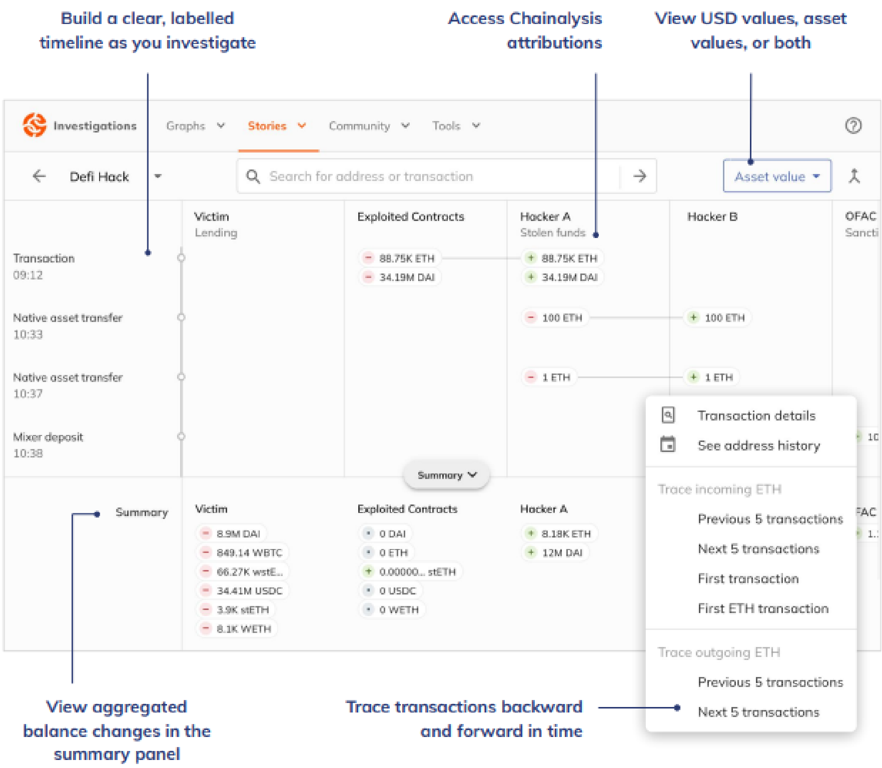

Figure 8: Source: Chainalysis tools tracking a sample Ethereum transaction

The DoD, Intelligence community, and law enforcement should deploy similar tools to track illicit finance, gather intelligence, and address threats to national security. These public-private partnerships are fertile ground for innovation, sharing expertise, and growing the defense industrial base ecosystem designed to address modern challenges.

The United States has historically led efforts to establish and update global financial regulations, and doing so is in the U.S.' national security interest. This type of positive statecraft led to the development of the Bretton Woods system and has served national security interests well in the intervening years. As the financial sector evolves and new opportunities and challenges arise, U.S. entities that include both finance and national security experts should serve as key conveners who proactively influence oversight and regulatory initiatives in international coordination bodies. A key topic that would benefit from U.S. leadership in shaping norms and standards is the global regulation of digital assets. Cryptocurrency allows individuals and entities to create self-hosted wallets with limited, and in many cases zero, intervention by a regulated entity. This gap allows malign actors the opportunity "to preserve their pseudonymity by avoiding know your customer [requirements] and other controls," and thus "cryptocurrency has become a channel for…terrorist financing and sanctions evasion."[128] Experts agree the cryptocurrency market's oversight requires an "effective regulatory and supervisory framework" that features "consistency and comprehensiveness of regulatory, supervisory and oversight approaches to crypto-asset activities and markets, and strengthen[ed] international cooperation, coordination and information sharing."[129] There are rules in place and under consideration within the United States, and both FATF and FinCEN have issued guidance for how the finance industry should address the threat from virtual assets.[130] Further, the ever-evolving sector requires "strong anti-money laundering…rules…to cover all entities and activities related to the issuance, trading, custody, or transfer of crypto."[131] The United States must expand the existing digital oversight regime and would benefit from asserting leadership on the global stage, lest its adversaries define the rules and norms related to cryptocurrency to suit their own interests. As such, the United States must proactively employ positive statecraft backed by its globally

[128] Alma Angatti, Justin Eddy, and William Jannace, "Financial Crimes: AML, Sanctions and Other Emerging Threats," (Class lecture, Eisenhower School for National Security and Resource Strategy, National Defense University, Washington, DC, February 23, 2024).

[129] "Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets: Consultative Report," October 11, 2022, https://www.fsb.org/2022/10/regulation-supervision-and-oversight-of-crypto-asset-activities-and-markets-consultative-report/.

[130] "Financial Action Task Force issues updated guidance for virtual assets," *Davis Polk (Blog)*, November 1, 2021, https://www.davispolk.com/insights/client-update/financial-action-task-force-issues-updated-guidance-virtual-assets and "Advisory on Illicit Activity Involving Convertible Virtual Currency," *FinCEN Advisory*, May 9, 2019, https://www.fincen.gov/sites/default/files/advisory/2019-05-10/FinCEN%20Advisory%20CVC%20FINAL%20508.pdf.

[131] Tobias Adrian et al, "Crypto Needs Comprehensive Policies to Protect Economies and Investors," IMF, July 18, 2023, https://www.imf.org/en/Blogs/Articles/2023/07/18/crypto-needs-comprehensive-policies-to-protect-economies-and-investors.

dominant role to call on allies and like-minded countries to prioritize thoughtful global regulation of the digital currency ecosystem.

Policy Recommendation 3 – Strengthen International and Domestic Efforts to Address Transnational Threats

Founded in 1989 by the G7 to combat money laundering and terrorist financing, the FATF "researches how money is laundered and terrorism is funded, promotes global standards to mitigate the risks, and assesses whether countries are taking effective action."[132] As a global watchdog, FATF's recommendations help member nations garner the political will to take action to address money laundering and other illicit activity.[133] Unfortunately, FATF's 40 members only fund its modest secretariat "on a temporary basis."[134] To ensure FATF's ability to continue to provide recommendations and maintain its grey- and black-lists that highlight jurisdictions with elevated risks of illicit activity, the United States and other members should make sustained and predictable financial commitments to FATF and seek to expand the number of participating countries. This investment in a key international finance oversight regime will enable it to hire more staff and increase its volume of research, recommendations, and advocacy; ultimately positioning the United States at the forefront of efforts to address this challenge.

Next, the CTA was enacted to counter manipulation of U.S. capital markets by entities that would disguise the true nature of their activities. The recent ruling by a U.S. District Court that found aspects of the law unconstitutional highlighted how Congress could amend the law to ensure constitutionality. As the DoD seeks to ensure U.S. capital is not used for adversarial

[132] "What We Do," FATF, accessed May 6, 2024, https://www.fatf-gafi.org/en/the-fatf/what-we-do.html.
[133] Alma Angotti, Justin Eddy, and William Jannace, "Financial Crimes: AML, Sanctions and Other Emerging Threats."
[134] "Frequently Asked Questions," FATF, accessed May 6, 2024, https://www.fatf-gafi.org/en/pages/frequently-asked-questions.html.

purposes, it is imperative that legislation, regulation, and policies regarding the disclosure of beneficial ownership are fully implemented. Failing to account for the ultimate beneficiary of investments is a national security threat and Congress and regulating bodies must work with financial institutions to provide a full accounting of this threat. Congress should amend the CTA and DoD should use the approved Federal authorities to take a proactive approach with regulating bodies to vet the resulting disclosed list for adversarial actors and intent.[135]

Consideration should also be given to passing legislation like the Establishing New Authorities for Businesses Laundering and Enabling Risks to Security (ENABLERS) Act.[136] In 2003, FATF determined certain non-bank businesses and professions should be subject to the same anti-money laundering rules as banks.[137] In 2021 U.S. lawmakers proposed the ENABLERS Act, which would "require trust companies, lawyers, art dealers and others to investigate clients as well as the source of money and other assets that are moved into the American financial system."[138] This legislation would help "plug holes" in current oversight and help "detect, flag, and prevent the laundering of corrupt and other criminal funds."[139] Despite vocal support from the current Administration and bipartisan support within Congress, the legislation has stalled, in part due to the organized opposition of impacted bodies such as the American Bar Association and entities in the states of Wyoming, South Dakota, and

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135 "Under the Corporate Transparency Act, who can access beneficial ownership information?" FinCEN, January 4, 2024, https://www.fincen.gov/boi-faqs#A_3.

136 Richard M. Cutshall, Kyle R. Freeny, Marina Olman-Pal, and Janiell Gonzalez, "ENABLERS Act Proposes to Expand Definition of 'Financial Institution'; Impose BSA/AML Requirements on Professional Service Providers," *The National Law Review*, October 14, 2022, https://natlawreview.com/article/enablers-act-proposes-to-expand-definition-financial-institution-impose-bsaaml.

137 "FATF Recommendations," FATF, October 2004, https://www.fatf-gafi.org/content/dam/fatf-gafi/recommendations/FATF%20Standards%20-%2040%20Recommendations%20rc.pdf

138 Will Fitzgibbon, "US Senate Blocks Major Anti-Money Laundering Bill, the Enablers Act," ICIJ, December 12, 2022, https://www.icij.org/investigations/pandora-papers/us-senate-blocks-major-anti-money-laundering-bill-the-enablers-act/

139 "Stop American Complicity in Russian & Other Foreign Corruption: Pass the ENABLERS Act," Transparency International U.S," July 2022, https://us.transparency.org/app/uploads/2022/07/ENABLERS-Act-4.13.22.pdf.

Delaware that seek to maintain jurisdictional autonomy.[140]

Additionally, in February 2024, FinCEN issued a Notice of Proposed Rule Making that would require "certain professionals involved in real estate closings and settlements" considered to be high-risk for money laundering "to report information…about non-financed transfers of residential real estate to legal entities or trusts."[141] FinCEN asserts that this proposed rule would "effectively end anonymous luxury-home purchases, closing a loophole that…allows corrupt oligarchs, terrorists and other criminals to hide ill-gotten gains."[142] The proposed rule would effectively unmask shell companies used to launder money and extend the current system of geographically targeted orders nationwide. Advancing this rule will reduce the misuse of the U.S. financial markets by malign actors but it faces headwinds due to criticism about potential unintended impacts to U.S. citizens.[143]

Policy Recommendation 4 - Align DoD with the Finance Industry

The Treasury Department's FSOC should operate with military input on a standing basis; the DoD must build its own cadre of experts who understand the intricacies of economic policies and are empowered to work with other departments and agencies. To achieve this, the DoD should establish a specialized group of military professionals who are well-versed in economic strategies and can actively collaborate with other governmental departments and agencies. This can be facilitated by creating specific Military Occupational Specialties focused on financial

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[140] "ABA Urges Senators to Oppose ENABLERS Act Amendment to Defense Authorization Bill," October 31, 2022, https://www.americanbar.org/advocacy/governmental_legislative_work/publications/washingtonletter/oct22-wl/enablers-1022wl/.

[141] Andri Gacki, "Anti-Money Laundering Regulations for Residential Real Estate Transfers," Federal Register, February 16, 2024, https://www.govinfo.gov/content/pkg/FR-2024-02-16/pdf/2024-02565.pdf.

[142] Luc Cohen and Chris Prentice, "US Set to Unveil Long-Awaited Crackdown on Real Estate Money Laundering," *Reuters*, August 10, 2023, sec. U.S., https://www.reuters.com/world/us/us-set-unveil-long-awaited-crackdown-real-estate-money-laundering-2023-08-10/.

[143] Amy Qin and Patricia Mazzei, "When Buying a Home is Treated as a National Security Threat," *New York Times (Online),* May 6, 2024, accessed May 24, 2024, https://www.nytimes.com/2024/05/06/us/florida-land-law-chinese-homes.html?smid=url-share.

objectives or by providing specialized training for military officers. These officers could then be assigned to broadening tours focusing on financial statecraft. Moreover, establishing a military-economic competency within the Joint Staff would allow the military to actively engage in intentional financial statecraft, helping to shape and direct U.S. financial tactics in alignment with broader strategic objectives. This unit would coordinate with other federal agencies to ensure that DoD and U.S. government financial policies are mutually supportive and symbiotic. Integrating these capabilities will allow the U.S. to leverage its financial strength as a critical instrument of national power, ultimately enabling a more cohesive approach to fighting and winning wars.

The evolving global landscape necessitates that the DoD adopt new mechanisms to incorporate and support innovative financial strategies in pursuit of geopolitical and national security objectives. This paper proposes that DoD should build inter-agency connectivity, through human capital and organizational structure, which enhance DoD’s participation in the formulation of strategy that aligns the military and finance IoPs. In doing so, the United States can once again ensure that all major IoPs work together to deliver national security objectives. By understanding and incorporating various viewpoints the United States can firmly re-establish its leading role in an updated and reinvigorated international order.

Appendix 1
Major Entities in the U.S. Finance Industry Regulation and Oversight Ecosystem

****NOTE: The only organization in which the DoD regularly participates is CFIUS****

Committee on Foreign Investment in the U.S.
Role / Purpose: Reviews certain transactions involving foreign investment in the U.S. and certain real estate transactions by foreign persons to determine the effect of such transactions on the national security of the U.S.
Host / Composition: An interagency committee chaired by the U.S. Department of the Treasury, with participation from the Departments of Commerce, Defense, Energy and Homeland Security; and the Offices of the U.S. Trade Representative and Science & Technology Policy. The following entities observe or participate as appropriate: Office of Management & Budget, Council of Economic Advisors, National Security Council, National Economic Council, Homeland Security Council

Federal Deposit Insurance Corporation
Role / Purpose: Insures deposits; examines and supervises financial institutions for safety, soundness, and consumer protection; makes large and complex financial institutions resolvable; and manages receiverships to maintain stability and public confidence in the U.S. financial system.
Host / Composition: Independent federal agency

Federal Reserve System
Role / Purpose: Promotes the effective operation of the U.S. economy by conducting the nation's monetary policy, promoting the stability of the financial system and minimizing systemic risks through monitoring and engagement in the U.S. and abroad, promoting the safety and soundness of individual financial institutions and monitoring their impact on the financial system, fostering payment and settlement system safety and efficiency, and promoting consumer protection through supervision, examination, research, and analysis of emerging issues and trends.
Host / Composition: Central Bank of the U.S.

Financial Action Task Force
Role / Purpose: Leads global action to tackle money laundering, terrorist, and proliferation financing. It researches how money is laundered and terrorism is funded, promotes global standards to mitigate the risks, and assesses whether countries are taking effective action. It sets international standards to prevent these illegal activities, and releases "black and grey lists" of countries with significant deficiencies in combatting money laundering.
Host / Composition: International membership currently comprised of two regional organizations, 37 full member countries (including the U.S.), and 150 additional networked countries.

Financial Crimes Enforcement Network
Role / Purpose: Safeguards the financial system from illicit use, combats money laundering and its related crimes including terrorism, and promotes national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence. It is the U.S.' financial intelligence unit and receives, analyzes, and disseminates sensitive financial information pertaining to potential illicit financial activity.
Host / Composition: U.S. Department of the Treasury

Financial Industry Regulatory Authority
Role / Purpose: Regulates and provides licenses for broker-dealers, capital acquisition brokers, and funding portals to protect investors and safeguard market integrity in a manner that facilitates vibrant capital markets.
Host / Composition: Private U.S. corporation that acts as a self-regulatory organization

Office of Foreign Asset Control
Role / Purpose: Administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals 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 U.S.
Host / Composition: U.S. Department of the Treasury

Office of the Comptroller of the Currency
Role / Purpose: Charters, regulates, and supervises all national banks, federal savings associations, and federal branches and agencies of foreign banks to ensure banks operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.
Host / Composition: U.S. Department of the Treasury

U.S. Securities and Exchange Commission
Role / Purpose: Enforces laws against market manipulation to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.
Host / Composition: Independent federal agency

United Nations Office on Drugs and Crime
Role / Purpose: Encourages states to develop policies to counter money laundering and the financing of terrorism, monitors and analyzes related problems and responses, and coordinates initiatives carried out jointly by other international organizations.
Host / Composition: The United Nations

Wolfsberg Group
Role / Purpose: Aims to develop frameworks and guidance for the management of financial crime risk with a focus on anti-money laundering and combatting the financing of terrorist in the banking sector.
Host / Composition: An association of 12 global banks