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Countering North Korean Procurement Networks Through Financial Measures: The Role of Southeast Asia

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**COUNTERING NORTH KOREAN PROCUREMENT
NETWORKS THROUGH FINANCIAL MEASURES:
THE ROLE OF SOUTHEAST ASIA**

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AUTHORS' NOTE

This Occasional Paper contains a set of four studies intended to inform the work of governments and financial institutions in Southeast Asia in combatting attempts by states of concern to use banks and corporate entities in the region to facilitate the financing of their weapons of mass destruction and related missile programs.

The four studies are:

- » Countering North Korean Procurement Networks through Financial Measures: The Role of Southeast Asia
- » Needed Next Steps to Strengthen Measures to Counter Proliferation Finance
- » The Chinpo Shipping Case: A Singaporean Financial Agent of North Korea
- » Due Diligence and the Panama Papers Episode: Lessons for Proliferation Finance

The studies read together provide an extensive grounding in this subject. For training purposes, however, training faculty may wish to use only individual studies. To facilitate this option, certain material is repeated in each study, such as the fully spelled-out versions of certain abbreviations the first time they are used, brief descriptions of organizations and legal instruments, and, occasionally, explanations of certain complex points.

We hope readers will excuse these incidental deviations from standard editing practice.

The studies formatted as individual documents and a set of additional PowerPoint training materials may be found at <http://www.nonproliferation.org/op35-countering-north-korean-procurement-networks-through-financial-measures-the-role-of-southeast-asia>

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EXECUTIVE SUMMARY

COUNTERING NORTH KOREAN PROCUREMENT NETWORKS THROUGH FINANCIAL MEASURES: THE ROLE OF SOUTHEAST ASIA

This Occasional Paper is made up of four studies intended to aid Southeast Asian governments and financial institutions in their efforts to counter the financing of weapon of mass destruction programs in North Korea and other states of concern.

“Countering North Korean Procurement Networks through Financial Measures: The Role of Southeast Asia,” highlights how North Korea has exploited weak financial controls in the region to advance its nuclear and missile programs. The study reviews Security Council and Financial Action Task Force actions to combat such abuse of the international banking system, as well as the role of US sanctions. Effective implementation of these measures in Southeast Asia, the study concludes, could contribute significantly to constraining North Korea and other proliferant states.

“Needed Next Steps to Strengthen Measures to Counter Proliferation Finance,” identifies gaps in international measures to combat proliferation finance, and calls on the Security Council and the Financial Action Task Force to clarify standards for national-level implementation of counter-proliferation-finance rules and to adopt improved enforcement mechanisms. The analysis urges Southeast Asian governments and financial institutions to implement existing measures with greater vigor.

“Chinpo Shipping: A Singaporean Financial Agent of North Korea” details how North Korea created an off-shore de facto bank to finance its illegal activities and how Singapore’s courts addressed the first known prosecution for financing proliferation. The case underscores that greater due diligence by banks and regulatory authorities is urgently needed.

Finally, “Due Diligence and the Panama Papers Episode: Lessons for Proliferation Finance,” shows how a North Korean bank, denied access to the international banking system, set up an off-shore entity to transact its business. The analysis calls for greatly strengthened enforcement efforts by off-shore tax havens, closer scrutiny of clients by banks and law firms conducting international business, and greater efforts by Southeast Asian governments to block sanctions-violating front companies from accessing their banking systems.

COUNTERING NORTH KOREAN PROCUREMENT NETWORKS THROUGH FINANCIAL MEASURES: THE ROLE OF SOUTHEAST ASIA

1. BACKGROUND AND INTRODUCTION

Counter-proliferation tools and policies that seek to cut off illicit procurement networks have become an increasingly important component of efforts to curtail the spread of weapons of mass destruction (WMD).¹ Today, efforts to cut off illicit procurement networks include not only intelligence and law enforcement actions, but also exploitation of financial measures. Unlike strategic trade controls that impede the physical transfer of WMD-related goods, financial measures try to interfere with these transfers by targeting the financial transactions associated with them. Among other benefits, this makes financial measures particularly useful in detecting advanced networks of illicit trade.

Southeast Asian countries are geographically proximal to the Democratic People's Republic of Korea ("DPRK" or "North Korea") and lack advanced export and financial controls systems. As a result, they are often vulnerable to North Korean abuse as that country seeks strategic goods essential for its prohibited nuclear and missile programs. In recent years, for example, Ocean Maritime Management (OMM), a North Korean shipping company operating under the control of the Korean Ministry of Land and Marine Transport, has taken advantage of Southeast Asia's weak export and financial control systems to circumvent sanctions aimed at curtailing Pyongyang's nuclear and missile activities.

In its 2014 report, the UN Panel of Experts monitoring the implementation of sanctions against North Korea exposed a number of evasion methods employed by OMM that involved Cambodia, Singapore, Malaysia, and Thailand.² The panel noted that North Korea had re-named and re-registered a significant number of vessels to evade sanctions, and OMM operated most of those vessels under foreign flags. By re-registering under foreign flags, such as Cambodia's, the vessels could readily access ports and routes closed to DPRK-flagged ships.³ This approach enabled DPRK vessels to avoid identification as high-risk vessels and allowed OMM to evade detection of financial transactions involving the ships.⁴

1 John Simpson, "The Future of the NPT," in Nathan E. Bush and Daniel H. Joyner, eds., *Combating Weapons of Mass Destruction: The Future of International Nonproliferation Policy* (University of Georgia Press, 2009).

2 UN Security Council Resolution 1718, Sanctions Committee (DPRK), Panel of Experts Report for 2015, February 24, 2016, S/2016/157, April 18, 2016. <http://www.un.org/ga/search/view_doc.asp?symbol=S/2016/157>.

3 With the adoption of UN Security Council Resolution (UNSCR) 2270 in March 2016, UN Member States are prohibited from registering and reflagging North Korean ships, and Cambodia has taken significant steps to comply with this mandate. Ven Rathavong, "Flags of Convenience Halted," *Khmer Times*, August 19, 2016, <<http://www.khmertimeskh.com/news/28703/flags-of-convenience-halted/>>.

4 UN Security Council, UNSCR 1718 Sanctions Committee (DPRK), Panel of Experts Report for 2014, February 23, 2015, <http://www.un.org/ga/search/view_doc.asp?symbol=S/2015/131>.

In addition to reregistering and renaming DPRK-related vessels to circumvent sanctions, OMM used financial intermediaries to conduct its financial dealings in different jurisdictions from those where it conducted its operations. OMM extensively used some Singaporean companies to conduct financial transactions associated with its operations both in Singapore and in other countries; the two primary companies were Senat Shipping and Trading Pte, Ltd and Chinpo Shipping Company (Private) Ltd.

Similarly, the Panel of Experts provided evidence that Thailand-based Mariners Shipping and Trading Co Ltd conducted financial transactions for OMM. These transactions included dollar transactions through US correspondent banks that omitted the vessel names associated with OMM to disguise their links to the North Korean entity.⁵ OMM also used a Malaysia-based North Korean citizen, Pak In Su, as an intermediary to make payments through Malaysian financial institutions. (The third study in this Occasional Paper, “The Chinpo Shipping Case,” explores OMM’s exploitation of weaknesses in Southeast Asian countries’ control measures.)

Given this background, if international efforts to use financial tools to curb North Korean proliferation are to be effective, Southeast Asian states will clearly have an important role to play. Some Southeast Asian states have already begun to adopt financial measures to combat clandestine procurement networks by disrupting their financing channels. However, Southeast Asian counter-proliferation policymakers appear to lack a thorough understanding of the significance of financial measures in halting proliferation and have failed to introduce comprehensive financial control measures into their national regulatory systems. Additionally, regional financial institutions often fail to execute similar measures in their day-to-day operations.

This study thus aims to increase awareness of the key role financial measures play in preventing illicit trafficking activities related to WMD proliferation among Southeast Asian policymakers and banks. This study will underline the investigative and preventive aspects of financial measures in countering proliferation activities, detailing the roles of three important external actors—the UN Security Council, the Financial Action Task Force (FATF), and the United States—that have established a range of counter-proliferation finance requirements that should be implemented by regional parties.⁶

5 UN Security Council, UNSCR 1718 Committee (DPRK), Panel of Experts Report for 2014.

6 The FATF is an independent inter-governmental body that develops and promotes policies to protect the global financial system from money laundering, terrorism finance, and WMD proliferation finance. The organization has 35 member states and is based in Paris. It has established a number of “FATF-Style Regional Bodies,” with membership comprised of states in the bodies’ respective regions. <http://www.fatf-gafi.org/>.

2. THE ROLE OF FINANCIAL MEASURES IN COUNTERING PROLIFERATION ACTIVITIES

Financial controls have become especially important as a tool for limiting acquisition of WMD-related materials, technology, and services on the open market because they principally target payments for those goods and services. Because illicit networks obtain proliferation-sensitive goods mostly from legitimate suppliers and manufacturers, proliferation networks cannot pay for these goods via informal financial institutions, such as hawala, or with cash, without raising suspicion. Consequently, organized proliferation networks utilize the international banking system for payment of their transactions.⁷ Since financial transactions leave behind footprints, an efficient financial control system is a critical complement to export controls, providing a tool to discover the details of illicit acquisition activities that include the methods used by criminals to disguise their efforts.

Effectively targeting financial flows of proliferation networks has investigative, analytical, deterrent, and preventive value in the fight against proliferation. Tracking financial transactions and associated documents pertaining to the trade of WMD-sensitive items assists investigators and prosecutors in their inquiries. With enough information, investigators and export control authorities can more easily unravel these formal networks in comparison to those that use informal systems. Financial information gathered by legal and formal financial institutions include all of the transactional data associated with a purchase, so investigators can effectively trace the ultimate end-users and end-uses of the procured goods, uncovering broader proliferation networks that include main actors, facilitators, and supporters, as well as their assets.⁸ Obtaining information and records from financial institutions regarding their customers and transactions thus enables authorities to more easily understand networks' operational structures. Financial measures, such as risk management and customer due diligence (CDD) practices, can also assist financial institutions in detecting illegal procurement activities, and if transactions raise concerns, these institutions may file Suspicious Activity Reports (SARs) with their national Financial Intelligence Units (FIUs).

As a result of the presence of robust financial controls, potential participants in illegal procurement networks may be deterred from engaging in these activities from fear of being discovered.⁹ Once detected, individuals and companies engaged in illegal procurement can be exposed to significant penalties, including asset freezes, heavy fines, confiscation of illicitly obtained profits, and imprisonment. Participants in proliferation networks are often driven by profit, so finance-based law enforcement activities can not only disrupt specific transactions and shut down components of procurement networks, but also provide a further deterrent to engaging in such activities in the first place.¹⁰

7 Leonard S. Spector and Egle Murauskaite, *Countering Nuclear Commodity Smuggling: A System of Systems*, (CNS Occasional Paper No. 20, 2014), <http://www.nonproliferation.org/wpcontent/uploads/2014/10/cns_occasional_paper_no_20_web.pdf>.

8 Anne Kramer Larson, US Department of the Treasury Office of Terrorist Financing & Financial Crimes, “Financial Tools to Identify & Disrupt WMD Proliferation,” <<http://www.state.gov/strategictrade/documents/organization/190346.pdf>>.

9 Nikos Passas, “Financial Controls and Counter-Proliferation of Weapons of Mass Destruction,” *Case Western Reserve Journal of International Law*, Vol. 44 (2012), <<http://scholarlycommons.law.case.edu/jil/vol44/iss3/29>>.

10 Anne Kramer Larson, “Financial Tools to Identify & Disrupt WMD Proliferation.”

In order to address the issue of proliferation finance, the Security Council, the FATF, and the United States have taken a series of substantial actions that create the international legal framework for addressing this challenge. The following sections discuss these actions so that they may be implemented by other actors seeking to protect themselves from North Korean abuse.

3. INTERNATIONAL LEGAL FRAMEWORK: UN SECURITY COUNCIL RESOLUTION 1540 ESTABLISHING REQUIREMENTS FOR ALL STATES

To counter proliferation finance, the UN Security Council has adopted a two-tiered approach: Resolution 1540, adopted in 2004, combats proliferation finance globally, and sanctions resolutions imposed against countries of particular proliferation concern, namely North Korea and Iran, adopted beginning in 2006, provide a focused, state-specific approach.¹¹ These sanctions will be discussed in greater detail in Section 4. The UN Security Council's global approach intends to prevent the acquisition of WMD by any non-state or state-level actor, whereas the more narrowly focused sanctions approach aims at disrupting the WMD programs of two specific countries.

Resolution 1540 requires UN Member States to establish and implement effective controls over WMD and missile-related goods and materials (a term that includes dual-use goods) to prevent non-state actors and states from gaining access to chemical, biological, and nuclear weapons, as well as their means of delivery. With regard to financial measures, the original resolution requires states to adopt controls to prevent attempts to “finance” proliferation-relevant activities by non-state actors, but it left the term “finance” poorly defined. A more precise provision of the resolution requires states to adopt “controls on providing funds and services” for the export or transshipment of goods that could contribute to the development of WMD and related missile capabilities. Over time, however, these mandates were interpreted broadly to require states to adopt measures to control proliferation finance more generally. Resolution 2325, adopted on December 15, 2016, reflects this view, which reinforces Security Council Resolution (UNSCR) 1540 (2004) and singles out proliferation finance as an issue to which Member States must devote greater attention.¹²

The Security Council 1540 Committee, established pursuant to Resolution 1540, is tasked with monitoring the status of Member State implementation of the resolution and reporting its findings to the UN Security Council. When monitoring Member State implementation, the committee requests reports from all countries that indicate the steps each country has taken or intends to take to implement the resolution's obligations. Based on these national reports, the committee publishes its own report on progress made on its website, but withholds the details of each country's information.

11 Most Security Council sanctions against Iran were lifted as part of its 2015 agreement with China, France, Germany, Russia, the United Kingdom, and the United States, known as the Joint Comprehensive Plan of Action (JCPOA). UN sanctions aimed at North Korea remain in effect and were intensified twice in 2016 and twice again in 2017.

12 UN Security Council Resolution 2325, SC/12628, December 15, 2016, OP 12, <<https://www.un.org/press/en/2016/sc12628.doc.htm>>.

The committee also prepares publicly available country matrices, which comprise the primary method for organizing information about Resolution 1540’s implementation by Member States.¹³ The matrices indicate the status of each state’s implementation of the more than two hundred individual requirements of Resolution 1540. The committee primarily obtains information for the matrices from country reports, intergovernmental organizations’ reports, and other official documents published by Member States, such as their national gazettes. Although the committee notes that “the matrices are not a tool for measuring compliance of States in their non-proliferation obligations but for facilitating the implementation of Resolution 1540 and its successor resolutions,” the country matrices provide insights into the implementation status of Member States with regard to the resolution’s requirements, including those for combatting proliferation finance.

Despite Resolution 1540’s obligations regarding the adoption and enforcement of measures to counter proliferation finance, many Southeast Asian states lack the capacity and resources necessary to effectively implement the resolution. Rather, these states allocate political energy and scarce resources towards other matters that they deem more urgent. Additionally, the ambiguous language of the Resolution, such as phrasing that calls upon states to adopt “appropriate” and “effective” financial measures without providing further detail, leaves many states uncertain of the resolution’s expectations. Without clarifying the meaning of appropriate and effective measures or the criteria for achieving its goals, Resolution 1540 leaves each Member State to implement financial control provisions depending on its national and regional circumstances.

Based on the country matrices, Figure 1 summarizes Southeast Asian countries’ declarations regarding their relevant laws. The middle column shows laws used to criminalize the financing of activities to “manufacture/produce, acquire, possess, stockpile/store, develop, transport, transfer, and use” WMD (as required under Operative Paragraph (OP) 2 of the resolution),¹⁵ and the right hand column shows laws that prohibit funding of WMD and missile-related exports and transshipments (as required by OP 3 of the resolution). As Figure 1 demonstrates, none of the countries in Southeast Asia has specific legislation to counter proliferation finance, such as placing controls to prevent funding of exports and transshipments of relevant commodities. Rather, most of them have integrated certain counter-proliferation finance measures into their existing anti-money laundering and countering the financing of terrorism (AML/CFT) legislation.

13 UN Security Council, 1540 Committee, 1540 Matrix, <<http://www.un.org/en/sc/1540/national-implementation/matrix.shtml>>.

FIGURE 1: SOUTHEAST ASIAN COUNTRIES STATUS

SOUTHEAST ASIAN COUNTRIES	OP 2 (FINANCING OF LISTED ACTIVITIES)	OP 3 (CONTROLS ON PROVIDING FUNDING OF EXPORTS)
Brunei (Brunei Darussalam)	Anti-Terrorism Law (Uncertain) ¹⁴	Internal Security Act (Uncertain)
Cambodia	AML/CFT Law (Uncertain)	—
East Timor (Timor Leste)	Penal Code, Funding of Terrorism, Constitution	Penal Code, Funding of Terrorism, AML/CFT Law
Indonesia	AML Law (Uncertain)	AML Law (Uncertain)
Laos (Lao People's Democratic Republic)	Penal Law (Uncertain)	Penal Law (Uncertain)
Malaysia	AML/CFT Law, Penal Code	AML/CFT Law, Penal Code
Myanmar	AML/CFT Law	AML/CFT Law
Philippines	CFT Law	CFT Law, nuclear weapons financing criminalized under other legislation
Singapore	CFT Law, Monetary Authority of Singapore Act	CFT Law, Monetary Authority of Singapore Act
Thailand	AML/CFT Law	AML/CFT Law
Vietnam	AML Law (Uncertain)	AML Law (Uncertain)

Although money laundering and terrorism finance bear many similarities to proliferation finance, including certain deceptive techniques used by criminals, the three offenses have fundamentally distinct features. Because money launderers aim to disguise the true nature of illegally obtained funds, banks' AML measures largely focus on the source of funds that customers ask the banks to transfer or process. However, actions to counter proliferation finance must not only address the source of funds and determine whether they are from a sanctioned party or potentially sanctioned party, but they

¹⁴ "Uncertain" refers to the questioning by the 1540 Committee of the pertinence of the measures referred to by the state under review or to the fact that the Committee has not been able to review the legislation in question. See <<http://www.un.org/en/sc/1540/national-implementation/matrix.shtml>>.

must also investigate the illegal use of funds that frequently appear to come from legitimate sources.¹⁵ Therefore, unless existing AML laws in Southeast Asian countries have specific provisions to address proliferation finance, their AML systems may not be adequate for blocking financial transactions prohibited on proliferation grounds.

Terrorism finance and proliferation finance share many similarities; for example, both often involve the use of legally obtained funds to commit a future violation of international rules. Unlike proliferation, terrorism is heavily financed through illegal means such as drug and human trafficking. However, donors may also finance terrorism through their legitimate businesses, or members of a terrorist organization may finance their activities through legal companies set up for financing purposes. Therefore, due to banks' frequent inability to obtain confidential data from their governments regarding customers and transactions that may be linked to terrorism, they have not been very successful in the identification of individuals and companies seeking to finance terrorism with legitimately obtained funds. In practice, banks' CFT applications rely primarily on the implementation of targeted financial sanctions, namely screening against lists of designated parties, and if a customer falls on a list, they may freeze that customer's assets and refuse to process its financial transactions.¹⁶ Although not explicitly required by the Resolution 1540, governments have also implemented targeted financial sanctions as part of their counter-proliferation finance control systems to freeze designated persons' assets and prevent their access to financial institutions under their government's jurisdiction.

Aside from checking proliferation-related lists, banks should also attempt to identify individuals, companies, and transactions related to WMD proliferation through other preventive measures, including risk management and CDD measures. Banks face significant challenges in the detection of proliferation-related transactions and persons because of the seemingly legitimate nature of their trade, a similar problem that arises when identifying terrorism-related parties and remittances. Therefore, to identify proliferation-related financial transactions, banks should look for traces of potential end-uses or end-users of seemingly legitimate trades involving dual-use or WMD-sensitive items. Banks should also attempt to identify potential proliferators, such as family members, who may be closely linked to designated parties or acting under their control.

Therefore, unless existing AML and CFT laws in Southeast Asian countries have specific provisions to address proliferation finance, the application of AML and CFT measures to counter proliferation finance will rarely yield a positive result. Some common measures, such as screening for designated

15 North Korea raises special issues because much of the state's revenue is derived from criminal activity, which would require the blocking of transactions linked to such activities on AML grounds. However, because of the pervasiveness of the North Korean government in the state's economy, any funds made available to the government could be diverted to support its nuclear or missile programs. Since Security Council Resolutions call upon UN Member States to avoid transactions that “could” support such programs, Member States must scrutinize virtually every transaction involving this country to ensure the DPRK government is not involved. Knowing this fact, the Security Council designated Government of the DPRK under Resolution 2270 (2016) – that is, listed the Government of the DPRK as a party to be sanctioned under the Resolution – and severely restricted banking relations with North Korea under that resolution and Resolution 2321 (2017).

16 Sonia Ben Ouagrham-Gormley, “Banking on Nonproliferation,” *Nonproliferation Review*, Vol. 19, No. 2(2012).

parties, may address this issue to some extent, but to effectively counter proliferation finance and protect their financial systems from being conduits for illegal purposes, Southeast Asian countries should adopt rules and regulations specifically targeting proliferation finance.

4. INTERNATIONAL LEGAL FRAMEWORK: UN SECURITY COUNCIL SANCTIONS RESOLUTIONS -- NORTH KOREA SANCTIONS AND OVERVIEW OF FINANCIAL PROVISIONS

Since 2006, the UN Security Council has passed a series of resolutions imposing sanctions on North Korea and Iran and on persons associated with their prohibited programs to target the two countries' WMD programs and related missile activities. However, on January 16, 2016, the Security Council lifted nuclear-related sanctions on Iran after the IAEA found that Iran had met the preconditions to begin implementation of the Joint Comprehensive Plan of Action (JCPOA).¹⁷ Nevertheless, because certain Security Council restrictions relating to Iran's missile activities remain in effect and because sanctions on its nuclear program could be re-imposed, Southeast Asian countries should continue to monitor transactions with Iran closely.

With respect to North Korea, the Security Council has continued to impose and strengthen sanctions, adopting Resolution 2270 in March 2016 following North Korea's fourth nuclear test and its launch of a satellite using ballistic missile technology; Resolution 2321 in November 2016 in response to Pyongyang's fifth nuclear test; Resolution 2371 in August 2017 in response to North Korea's continued testing of intercontinental-range missiles and finally Resolution 2375 in September 2017 as a response to North Korea's sixth nuclear test. The FATF's classification provides a lens for understanding the most important financial provisions of these resolutions. In its 2013 report, titled "Guidance on the Implementation of Financial Provisions of United Nations Security Council Resolutions to Counter the Proliferation of Weapons of Mass Destruction," *the FATF classified the UN financial measures focused on the WMD programs of North Korea and Iran into four categories: targeted financial sanctions, activity-based financial sanctions, vigilance measures, and other financial provisions.*¹⁸

17 US Department of Treasury, "Iran Sanctions," January 16, 2016, <<https://www.treasury.gov/resource-center/sanctions/Programs/pages/iran.aspx>>.

18 FATE, "Guidance on the Implementation of Financial Provisions of United Nations Security Council Resolutions to Counter the Proliferation of Weapons of Mass Destruction," June 2013, <<http://www.fatf-gafi.org/media/fatf/documents/recommendations/Guidance-UNSCRS-Prolif-WMD.pdf>>. Although it needs to be updated to reflect the latest sanctions provisions, the FATF's document is the only guidance providing detailed assistance for countries seeking to implement UN financial sanctions. See, Emil Dall, Andrea Berger, and Tom Keatinge, "Out of Sight, Out of Mind?" *Royal United Services Institute for Defence and Security Studies*, June 20, 2016, <<https://rusi.org/publication/whitehall-reports/out-sight-out-mind-review-efforts-counter-proliferation-finance>>.

4.1. TARGETED FINANCIAL SANCTIONS

Targeted financial sanctions refer to the freezing of assets—funds and other economic resources, which may include physical assets, such as vessels—of designated individuals or entities, denying these parties access to the international financial system. For sanctions on the DPRK, the Security Council established the UNSCR 1718 Committee to monitor the implementation of these sanctions; UNSCR 1718 (2006) was the initial DPRK sanctions resolution. The committee, comprised of representatives of all states on the Security Council, and the Security Council itself are responsible for designating the individuals and entities involved in the DPRK’s proliferation-related activities that will be subjected to targeted sanctions. UN Member States identify suspicious activities and propose the persons and entities linked to such activities to the UNSCR 1718 Committee for sanctioning. In practice, designation occurs in conjunction with negotiations on the periodic resolutions that intensify sanctions on North Korea.¹⁹ Once a person or entity is designated, the Committee adds it to the consolidated list of designated persons and entities at the time when the Security Council adopts that resolution.²⁰

The Security Council has designated many parties that are involved in North Korean illicit procurement activities or have held official positions in North Korea’s government institutions or banks. Southeast Asian governments need to ensure that their regulatory systems instruct, or at least enable, financial institutions under their jurisdiction to freeze the assets of such designated parties. Southeast Asian financial institutions must therefore stay up to date on the additions to and removals from the UN lists. They should also ensure that their transaction monitoring software enables them to screen against these lists, and in cases where they find a positive match with one of their customers, these financial institutions should take appropriate follow-up action by rapidly freezing the assets of the designated person and denying the customer’s access to the financial system of the bank’s host country.

With its latest sanctions resolutions, Resolutions 2270 (2016), 2321 (2016), 2371 (2017), and 2375 (2017), the Security Council added a number of individuals and entities, including many North Korean banks, to the list of parties identified in previous resolutions, requiring Member States to freeze those parties’ foreign assets and deny their access to the international financial system. Resolution 2270 further requires Member States to:

Prevent any funds, financial assets or economic resources being made available by their nationals or by any individuals or entities within their territories to the benefit of the Government of the DPRK or Worker’s Party of Korea, or to the individuals

19 UNSC Subsidiary Organs, Guidelines of the UNSCR 1718 Committee for the Conduct of its Work, December 31, 2014, <https://www.un.org/sc/suborg/sites/www.un.org.sc.suborg/files/dprk_guidelines.pdf>.

20 A similar process has been used with respect to Iran. However, under the JCPOA, parties previously designated because of their links to Iran’s nuclear program have been delisted. UNSC Subsidiary Organs, Consolidated List of Designated Persons and Entities under Resolution 1718, <<https://scsanctions.un.org/fop/fop?xml=htdocs/resources/xml/en/consolidated.xml&xslt=htdocs/resources/xsl/en/consolidated.xsl>>.

or entities acting on their behalf or at their direction, or to the entities owned or controlled by them.

The designations of Resolution 2371 (2017) include the state-owned Foreign Trade Bank (FTB), which acts as North Korea's primary foreign exchange bank. FTB also provides financial support to the US-sanctioned Korea Kwangson Banking Corporation.

The latest Security Council Resolution, Resolution 2375, on the other hand, names Organizational Guidance Department, Central Military Commission, and Propaganda and Agitation Department that run key elements of the DPRK government and military. In addition to the listing of individuals and entities, Resolution 2375 facilitates the listing of additional dual-use items and technology used for WMD purposes, and facilitates a process to identify vessels used to smuggle North Korean goods.

4.2. ACTIVITY-BASED FINANCIAL SANCTIONS

To counter proliferation finance, financial institutions must take action beyond the relatively straightforward task of implementing targeted financial sanctions. In order to comply with the UN resolutions against countries of proliferation concern, financial institutions must carry out a more challenging task: implementing activity-based financial sanctions. This type of sanction aims at preventing Member States from providing financial services, resources, or assistance that could contribute to the prohibited activities and programs of North Korea or Iran. By adopting such measures, the Security Council seeks to block financial flows to the prohibited activities while leaving other financial dealings unrestricted.

A risk-based approach, which has become more popular since the FATF's latest revision of its standards in 2012, is at the core of effective implementation of activity-based financial prohibitions. This approach requires financial institutions to identify high-risk customers and transactions, apply enhanced due diligence (EDD) measures to them, and take appropriate action on the basis of the results of such scrutiny.²¹ The first step in implementing a risk-based approach is identifying high-risk clients and operations based on all available information, including information obtained by routine due diligence practices and parallel AML/CFT due diligence measures.

Regarding North Korea's proliferation-related activities, the FATF's "Guidance on the Implementation of Financial Provisions of United Nations Security Council Resolutions to Counter the Proliferation of Weapons of Mass Destruction" lists certain risk indicators, including:

- » Customers and transactions associated with the DPRK;
- » Vehicles that could be used to finance activity-based financial prohibitions, such as certain trade financing products and services;

21 FATF, "Guidance on the Implementation of Financial Provisions of United Nations Security Council Resolutions to Counter the Proliferation of Weapons of Mass Destruction."

- » Customers involved with and/or transactions related to [nuclear- and missile-related] items, materials, equipment, goods and technology prohibited under resolutions 1874(2009), 2087(2013) and 2094(2013);
- » Significant withdrawals or deposits of cash that could potentially be used to evade DPRK-related sanctions and activity-based financial prohibitions.²²

The second step of a risk-based approach is conducting EDD on high-risk customers and transactions. Enhanced monitoring by financial institutions includes conducting more frequent monitoring of these customers and their transactions in order to identify and investigate anomalies. Such intensified monitoring also includes obtaining additional information about specific financial transactions that may involve proliferation-related items. Concerning the DPRK sanctions, the FATF’s guidance lists some examples of additional information that may be sought regarding specific transactions:

- » Details about the nature, end-use, or end-user of the item;
- » Export control information and certifications, such as copies of export-control licenses, other licenses issued by national export control authorities, and end-user certifications; and
- » The purpose of the transaction.

As the final step of a risk-based approach, financial institutions can take the following actions, assuming the necessary legal framework is in place: suspend the suspect transaction; freeze financial assets or resources associated with the WMD and ballistic missile-related programs or activities at issue; and/or terminate the business relationship with the customer.

To block financial transactions that could contribute to banned activities under the Security Council resolutions, Southeast Asian governments must adjust their regulatory frameworks to instruct financial institutions under their jurisdiction to develop a system of preventive measures with a risk-based approach at their core. Southeast Asian authorities should also require financial institutions to ask proliferation-related questions as part of their due diligence practices and explicitly require them to file SARs if they encounter unusual activities potentially related to proliferation.

Financial institutions in the region, in turn, should regularly scrutinize profiles of their customers, the products they trade, and the countries involved in transactions, in addition to monitoring their customers’ business activities and associated financial transactions. If financial institutions identify suspicious or unusual activities that may be related to the financing of WMD proliferation, they should take appropriate steps and report the activity of concern to relevant agencies.

22 Ibid.

4.3. VIGILANCE MEASURES

Vigilance measures require financial institutions, individuals, and companies in UN Member States to show caution in their activities with banks and entities domiciled in countries of concern. The latest North Korean sanctions impose severe financial restrictions on banking relationships with that country. As the international community puts pressure on North Korean financial activities, Southeast Asian banks are at increased risk of being used by North Korean procurement networks seeking to circumvent these restrictions.

According to Andrea Berger, former deputy director of proliferation and nuclear policy at the Royal Uniformed Services Institute and current senior research fellow at the James Martin Center for Nonproliferation Studies, North Korea will likely continue to keep its funds in offshore accounts that conceal North Korean links to those assets, circumventing the latest financial barriers and continuing to finance its international transactions.²³ North Korea may also use other countries' banks to conduct its illegal procurement activities through local accounts opened by local persons. Southeast Asian banks should be wary of DPRK-affiliated accounts and transactions, as they may serve North Korea's nuclear and related missile programs. If such restrictions on the use of legitimate international banking arrangements are effective, the Kim regime would be forced to rely on far less convenient money transfer systems, such as hawala or the use of cash, that could raise suspicions on the part of legitimate counterparties.

4.4. OTHER FINANCIAL PROVISIONS

The UN resolutions targeting North Korean illicit programs also ban Member States from conducting other types of financial dealings with North Korea that do not fall into any of three above-mentioned categories. Although the label "other measures" implies such measures are of lesser significance than targeted and activity-based sanctions and vigilance measures, the sanctions imposed under "other measures" are considerably more powerful and far-reaching—and, in some respects, more readily understood and implemented.

4.4.1. TERMINATION OF BANKING RELATIONSHIPS

One key measure of Resolution 2270 (2016) focuses on North Korean banks operating in UN Member States and on banks of such Member States operating in North Korea. Regarding North Korean banks operating abroad, Member States must instruct their banks to shut down existing branches, subsidiaries, and representative offices of such DPRK banks. In addition, the resolution requires Member States to prohibit the opening and operation of new branches, subsidiaries,

23 Andrea Berger, "The New UNSC Sanctions Resolution on North Korea: A Deep Dive Assessment," *38 North*, March 2, 2016, <<http://38north.org/2016/03/aberger030216/>>.

and representative offices of DPRK banks within their territories without prior approval from the UNSCR 1718 Committee.²⁴

Resolution 2270 (2016) allowed existing representative offices, subsidiaries, or bank accounts of Member State banks in the DPRK to continue to operate (unless the Member State had reasonable grounds to believe they contribute to the DPRK’s nuclear or missile program). However, Resolution 2321 (2016) requires these offices and accounts to be closed unless the UNSCR 1718 Committee determines that they serve humanitarian purposes.²⁵

Likewise, under UNSCR 2270 (2016) states must terminate joint ventures, ownership interests, and correspondent banking relationships with DPRK banks. Resolution 2270 (2016) additionally requires states to prevent their financial institutions from establishing new joint ventures, ownership interests, and corresponding banking relationships with DPRK banks unless they obtain approval from the UNSCR 1718 Committee in advance.

Terminating banking and other business relationships between North Korean banks and banks in Member States, as well as conditioning the creation of new relationships on the approval of the UNSCR 1718 Committee, is having a profound effect on the North Korean financial system. These measures seriously constrict Pyongyang’s international payment channels by aiming to halt North Korea’s use of its banks for the financing of WMD-related procurement activities and its other business with foreign companies. Additionally, considering the Kim regime’s unwillingness to restrain its nuclear ambitions, the UNSCR 1718 Committee is unlikely to grant approvals for new financial relationships.

4.4.2. PROHIBITION OF FINANCIAL SUPPORT

Both Resolution 2270 (2016) and Resolution 2321 (2016) require Member States to prohibit public and private financial support for trade with the DPRK, another step to cut off North Korea’s financial channels to support its illicit activities. These provisions include a ban on export credits, guarantees, and insurance from reaching the DPRK if such support could contribute to the DPRK’s prohibited activities. Resolution 2321 (2016), however, further banned the provision of insurance services of any kind to North Korean ships.²⁶

Prohibiting public and private financial support for trade with the DPRK makes conducting trade with high-risk countries more difficult for foreign firms that might otherwise be willing to do so. Because trade supports, such as export credits, are critical for these companies, depriving them of

²⁴ UN Security Council Resolution 2270 (2016), OP 33-35.

²⁵ This measure has aspects of an activity-based sanction because it requires an examination of how the actors use funds in various accounts, but it is grouped with other financial measures because of its focus on banking relationships. UN Security Council Resolution 2321 (2016), OP 31.

²⁶ UN Security Council Resolution 2270 (2016); UN Security Council Resolution 2321 (2016), OP 33.

such support can have a significant impact; this effect was exhibited when a similar sanction was imposed on Iran between 2008 and 2010.²⁷

4.4.3. LIMITATION OF THE NUMBER OF ACCOUNTS

Considering that DPRK diplomats have engaged in illicit activities, including illicit procurement efforts, Resolution 2321 (2016) calls upon Member States to limit the number of bank accounts held by North Korean diplomatic personnel.²⁸

4.4.4. PROHIBITION OF JOINT VENTURES

Resolution 2371 (2017) prohibits Member States from opening new joint ventures or cooperative entities between North Korean companies or individuals and other UN Member States. Although the resolution does not obligate closing existing joint ventures, it bans making additional investments in existing joint ventures. However, with the adoption of Resolution 2375 the existing joint ventures are banned unless they are approved by the United Nations in advance. After 120 days, entities are required to withdraw from existing joint ventures. Nevertheless, this provision does not apply to hydroelectric power project on the Yalu River with China and North Korea, and ports and rail projects with Russia and North Korea.

4.4.5. PROHIBITION OF CLEARING OF FUNDS THROUGH UN MEMBER STATES

Although US regulations prohibit dollar clearing services for North Korean banks, Resolution 2371 (2017) prohibits all Member States from clearing of funds through their jurisdictions.

4.4.6. EXTENSION OF THE CONCEPT OF FINANCIAL INSTITUTION

Resolution 2371 (2017) regards companies that provide financial services similar to banks as financial institutions for the purpose of implementing the resolutions' provisions. This rule apparently targets companies such as DCB Finance Limited, which was set up in the British Virgin Islands through a Panamanian law firm, Mossack Fonseca, in an effort to act as the front company of North Korean Daedong Credit Bank, which finances North Korea's illicit programs. This new provision is significant because North Korea heavily uses trading companies for financing its programs. ("Due

27 Richard Nephew, "UN Security Council's New Sanctions on the DPRK," *38 North*, March 11, 2016, <<http://38north.org/2016/03/rnephew030216/>>.

28 UNSCR 2371 (2017); United Nations Press Release, "Security Council Toughens Sanctions against Democratic People's Republic of Korea, Unanimously Adopting Resolution 2371 (2017)," August 5, 2017, <<https://www.un.org/press/en/2017/sc12945.doc.htm>>.

Diligence and the Panama Papers Episode: Lessons for Proliferation Finance,” the final study in this Occasional Paper, discusses the creation of DCB Financial Limited in detail.)²⁹

5. INTERNATIONAL LEGAL FRAMEWORK: FINANCIAL ACTION TASK FORCE

Since 2008, the FATF has published a number of reports to assist countries in fulfilling their anti-proliferation finance responsibilities. Following the passage of Security Council resolutions to counter proliferation in North Korea and Iran, the FATF began to issue guidelines to facilitate the resolutions’ implementation, including “The Implementation of Financial Provisions of UNSCRs to Counter the Proliferation of WMD (June 2007),” “The Implementation of Activity-Based Financial Prohibitions of UNSCR 1737 (October 2007),” and “The Implementation of Financial Provisions of UNSCR 1803 (October 2008).” In June 2013, the FATF updated and consolidated the aforementioned guidelines to assist jurisdictions in implementing the financial provisions of Security Council resolutions on nonproliferation, which, as discussed, are classified as: targeted financial sanctions, activity-based financial prohibitions, vigilance measures, and other financial restrictions.³⁰

Although the FATF’s inclusion of proliferation financing on its agenda dates back to 2008, the FATF did not incorporate anti-proliferation financing measures into its binding standards until 2012. The latest revision, entitled “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: the FATF Recommendations,” includes two separate recommendations for jurisdictions to counter proliferation financing.³¹

Recommendation 2 calls on countries to ensure national cooperation and coordination among their relevant domestic authorities to prevent proliferation finance. To better implement the requirements of Recommendation 2, the FATF issued a report in 2012 called “Sharing among Domestic Competent Authorities Information Related to the Financing of Proliferation.”³² The report sought

29 Security Council resolutions issued in 2016 and 2017 also sought to limit the ability of North Korea to earn foreign exchange by restricting Member States from importing certain raw materials from North Korea and from extending the duration of work permits for DPRK nationals, who send most of their wages to the North Korean government. See United States Mission to the United Nations, “FACT SHEET: Resolution 2375 (2017) Strengthening Sanctions on North Korea,” September 11, 2017, <<https://usun.state.gov/remarks/7969>>. Because these sanctions do not directly involve the North Korean or international financial systems they are not included in this analysis.

30 FATE, “The Implementation of Financial Provisions of United Nations Security Council Resolutions to Counter the Proliferation of Weapons of Mass Destruction,” July 2013, <<http://www.fatf-gafi.org/publications/financingofproliferation/documents/unscr-proliferation-wmd.html>>.

31 FATE, “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: the FATF Recommendations,” 2012, <<http://www.fatf-gafi.org/media/fatf/documents/recommendations/Guidance-UNSCRS-Prolif-WMD.pdf>>.

32 FATE, “Sharing Among Domestic Competent Authorities Information Related to the Financing of Proliferation,” February 2012, <<http://www.fatf-gafi.org/media/fatf/documents/recommendations/BPP%20on%20Recommendation%202%20Sharing%20among%20domestic%20competent%20authorities%20re%20financing%20of%20proliferation.pdf>>.

to outline best practices for information sharing among national authorities with roles in countering proliferation finance. In an effort to assist countries, the paper also puts forward effective strategies for cooperation and collaboration among responsible organizations.³³

Recommendation 7, on the other hand, requires states to implement the targeted financial sanctions imposed by Security Council Resolutions against Iran and the DPRK.³⁴ Although the resolutions that Recommendation 7 refers to include a broad range of additional finance-related requirements, Recommendation 7 relates only to targeted financial sanctions, namely the freezing of assets and ensuring that no funds and other assets are made available to designated persons and entities.³⁵ In June 2013, the FATF updated and consolidated the aforementioned guidelines to assist jurisdictions in implementing the financial provisions of the sanctions resolutions. However, to ensure current compliance with Recommendation 7, the FATF needs to issue updated guidance following the adoption of Resolution 2231 in 2015, which established the framework for the lifting of nuclear-related sanctions against Iran in January 2016, and the adoption of the recent resolutions sanctioning North Korea, including Resolutions 2270 (2016), 2321 (2016), 2371 (2017), and 2375 (2017). These resolutions imposed wider obligations on Member States than those covered by the FATF's 2013 report.

UNSCR 2270 (2016) underlines the fact that the FATF has called upon jurisdictions to practice enhanced due diligence and effective countermeasures to protect their financial systems from the DPRK's illicit activities. Additionally, the resolution urged Member States to apply FATF Recommendation 7, its Interpretive Note, and related guidance to effectively implement targeted financial sanctions with regards to proliferation.

5.1. MUTUAL EVALUATIONS

In order to encourage greater compliance by its members, the FATF and FATF-style regional bodies conduct mutual evaluations at regular intervals. These country evaluations, including in-country on-site visits, are based on the FATF's Methodology issued in 2013.³⁶ After carrying out mutual evaluations, the FATF provides an in-depth description and analysis of each country's implementation system in a publicly available report. If the FATF is not satisfied with the assessed country's systems of AML/CFT and countering proliferation finance and the country fails to address its deficiencies in a certain timeframe, the FATF places the country on a publicly available list and warns its members

33 Ibid.

34 Recommendation 7 still applies to Iranian sanctions, despite the lifting of nuclear-related sanctions, which resulted in delisting of 36 individuals and entities. As of August 9, 2017, there were 23 individuals and 53 entities on the UNSCR 2231 list, which was revised with the adoption of Resolution 2231 (2015), most parties designated for links to Iran's missile program. Further information about the Resolution and the list can be found at: <<https://scsanctions.un.org/fop/fop?xml=htdocs/resources/xml/en/consolidated.xml&xslt=htdocs/resources/xsl/en/iran.xsl>>.

35 International Monetary Fund, "Revisions to the FATF Standard-Information Note to the Executive Board," 2012, <<http://www.imf.org/external/np/pp/eng/2012/071712a.pdf>>.

36 FATE, "Methodology for Assessing Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems," updated October 2016, <<http://www.fatf-gafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf>>.

and other jurisdictions about the financial risks emanating from that country.³⁷ The possibility of being identified as high-risk has encouraged many listed countries to address their deficiencies by enacting necessary laws and developing implementation procedures.

Since the 2012 revision of its standards, for the first time the FATF has begun to evaluate countries’ compliance with its new recommendations for combating proliferation finance.³⁸ In contrast to its previous approach, the FATF has started to assess countries’ systems based on both technical compliance with the FATF Recommendations and the effectiveness of their implementation. The technical compliance assessments intend to determine whether evaluated countries have the legal and institutional framework upon which to build their AML/CFT and countering proliferation finance systems. On the other hand, the effectiveness assessment seeks to evaluate to what extent the assessed country meets the objectives of the FATF standards.

The FATF Methodology, which assessors take into account during their work, includes detailed criteria for evaluating technical compliance and effectiveness with FATF standards. When establishing legal bases for implementation of Security Council targeted financial sanctions, Southeast Asian governments need to keep these criteria in mind. The criteria for Recommendation 7 include the following:

- » Implementing the targeted financial sanctions “without delay;”³⁹
- » Developing mechanisms for communicating with financial institutions about updates in UN designations;
- » Having systems in place to ensure compliance of these institutions; and
- » Developing written rules regarding the listing and delisting of persons designated by the Security Council.

In the FATF’s technical compliance assessments, most of the evaluated countries do not have sufficient rules and procedures to freeze a designated person’s assets “without delay” as required by

37 FATF, “Topic: High-Risk and Non-Cooperative Jurisdictions,” <[http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/?hf=10&b=0&s=desc\(fatf_releasedate\)](http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/?hf=10&b=0&s=desc(fatf_releasedate))>.

38 Javier Serrat and Melissa Hanham, “Paris-Based Banking Group Tightens Rules Against Financing of Banned Weapon of Mass Destruction-Related Transfers,” *James Martin Center for Nonproliferation Studies*, 2012, <http://cns.miis.edu/stories/120305_wmd_financing.htm>.

39 The glossary of the FATF Recommendations defines the term without delay as “ideally, within a matter of hours of a designation by the United Nations Security Council or its relevant Sanctions Committee (e.g. the 1267 Committee, the 1988 Committee, the 1718 Sanctions Committee or the 1737 Sanctions Committee). For the purposes of S/RES/1373(2001), the phrase *without delay* means upon having reasonable grounds, or a reasonable basis, to suspect or believe that a person or entity is a terrorist, one who finances terrorism or a terrorist organization. In both cases, the phrase *without delay* should be interpreted in the context of the need to prevent the flight or dissipation of funds or other assets which are linked to terrorists, terrorist organizations, those who finance terrorism, and to the financing of proliferation of weapons of mass destruction, and the need for global, concerted action to interdict and disrupt their flow swiftly.” The glossary may be found at the end the FATF Recommendations, <http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf>.

Recommendation 7. The evaluated countries usually require weeks or months to freeze assets, so they involuntarily give designated persons sufficient time to move their assets to countries with weak financial controls or otherwise hide their ownership of the assets in question.

As for the FATF's effectiveness assessment, the FATF methodology identifies certain desired outcomes, and the FATF team evaluates to what extent countries achieve those outcomes. Immediate Outcome 11 evaluates the effectiveness of the technical compliance of countries with respect to Recommendations 2 and 7, and it is defined as, "Persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving, and using funds, consistent with the relevant UNSCRs."

At the time of this writing, assessment teams comprised of experts from FATF and the Asia-Pacific Group (APG), the FATF-Style Regional Body to which Southeast Asian states belong, have assessed only two of the eleven Southeast Asian countries. These organizations have evaluated Singapore,⁴⁰ Malaysia,⁴¹ and Cambodia,⁴² and based on their mutual evaluation reports, those countries' ratings for technical compliance and effectiveness are shown in Figure 2. Since the FATF and the FATF-Style Regional Bodies have only begun to publish expanded country reports after revising the FATF standards, these two reports could provide an understanding of how other Southeast Asian countries should implement the Security Council's targeted financial sanctions before being evaluated by the FATF/APG teams.

FIGURE 2: RATINGS FOR SINGAPORE AND MALAYSIA

	TECHNICAL COMPLIANCE (REC. 2)	TECHNICAL COMPLIANCE (REC. 7)	EFFECTIVENESS (PROLIFERATION FINANCING FINANCIAL SANCTIONS)
Singapore	Compliant	Largely Compliant	Substantial
Malaysia	Compliant	Partially Compliant ⁴³	Moderate
Cambodia	Partially Compliant	Non-Compliant ⁴⁴	Low

40 FATE, "Singapore Mutual Evaluation Report," 2016, <<http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-singapore-2016.html>>.

41 FATE, "Malaysia Mutual Evaluation Report," 2016, <<http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-malaysia-2015.html>>.

42 FATE, "Cambodia Mutual Evaluation Report," 2017, <<http://www.apgml.org/mutual-evaluations/documents/default.aspx>>.

43 This score is due to "significant delays in transposing UN designations to domestic freezing obligations and prohibitions." For further information, see Malaysia's mutual evaluation report.

44 His score was given because Cambodia does not have "a legislative basis for, nor has it taken steps to implement targeted financial sanctions relating to combating proliferation of WMD." For further information, see Cambodia's mutual evaluation report.

To avoid being “named and shamed” by the FATF and facing possible financial setbacks thereafter, states in Southeast Asia should adopt necessary measures to comply with the UN Security Council resolutions that Recommendation 7 refers to and establish cooperation channels with domestic authorities as required by Recommendation 2. The new legislative framework should be in line with the FATF methodology, which includes the criteria to be fully compliant with FATF protocols and taken as a basis for the FATF team conducting country evaluations.

6. INTERNATIONAL LEGAL FRAMEWORK: US LAWS AND REGULATIONS

US sanctions that complement those of the UN Security Council can greatly enhance the effectiveness of the sanctions regime that seeks to deter North Korea from pursuing its nuclear and ballistic missile programs. Because the Security Council sanctions lack an enforcement mechanism, some governments may be reluctant to implement and enforce the UN measures. However, the dominance of the US dollar in the global financial system provides strong encouragement for foreign financial institutions and companies to comply with related US regulations on North Korea in order to maintain their correspondent accounts in US financial institutions.⁴⁵ With the enactment of the North Korea Sanctions and Policy Enhancement Act (NKSPEA) in February 2016, and the issuance of Executive Order 13722 in March 2016, as well as the enactment of the Korean Interdiction and Modernization of Sanctions Act (KIMSA) in August 2017, and the issuance of the Executive Order 13810 in September 2017, the United States has provided the latest UN sanctions resolutions with a powerful indirect enforcement mechanism.⁴⁶ New powers authorized by NKSPEA and KIMSA, including those targeting third party enablers by means of “secondary sanctions,” give the United States leverage to press UN Member States to implement Security Council resolutions, as well as the United States’ own regulations, which are more extensive than the Security Council resolutions.

Pursuant to NKSPEA the US Treasury Department determined that North Korea is a jurisdiction of “primary money laundering concern” under Section 311 of the USA PATRIOT Act. This action requires US banks to implement additional due diligence measures to prevent North Korean

45 Joshua Stanton, “North Korea: The Myth of Maxed-Out Sanctions,” *Fletcher Security Review*, January 21, 2015, <<http://www.fletchersecurity.org/#!stanton/c1vgi>>.

46 Joshua Stanton, “How the New UN and US Sanctions on North Korea Can Complement Each Other,” *One Free Korea Blog*, February 29, 2016, <<http://freekorea.us/2016/02/29/how-the-new-u-n-and-u-s-sanctions-can-complement-each-other/>>; Ed Stein, “Russia, North Korea, Iran: The Comprehensive Sanctions Bill Currently on Trump’s Desk,” *Lawfare blog*, <<https://www.lawfareblog.com/russia-north-korea-iran-comprehensive-sanctions-bill-currently-trumps-desk>>; Paul, Weiss News Letter, “President Trump Signs Sanctions Legislation Targeting Russia, North Korea and Iran, Creating New Compliance Risks for U.S. and Non-U.S. Companies,” August 3, 2017, <<https://www.paulweiss.com/practices/litigation/financial-institutions/publications/president-trump-signs-sanctions-legislation-targeting-russia-north-korea-and-iran-creating-new-compliance-risks-for-us-and-non-us-companies?id=24620>>; “A Detailed Look at the Countering America’s Adversaries Through Sanctions Act,” *Steptoe and Johnson International Compliance Blog*, August 10, 2017, <<http://www.steptoec.com/publications-12112.html>>; North Korea Sanctions and Policy Enhancement Act of 2016, 22 USC Section 9202. KIMSA is Title III of the Countering America’s Adversaries Through Sanctions Act, Public Law 115-44, <<https://www.congress.gov/bill/115th-congress/house-bill/3364/text>>.

financial institutions from accessing the US financial system, including access through US banks' correspondent accounts with foreign banks. This action also prohibits foreign banks from using their correspondent accounts with US banks to process North Korean transactions. If they fail to comply, those foreign banks will be at risk of having their correspondent accounts with US banks closed down, thereby risking loss of direct access to the US financial system. Thus, designation of North Korea as a jurisdiction of primary money laundering concern requires foreign financial institutions, including those in Southeast Asia, to be wary of North Korea's sanctions evasion techniques and to protect against North Korean procurement networks' misusing the financial services they provide. (KIMSA, which amended NKSPEA to strengthen a number of its provisions, is discussed below.)

Although the United States obtained substantial additional tools for employing secondary sanctions in March 2016, the US government first used this authority to sanction third-country enablers of the Kim regime after North Korea's fifth nuclear test in September 2016. On September 26, 2016, the US Department of Treasury's Office of Foreign Assets Control (OFAC) designated a China-based company, Dandong Hongxiang Industrial Development Company Ltd (DHID), and four individuals on the grounds that they violated US sanctions against the DPRK by facilitating US dollar transactions of Korea Kwangson Banking Corporation (KKBC).⁴⁷ To facilitate transactions on behalf of KKBC, DHID used numerous front and shell companies, financial facilitators, and trade representatives, including one in Singapore. As a result of US action, all dollar-denominated assets under US jurisdiction of five designated parties were frozen, and US persons are prohibited from doing business with them.⁴⁸

The US Justice Department also filed a civil forfeiture action against twenty-five bank accounts belonging to DHID in various Chinese banks.⁴⁹ Unlike freezing, which blocks the assets until certain conditions are met, a forfeiture action results in asset confiscation if the government proves that their owners are involved in illicit activity. In practice, the forfeited amount is taken from the US correspondent accounts of these (non-sanctioned) Chinese banks.⁵⁰ Although OFAC's action was significant, it did not designate the Chinese banks involved. However, these banks may hold a significant amount of North Korean assets and process many of the regime's financial transactions in violation of international sanctions.

In late June 2017, however, the US Treasury Department found a Chinese regional bank, Bank of Dandong, to be an organization of primary money laundering concern and proposed rules to cut it off from the US banking system. If finalized, the Treasury action would prohibit US financial institutions from maintaining correspondent accounts for or on behalf

47 KKBC was designated by OFAC in 2009 for providing financial services in support of the previously designated North Korean entities Tanchon Commercial Bank and the Korea Hyoksin Trading Corporation. See the designation at <<https://www.treasury.gov/press-center/pressreleases/Pages/tg260.aspx>>.

48 US Department of Treasury Press Release, "Treasury Imposes Sanctions on Supporters of North Korea's Weapons of Mass Destruction Proliferation," September 26, 2016, <<https://www.treasury.gov/press-center/pressreleases/Pages/j15059.aspx>>.

49 US Department of Justice, "Forfeiture Action," September 26, 2016, <<https://www.justice.gov/opa/file/897051/download>>.

50 Joshua Stanton, "Treasury Sanctions, DOJ Indicts Chinese for Violating N. Korea Sanctions," *One Free Korea Blog*, September 27, 2016, <<http://freekorea.us/2016/09/27/treasury-sanctions-doj-indicts-chinese-for-violating-nkorea-sanctions/>>.

of the bank. Covered financial institutions would also be required to apply special due diligence measures to all their foreign correspondent accounts to ensure that they are not used to process transactions involving Bank of Dandong.⁵¹ In explaining the basis for this action, Treasury officials declared:

[The] Bank of Dandong acts as a conduit for North Korea to access the US and international financial systems, including by facilitating millions of dollars of transactions for companies involved in North Korea’s WMD and ballistic missile programs. Bank of Dandong also facilitates financial activity for North Korean entities designated by the United States and listed by the United Nations for proliferation of WMDs, as well as for front companies acting on their behalf.

The Department of Treasury also claimed that between May 2012 and May 2015, Bank of Dandong had processed \$786 million in transactions through its correspondent banks in the United States, which include the bank’s legitimate business. However, “at least seventeen percent” of this amount involved transactions for “companies that have transacted with, or on behalf of, US- and UN-sanctioned North Korean entities.”⁵²

The US sanctions law enacted in August 2017, KIMSA, strengthens these US sanctions. It requires the imposition of sanctions on foreign financial institutions if the US President determines that the institution maintains correspondent accounts with any North Korean financial institution (unless authorized by the Security Council). KIMSA also authorizes (but does not require) sanctioning financial institutions that facilitate significant transfers of funds or property of the Government of North Korea that materially contribute to the violation of an applicable UN Security Council resolution, or if they conduct a significant transaction in North Korea’s financial services industry or facilitate the operation of any branch, subsidiary, or office of a North Korean financial institution. The principal sanction in all of these instances is blocking the assets of the designated financial institution under US jurisdiction and prohibiting US parties from dealing with that institution.⁵³

KIMSA also imposes financial sanctions against Iran, but these simply codify pre-existing sanctions, regulations, and determinations.⁵⁴ Most relevant to the discussion here is the sanctioning of parties who knowingly engage in any activity that materially contributes to the Iranian Government’s ballistic missile program or any other Iranian program for developing, deploying or maintaining weapons

51 US Department of the Treasury Press Release, “Treasury Acts to Increase Economic Pressure on North Korea and Protect the U.S. Financial System,” June 29, 2017, <<https://www.treasury.gov/press-center/press-releases/Pages/sm0118.aspx>>.

52 “Proposal of Special Measure against Bank of Dandong as a Financial Institution of Primary Money Laundering Concern,” *FINCEN*, June 29, 2017, <https://www.fincen.gov/sites/default/files/federal_register_notices/2017-06-29/NPRM_311Dandong_0.pdf>.

53 Ed Stein, “Russia, North Korea, Iran: The Comprehensive Sanctions Bill Currently on Trump’s Desk,” Lawfare blog, August 2, 2017, <<https://www.lawfareblog.com/russia-north-korea-iran-comprehensive-sanctions-bill-currently-trumps-desk>>.

54 Countering America’s Adversaries through Sanctions Act.

of mass destruction. Presidential Executive Order 13382, issued in July 2005, had previously imposed sanctions on such parties.⁵⁵

OFAC's designations in August 2017 of sixteen Chinese and Russian individuals and entities, including two Singapore-based companies,⁵⁶ highlight the significant international reach of US sanctions measures once again, underscoring the need for states of Southeast Asia to be attentive to US regulations.

Executive Order 13810 issued on September 21, 2017, substantially increases OFAC's authority to impose primary sanctions on North Korea and secondary sanctions on its facilitators. Specifically, the OFAC gained the authority to designate all North Korean citizens and permanent residents and all entities registered in North Korea. Additionally, the OFAC is authorized to designate any foreign company or individual who knowingly does business with North Korea or provides material support to designated individuals and entities.

In addition to the expansion of designation criteria, the new Executive Order authorizes OFAC to sanction any foreign financial institution that knowingly conducts or facilitates any significant transaction on behalf of any party blocked under any North Korea-related Executive Order or in connection with trade with North Korea. If a foreign financial institution does not comply with these requirements, OFAC may prohibit it from maintaining correspondent accounts or payable-through accounts in the United States, and may block their property. Upon the issuance of the Executive Order, the White House underlined its significance by stating that, "Foreign financial institutions must choose between doing business with the United States or facilitating trade with North Korea or its designated supporters."⁵⁷ The new Executive Order also authorizes OFAC to block funds that originate from, are destined for, or pass through a foreign bank account that has been determined by the Secretary of the Treasury to be owned or controlled by a North Korean party .

These regulations highlight US willingness to take more aggressive action in sanctioning North Korea, underscoring the need for states of Southeast Asia and their financial institutions to be attentive to these US developments.

55 Executive Order 13382, Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters, June 28, 2005, Federal Register, vol. 70, no. 126, p. 38567 (July 1, 2005).

56 US Department of the Treasury Press Release, "Treasury Targets Chinese and Russian Entities and Individuals Supporting the North Korean Regime," August 22, 2017, <<https://www.treasury.gov/press-center/press-releases/Pages/sm0148.aspx>>.

57 The White House, "Fact Sheet: President Donald J. Trump Increases Pressure to Cut off Funding for North Korea," September 21, 2017, <<https://www.whitehouse.gov/the-press-office/2017/09/21/fact-sheet-president-donald-j-trump-increases-pressure-cut-funding-north>>.

7. CONCLUSIONS

Measures to combat proliferation are somewhat complex, but basic reminders can provide a useful roadmap through this thicket for Southeast Asian governments:

Chain of obligations. First, UNSCR 1540’s general requirement for the adoption of “appropriate” and “effective” controls over financial activities that could support proliferation and the Security Council’s more narrowly focused financial sanctions against North Korea are requirements that states must implement. To do this, states must, in turn, impose these obligations domestically on their financial institutions through various laws and regulations. A similar chain of obligation, moving from international organization to national governments to financial institutions, can be seen in implementing the recommendations of the FATF. However, US sanctions against North Korea and Iran, particularly secondary sanctions, impose requirements *directly on financial institutions* around the globe, which must take these into account, along with their applicable domestic laws. The United States has begun to utilize this extraterritorial mechanism more aggressively than in the past to attempt to counter North Korea’s nuclear and missile programs.

Legal bases for implementing finance-based counter-proliferation measures. UNSCR 1540 does not state what would constitute “appropriate” and “effective” counter-proliferation finance controls, leaving this matter to individual states. However, the Security Council sanctions resolutions implicitly provide substantial guidance on this issue. With their requirements for the imposition of targeted financial sanctions, activity-based financial sanctions, vigilance measures, termination of banking relationships, and prohibitions on proliferation-facilitating financial services, the sanctions resolutions necessitate that national governments adopt laws that (1) require the implementation of such measures by their financial institutions and (2) provide them the authority to execute asset freezes and other UN-required actions.

With respect to countering proliferation, the FATF focuses its mutual evaluations solely on the implementation of Recommendations 2 and 7, but the non-binding guidance documents associated with these recommendations provide instructions on building institutional capacity for coordination among relevant government agencies and implementing of *all categories* of Security Council mandated sanctions. Notably, if national governments embrace and implement the guidance on implementation of UN Security Council resolutions, their financial institutions will be well equipped to avoid US secondary sanctions.

Variety of measures: Direct, Secondary, Indirect/Sectoral. Finally, the variety of finance-based counter-proliferation measures can be confusing, but essentially, they roughly fall into three broad categories. Some measures, such as prohibitions on the financing of proliferation activities, the blocking of proliferation-relevant transactions, and the freezing of assets of key organizations and parties engaged in WMD programs, can directly impact programs of concern. Secondary sanctions do not directly disrupt proliferation activities, but they penalize third parties, especially financial institutions, that facilitate these activities carried out by others. A third category of measures, such as the

across-the-board termination of correspondent banking relationships, have a broader goal, namely crippling a key sector of the target country's economy as a means for pressuring the country to curtail its suspect programs and/or to enter into negotiations to limit those programs. This third category of measures – known generically as sectoral sanctions – is not focused on disrupting specific proliferation activities, but it attempts to constrain them indirectly by bringing about a change in the target state's nuclear and missile policies. All of these approaches were used against Iran and are now being deployed to constrain North Korea's nuclear and missile programs.

As the international community intensifies sanctions on North Korea, Pyongyang will likely increase its reliance on countries, particularly those in Southeast Asia, with relatively weak financial control systems to conduct transactions in support of its WMD and related missile programs. Therefore, if states in the region do not strengthen those systems, they could inadvertently contribute to the spread of WMD.

Additionally, if Southeast Asian countries fail to comply with the key UN resolutions, namely Resolution 1540 and the resolutions directed against North Korea (and Iran), as well as the FATF standards, their reputations as suitable banking partners could suffer in the eyes of the international community. Regional financial institutions could also risk becoming subject to potentially costly US secondary sanctions, including loss of access to the US financial system.

In this environment, introducing adequate legislation, institutions, and procedures in order to fight proliferation financing and aggressively implementing these measures can serve the interests of Southeast Asian governments, financial institutions in the region, and the international community at large.

NEEDED NEXT STEPS TO STRENGTHEN MEASURES TO COUNTER PROLIFERATION FINANCE

NEXT STEPS FOR THE INTERNATIONAL COMMUNITY

This study highlights important gaps in the network of measures that seek to combat the financing of weapon of mass destruction and related delivery system programs in countries of concern. Although international organizations, national governments, and a wide range of financial institutions have adopted various counter-proliferation finance policies, the UN Security Council, the Financial Action Task Force (FATF), and similar organizations consistently identify proliferation finance as an area requiring greater attention from state actors, particularly in Southeast Asia. This study will address deficiencies in the current proliferation finance regime and then suggest actions by international, state-level, and private sector actors to address those deficiencies, stressing the need for greater harmonization among actors at different levels and across each level.

1.1. DEFINITION OF PROLIFERATION FINANCING

At present, no internationally accepted standard definitions of “proliferation” and “proliferation finance” exist. Although UNSCR 1540 obligates UN Member States to enact effective financial controls to prevent WMD proliferation, it fails to explicitly enumerate prohibited financial activities; it neither elaborates the actions whose financing states must prohibit, nor the financial services that fall under the umbrella of proliferation finance.⁵⁸

The Paris-based FATF—an independent inter-governmental body that develops and promotes international standards to protect the global financial system against money laundering, terrorism finance, and proliferation finance—adopted a more specific working definition of proliferation financing for the purpose of its June 2008 “Proliferation Financing Typology Report.” For the purposes of the report, the FATF stated that “proliferation financing” refers to providing financial services for the transfer and export of nuclear, chemical, or biological weapons, their means of delivery, and related materials. According to this definition, proliferation finance involves particular actions such as financing trade in proliferation-sensitive goods or providing other financial support to individuals

58 UN Security Council Resolution 1540, S/Res/1540, April 28, 2004, (especially OP 3 (d)) <[http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1540%20\(2004\)](http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1540%20(2004))>.

or entities engaged in proliferation.⁵⁹ The definition, the report notes, does not make a distinction between those providing financial services intentionally and those doing so unintentionally.⁶⁰

The FATF revised its definition for the purpose of a later report made in February 2010, “Combating Proliferation Financing: A Status Report on Policy Development and Consultation.” Unlike the 2008 report, the FATF’s 2010 report adopted a more detailed approach that lists the actions that constitute proliferation financing. In this report, “proliferation financing” refers to the act of providing funds or financial services that are used, in whole or in part, for the manufacture, acquisition, possession, development, export, transshipment, brokering, transport, transfer, stockpiling, or use of nuclear, chemical, or biological weapons along with their means of delivery and related materials (including both technologies and dual-use goods used for non-legitimate purposes) in contravention of national laws or, where applicable, international obligations.⁶¹ The FATF’s new working definition includes providing funds, as well as financial services, for the range of activities related to proliferation. In contrast to the previous report, this definition does not include financial support provided to individuals engaged in proliferation activities. However, like the previous working definition, the new definition does not refer to knowledge, intention, or negligence.⁶²

The absence of a universal definition of proliferation finance has created a patchwork system where individual states frequently adopt and implement inconsistent and inadequate measures for countering proliferation finance. Although illicit procurement groups working to support WMD and related delivery system programs in states of concern do not necessarily conduct all of their activities across national borders, recent cases demonstrate that these groups primarily carry out their objectives through exports and transshipments of high-technology WMD-related items. Because proliferation networks involve multiple transactions and jurisdictions, proliferators frequently abuse the export controls and financial systems of multiple countries in a single procurement action. Therefore, if countries do not define and criminalize proliferation financing uniformly, proliferators are more likely to operate in countries with less stringent laws. Therefore, to effectively combat proliferation-finance, countries in the global financial system must align their anti-proliferation finance systems. Adopting a universally agreed upon and binding definition of proliferation financing would thus be a first and necessary step to effectively combat proliferation finance and, in turn, control proliferation.

59 FATF, “Proliferation Financing Report,” 2008, <<http://www.fatf-gafi.org/media/fatf/documents/reports/Typologies%20Report%20on%20Proliferation%20Financing.pdf>>.

60 In its 2008 report, the FATF also defines “proliferation” as “the transfer and export of nuclear, chemical or biological weapons; their means of delivery and related materials.” This definition is based on the FATF’s aforementioned proliferation financing definition. The definition, the FATF states, includes technology, goods, software, services, and expertise.

61 FATF, “Combating Proliferation Financing: A Status Report on Policy Development and Consultation,” February 2010, <<http://www.fatf-gafi.org/media/fatf/documents/reports/Status-report-proliferation-financing.pdf>>.

62 Although the FATF’s 2010 report does not explicitly define proliferation, based on its updated proliferation financing definition and the FATF’s strategy for defining proliferation in its 2008 report, “proliferation” refers to “the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual use goods used for non-legitimate purposes) in contravention of national laws or, where applicable, international obligations.”

Additionally, the absence of an internationally agreed-upon definition of and standardized criminalization laws regarding proliferation finance could hinder international legal cooperation. These cooperation channels include requests for mutual legal assistance, extradition, and information exchange. Countries will more likely cooperate and render mutual legal assistance when the requesting countries have similar laws criminalizing proliferation finance—a condition known as “dual criminality.” On some occasions, even if a country desires to provide mutual legal assistance to other countries that lack similar criminalization laws, its extradition laws may prevent it from doing so. To facilitate exchange of information among various actors, states must therefore adopt consistent legal definitions and criminalization laws.

1.2. NEED FOR SPECIFIC REGULATIONS

The absence of an internationally accepted definition of proliferation financing and standardized countermeasures targeting those activities creates a disjointed system where each country criminalizes this conduct and determines the scope of its financial controls based on its unique understanding, experience, and political situation. Many national governments, particularly in developing countries, may neglect their anti-proliferation finance infrastructures because they must allocate limited resources to more immediate problems. Because illicit WMD procurement networks exploit weaknesses in a country’s financial regulations to attain their objectives, this system fails to ensure that illicit actors cannot finance their activities.

Since the adoption of Resolution 1540, most Member States have taken legislative measures to regulate proliferation finance. According to the UNSCR 1540 Committee’s latest report in 2011, 125 states have taken legislative action to prohibit the financing of activities concerning nuclear weapons; in 2008, only sixty-six states had established such laws. Similarly, from 2008 to 2011, the number of states that had passed laws regarding the financing of chemical weapons rose from seventy-one to 128 states, and the number of states that had adopted similar legislation regarding biological weapons grew from sixty-four to 121.⁶³ Member States have also taken significant steps to enforce their legal frameworks. In 2008, only seventy-eight states had adopted enforcement measures regarding the financing of nuclear weapons; eighty-seven states had adopted similar laws for chemical weapons, and seventy-five states had enforcement mechanisms for biological weapons. However, the Committee’s 2011 report indicates that 120, 122, and 114 states now have enforcement mechanisms regarding nuclear, chemical, and biological weapons, respectively. The UNSCR 1540 Committee explained this positive trend as a result of many countries’ incorporating criminalization of financing WMD and their means of delivery into their pre-existing anti-money laundering and countering the financing of terrorism (AML/CFT) legislation.⁶⁴

Though the number of states that have adopted proliferation finance laws has substantially increased, these laws lack definitional consistency. To counter proliferation, Security Council Resolution 1540

63 UNSCR 1540 Committee, “Report of the Committee Established pursuant to Security Council Resolution 1540 (2004),” September 14, 2011, <http://www.un.org/en/ga/search/view_doc.asp?symbol=S/2011/579>.

64 Ibid.

obligates Member States to adopt and implement adequate financial controls, including a provision for “appropriate” civil and criminal penalties. Resolution 1540 therefore sets broad requirements without prescribing specific approaches to achieve that end. Rather, the resolution leaves Member States to determine their own regulations and implementation procedures based on national laws and international obligations. For example, some jurisdictions may decide to specifically define a proliferation finance offense as separate from a proliferation offense, but other jurisdictions may prefer to regulate proliferation finance offenses under an overarching proliferation offense, either as providing a type of assistance to committing that offense or as a type of ancillary offense. Jurisdictions may even classify proliferation finance as illicit trade and criminalize it under AML/CFT laws rather than laws on nonproliferation.⁶⁵ Furthermore, countries can impose civil penalties instead of or in addition to criminal ones to punish the financiers of WMD proliferation. These legal inconsistencies constitute a major barrier to addressing proliferation finance activities that occur across national borders.

The absence of actual cases with proliferation finance as the primary offense reflects the insufficiency of countries’ existing legislative frameworks in detecting and punishing individuals and entities engaged in illicit funding activities. Although the UNSCR 1540 Committee does not object to states’ regulating proliferation finance offenses under AML/CFT laws, countries need to bear in mind that the three offenses have distinct characteristics, requiring specific measures for each. Admittedly, AML/CFT measures often overlap with counter-proliferation financing measures, but proliferation finance involves particular issues that AML/CFT laws do not always address.⁶⁶

Because proliferation finance is a relatively recent concern, many UN Member States lack awareness of its particulars. Many states equate combating proliferation finance with the implementation of targeted (entity-based or list-based) financial sanctions imposed by the United Nations.⁶⁷ However, such sanctions only encompass one dimension of states’ Security Council-mandated obligations. Countries must also implement measures to detect proliferation-related finance activities and, more importantly, to prevent these activities before they occur. To most effectively reach this goal, each state should adopt specific regulations that cover all aspects of countering proliferation finance.

The international community should therefore encourage states to enact laws that directly address the proliferation finance threat. One highly effective approach consists of criminalizing proliferation finance offenses separately from other crimes. This strategy requires states to develop a national definition of proliferation financing that addresses the issues of intentionality and negligence. Without

65 Ibid, p.12.

66 On the overlaps and differences among AML, CFT, and countering proliferation finance measures, see discussion in “Countering North Korean Procurement Networks through Financial Measures: The Role of Southeast Asia” above, pp. 6-7; Emil Dall, Andrea Berger, and Tom Keatinge, “Out of Sight, Out of Mind?” Royal United Services Institute for Defence and Security Studies, June 20, 2016, <<https://rusi.org/publication/whitehall-reports/out-sight-out-mind-review-efforts-counter-proliferation-finance>>.

67 Targeted financial sanctions—also known as “list-based or entity-based” sanctions—focus on specific individuals and entities that have been designated by the Security Council or other authorities as engaged in or directly supporting prohibited proliferation activities. The principal financial penalty imposed on such designated parties is the freezing of their assets and the denial of access to financial systems of states.

establishing such a definition, states may not be able to determine a framework of forbidden activities. Specific criminalization would also raise awareness of the proliferation finance threat among relevant authorities and allow them to adopt countermeasures that take into account the unique characteristics of this challenge. More importantly, regulations targeting proliferation finance would specify the obligations of vulnerable parties, such as the financial sector and other industries that may be the target of illicit procurement activities.

1.3. INTERNATIONAL STANDARDS AND ENFORCEMENT

The Security Council and the FATF have made substantial efforts to address the issue of proliferation finance. On one hand, the Security Council adopted Resolution 1540 in an effort to obligate Member States to undertake effective financial controls to prevent WMD proliferation. To monitor and facilitate the implementation of the resolution, the Security Council established the UNSCR 1540 Committee. However, the absence of formal assessments and an enforcement mechanism reduces the efficacy of the UNSCR 1540 Committee in the counter-proliferation finance regime.

On the other hand, the FATF has provided more specific guidance regarding proliferation finance and undertakes evaluations of member states' counter-proliferation finance systems, which serves as an indirect enforcement method of its standards. In 2012, the FATF revised its standards to include two official recommendations on combatting the financing of WMD proliferation. However, the scope of the FATF measures on proliferation finance is not as broad as that found in the relevant resolutions from the Security Council, and the organization does not require a set of countermeasures to address proliferation finance that are as extensive as those that it requires for combatting money laundering and terrorism financing. Unlike the UNSCR 1540 Committee, however, the FATF does have a form of enforcement mechanism—a process of mutual assessment whose results are made public. This process exposes underperforming states to the risk of considerable embarrassment and possible financial loss. Moreover, in the most serious cases of underperformance, the FATF issues a warning to other states to exercise caution in dealing with the country at issue and to implement countermeasures to ensure the integrity of their own financial systems is not compromised by dealing with a state with weak protections.

Given that the UNSCR 1540 Committee and the FATF are the only international bodies with responsibilities for countering proliferation finance, it is important, as discussed in further detail below, that they strengthen their valuable, though incomplete, efforts to build a robust and comprehensive international counter-proliferation finance regime.

1.3.1. 1540 COMMITTEE

The UNSCR 1540 Committee is required to report to the Security Council on the status of UN Member States' implementation of the resolution. Countries, in turn, must submit regular reports that indicate the steps they have taken or intend to take to implement the obligations of the resolution.

However, many countries lack the capacity and resources necessary to effectively implement provisions of the resolution. Countries in developing regions, as noted earlier, often allocate political energy and scarce resources towards matters that these countries deem to be of greater urgency.⁶⁸ Additionally, the ambiguous language of the resolution, such as requiring countries to adopt "appropriate" and "effective" laws without further guidance, leaves many states uncertain of UN expectations.

Resolution 1540 also did not charge the 1540 Committee with establishing legal norms, assessing whether Member States meet their binding obligations, imposing sanctions in case of noncompliance, or taking other enforcement actions. Instead, the committee encourages Member States to comply with the provisions of the resolution by raising awareness, sharing information, and matching states seeking technical assistance with states that can provide it.⁶⁹ The UNSCR 1540 Committee thus lacks authority to intervene if a Member State's financial system contains severe deficiencies.

Additionally, despite the gradual increase in the committee's workload due to more states' implementing the resolution, the committee's resources remain relatively limited. For years, the committee has carried out its mandate through nine experts, with a budget of just over \$3 million.⁷⁰ Considering that the assessment of a state's export control system—only one of the many requirements under UNSCR 1540—can cost more than \$100,000 if it involves in-country visits, the Committee could take decades to conduct a comprehensive review of every Member State unless it receives significantly expanded resources.⁷¹

Therefore, to monitor the resolution's implementation, the committee uses the 1540 Matrix. This matrix lists all of the requirements of the resolution and notes the status of each Member State's implementation of each requirement. The committee obtains information for the matrix primarily

68 Johan Bergenas and Lawrence Scheinman, "UN Security Resolution 1540: Historical Analysis, Current Status of Implementation, and a Look to the Future," *CISTEC Journal*, 2010, <http://cns.miis.edu/other/bergenas_scheinman_1003_cistec_english.pdf>.

69 Richard T. Cupitt, "Nearly at the Brink: The Tasks and Capacity of the 1540 Committee," *Arms Control Today*, August 30, 2012, <http://www.armscontrol.org/act/2012_09/Nearly-at-the-Brink-The-Tasks-and-Capacity-Of-the1540-Committee>.

70 Scott Spence, "The future of UN Security Council Resolution 1540 (2004)," speech given at the Verification, Research, Training and Information Centre, July 8, 2016, <http://www.vertic.org/media/assets/Presentations/VERTICS%20Spence_1540%20Open%20Consultations_FINAL.pdf>.

71 Cupitt, "Nearly at the Brink."

from state-submitted reports, official documents published by a state (e.g. a national gazette), and reports submitted by other intergovernmental organizations (e.g. the IAEA).⁷²

However, the committee does not have a mandate to carry out detailed evaluations via in-country visits unless a country invites it to do so.⁷³ Therefore, the UNSCR 1540 Committee obtains only partial information, hindering its ability to make an authoritative assessment of Member States’ implementation of the resolution. The absence of an effective enforcement mechanism for the resolution and its reporting requirements further exacerbates the difficulty in monitoring Member State implementation.

1.3.2. FINANCIAL ACTION TASK FORCE

In 2012, the FATF included two new recommendations on combating proliferation finance in its standards, which take the form of “recommendations.”⁷⁴ Recommendation 2 calls on countries to ensure national cooperation and coordination among competent authorities to prevent proliferation finance. Recommendation 7 requires countries to apply Security Council resolutions imposing targeted financial sanctions on designated persons and entities associated with North Korea and Iran’s nuclear programs. Although the resolutions that Recommendation 7 refers to contain a broad range of requirements, including implementation of targeted financial sanctions, activity-based financial sanctions, vigilance provisions, and the termination of certain banking relationships, Recommendation 7 refers only to the resolutions’ targeted financial sanctions, i.e. freezing of funds and other assets and ensuring that no funds or other assets are made available to designated persons and entities.⁷⁵

In addition to the two formal recommendations, the FATF publishes guidelines and reports on some aspects of counter-proliferation finance measures to assist countries in the process of establishing their own systems. However, since the FATF does not recognize these guidelines and reports as its international standards—which are contained in the FATF’s 40 Recommendations, Interpretive

72 The UNSCR 1540 Committee, “1540 Matrix,” <<http://www.un.org/en/sc/1540/national-implementation/matrix.shtml>>. This limitation was reiterated in UNSCR 2325, the most recent Security Council resolution addressing the implementation of UNSCR 1540.

73 This limitation was reiterated in UNSCR 2325, the most recent Security Council resolution addressing the implementation of UNSCR 1540.

74 FATF, “International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: the FATF Recommendations,” 2012, <http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf>.

75 IMF Website, “Revisions to the FATF Standard-Information Note to the Executive Board,” 2012, <<http://www.imf.org/external/np/pp/eng/2012/071712a.pdf>>. Activity-based sanctions are sanctions that seek to block transactions that could contribute to WMD proliferation and require careful analysis of the particulars involved, such as the nature of the goods being purchased. In contrast, targeted sanctions are list-based. Here, a financial institution need only determine whether a customer or a party to a transaction has been sanctioned by consulting a list of sanctioned parties, then taking steps to freeze the party’s assets or refuse a transaction in which it is involved. Most targeted financial UN sanctions against Iranian parties were lifted following the July 2015 nuclear agreement between Iran and China, France, Germany, Russia, the United States and the United Kingdom. For information on the Security Council’s North Korea sanctions, see the website of the Security Council Committee overseeing implementation of the relevant resolutions, <<https://www.un.org/sc/suborg/en/sanctions/1718>>.

Notes, and Methodology—countries are not required to follow them. FATF reports on counter-proliferation finance also insufficiently cover all aspects of relevant measures, unlike the FATF's AML/CFT measures.

Although the FATF has significant resources to draw from, extensive procedures in place, and an established oversight program of countries' AML/CFT systems through in-country visits, their measures do not adequately cover all aspects of combating proliferation finance. In contrast to its broad AML/CFT standards, the scope of its proliferation finance standards does not include, for example, the criminalization of proliferation finance, reporting of suspicious transactions, implementation of customer due diligence (CDD) measures, scrutiny of correspondent banking relationships, clarification of law enforcement and investigative authority responsibilities, and contribution to international cooperation.⁷⁶ However, although the FATF does not require certain countermeasures with respect to proliferation finance, it encourages countries to adopt them. Such adoption assists countries in implementing other financial provisions under UNSC resolutions on North Korea, namely activity-based financial measures and exercising vigilance to identify transactions that could contribute to proliferation.

1.3.3. IMPROVEMENT OF GLOBAL COUNTER-PROLIFERATION FINANCE MEASURES

To strengthen the financial control regime in an effort to prevent, suppress, and disrupt the financial channels of WMD proliferation, relevant organizations must set international standards and pressure countries to implement them effectively. Adopting and implementing international standards in line with the Security Council sanctions regime, specifying the obligations of financial institutions, and ensuring that UN Member States have adopted and implemented the regime would significantly enhance the effectiveness of the global counter-proliferation finance system.

1.3.3.1. FATF'S CONTRIBUTION (SETTING INTERNATIONAL STANDARDS)

Currently, the FATF appears to be the best candidate to set standards for national governments to carry out. The FATF has ample experience in setting international standards on financial measures and pressuring countries to comply with them. These international standards should at least include the following: criminalization of proliferation financing in a comprehensive manner, including the definition of proliferation financing and a framework of forbidden financial activities; implementation of activity-based financial sanctions in compliance with UNSC resolutions; and specifications of financial institutions' obligations such as filing suspicious activity reports (SARs) associated with proliferation-related transactions and applying CDD measures.

76 Javier Serrat, "International Task Force Takes Aim at Illicit Proliferation Financing," *James Martin Center for Nonproliferation Studies*, 2011, <http://wmdjunction.com/110912_funding_task_force.htm>.

1.3.3.2. UNSCR 1540 COMMITTEE’S CONTRIBUTION (ADOPTING FATF MECHANISMS AT THE 1540 COMMITTEE TO IMPROVE COMPLIANCE)

The international regime to counter proliferation finance could be greatly strengthened if the UNSCR 1540 Committee adopted key practices used by the FATF, including an easily understood system for rating national implementation of the resolution’s requirements. Given the history of the resolution, however, this action would represent a significant departure from the Security Council’s traditional focus on voluntary compliance and leaving policy details to individual Member States. The committee has experimented with peer reviews, and the 1540 Matrix serves to alert the international community to states with poor financial controls.⁷⁷ However, the matrices’ numerous complex categories do not reflect the committee’s assessment regarding the adequacy and efficiency of a country’s systems. Therefore, examining country matrices often does not yield clear understandings of the overall performance of a particular state. In contrast, the FATF uses a highly comprehensible rating system with four categories: compliant, largely compliant, partially compliant, and non-compliant. The clarity of the ratings exposes member countries to the risk of substantial embarrassment if they underperform, thus creating incentives to improve.

In addition to the matrices, the UNSCR 1540 Committee should strengthen the “naming and shaming” dimension of its monitoring activities by establishing three or four easily understood levels of effectiveness in implementing Resolution 1540’s measures, establishing a system of indirect enforcement akin to the FATF’s rating system. A state’s placement on the “rungs” of this ladder would be based on the 1540 Matrix data but would be more easily understood by outside parties, creating incentives for a given state to reduce the risk of international disapproval by improving its record.

NEXT STEPS FOR SOUTHEAST ASIAN COUNTRIES

Due to Southeast Asia’s proximity to the DPRK, the region plays a critical role in the global anti-proliferation finance regime. North Korean procurement networks employ various deceptive techniques to gather proliferation-related materials in the global marketplace, using front companies to gain access to the international banking system and various transshipment points in Southeast Asia. Since these purchases need to use the formal financial system for payment in order to avoid raising questions from suppliers about their legitimacy, such financing is a potentially vulnerable point of the procurement chain. At present, most Southeast Asian countries cannot fully contribute to global nonproliferation efforts because they lack sufficient awareness of and thus effective mechanisms to detect and interrupt proliferation-related financial activities or to rapidly implement targeted financial sanctions.

⁷⁷ See “Joint Report of Croatia and Poland on the Bilateral Peer Review of Implementation of the UN Security Council Resolution 1540 (2004),” <<http://www.un.org/en/sc/1540/pdf/CroatiaPoland%20Letter%20re%20effective%20practices%202014.pdf>>.

In 2016, the Asia-Pacific Group (APG)—a FATF-style regional body that includes all Southeast Asian states—organized a workshop held in Seoul, South Korea, where participating countries developed action plans outlining steps to better implement measures to counter proliferation finance and committed to implement the measures within a given timeframe. These action plans can guide the United States and other countries in providing technical assistance to states in the region. However, the countries' action plans have not been made public. Nonetheless, the recommendations provided in this study can serve as a checklist for assisting-state officials as they take stock of these action plans and formulate assistance programs.

2.1. COMPLIANCE WITH INTERNATIONAL OBLIGATIONS

First, all states should take steps to comply with international obligations by establishing a legislative and institutional framework to address proliferation finance. Such a system requires Southeast Asian countries to adopt and enforce new laws and regulations or amend their existing ones to cover all dimensions of countering proliferation finance. The new rules and implementation procedures should be in line with FATF criteria for the implementation of Security Council targeted financial sanctions, prescribed in the FATF's formal recommendations, interpretive notes, and methodology. At the least, these regulations should identify responsible government institutions and their roles, as well as establish rules to ensure that these agencies meet their obligations.

2.1.1. EFFECTIVE IMPLEMENTATION OF UN SECURITY COUNCIL SANCTIONS

All UN Member States, including Southeast Asian countries, must implement key UN Security Council resolutions addressing proliferation finance because the resolutions were adopted under Chapter VII of the UN Charter, which makes them binding. To comply with the Security Council's targeted financial sanctions regarding the prevention and disruption of WMD proliferation, namely freezing the assets of designated persons and denying their access to the international financial system, Southeast Asian governments need to ensure that their regulatory systems instruct and enable financial institutions to efficiently implement targeted financial sanctions. These countries' domestic legislation should allow relevant authorities to rapidly identify and sanction persons following Security Council designations and implement the relevant targeted financial sanctions in a timely manner.

For the Security Council's targeted financial sanctions to be effective, Southeast Asian countries must contribute to this system. Importantly, these countries should propose new names for designation to the UNSCR 1718 Committee, which oversees implementation of Security Council sanctions against North Korea. For this task to be fulfilled, countries should conduct investigations to detect DPRK-related smuggling activities and associated financial transactions. Although, it is widely known that North Korea has obtained necessary items and goods for its prohibited programs by exploiting loopholes in the systems of many countries, including those in Southeast Asia, Southeast Asian countries apparently have not proposed names to the UNSCR 1718 Committee for designation, particularly those of parties under their jurisdiction. This inaction suggests that countries either do not detect

these activities, or they detect the crimes but prefer to punish their citizens or companies themselves. This policy, however, hinders international cooperation in the global fight against proliferation.

Southeast Asian Countries can also contribute to the Security Council’s targeted financial sanctions regime by collaborating with the UN Panel of Experts on North Korea. Southeast Asian countries should send their country reports, which disclose their efforts to implement North Korean sanctions, to the UNSCR 1718 Committee in a timely manner. In addition, they should inform the Committee’s Panel of Experts about incidents regarding both designated persons and DPRK-related sanctions violations in their territory.

In addition to the implementation of the Security Council’s targeted financial sanctions, Southeast Asian countries should adopt adequate measures to implement the complementary financial provisions imposed by the Security Council, which include activity-based financial sanctions, vigilance measures, and other types of financial measures, such as the termination of banking relationships with designated parties and states.

2.1.2. COMPLIANCE WITH THE FATF STANDARDS

Southeast Asian countries should implement the FATF’s formal recommendations on countering proliferation finance before these countries undergo mutual evaluations by the FATF’s regional organization, the APG. However, compliance with FATF standards has become more challenging since the FATF’s revision of its mutual evaluation system after its standards revision in 2012. In contrast to its previous approach, the FATF has begun to assess the countries’ systems on both technical compliance and on effectiveness. The technical compliance assessments examine whether evaluated countries have met FATF standards in adopting the legal and institutional frameworks to develop comprehensive AML/CFT laws and counter-proliferation finance systems. On the other hand, the effectiveness assessment seeks to evaluate to what extent the assessed country meets the *objectives of the FATF standards*.

After its technical compliance evaluations, the FATF gives the evaluated country one of the scores shown in Figure 1 for each recommendation. Southeast Asian countries should interpret compliant or largely compliant scores for Recommendations 2 and 7 as an indication that they have efficient systems in place to ensure adequate cooperation among relevant domestic institutions and to implement the Security Council’s targeted financial sanctions. The FATF methodology, which assessors take into account during evaluations, includes detailed criteria for technical compliance with FATF standards.⁷⁸ When establishing legal bases for implementation of UNSC targeted financial sanctions, Southeast Asian governments should consider the assessment criteria provided by the FATF. The criteria for Recommendation 7 includes implementing the targeted financial sanctions “without

78 FATE, “Methodology: For Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems,” February 20, 2013, <<http://www.fatfgafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf>>.

delay;” developing systems for communicating with financial institutions about updates in Security Council designations; ensuring compliance by these institutions and businesses; and publishing rules for listing and delisting persons consistent with Security Council actions.⁷⁹

FIGURE 1: FATF RATINGS FOR TECHNICAL COMPLIANCE ASSESSMENTS

TECHNICAL COMPLIANCE RATINGS		
Compliant	C	There are no shortcomings.
Largely compliant	LC	There are only minor shortcomings.
Partially compliant	PC	There are moderate shortcomings.
Non-compliant	NC	There are major shortcomings.
Not applicable	NA	A requirement does not apply, due to the structural, legal or institutional features of a country.

SOURCE: FATF METHODOLOGY

The immediate outcome associated with effective implementation of Recommendations 7 and 2 is defined as: “persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving, and using funds, consistent with the relevant UNSCRs.”⁸⁰ The methodology further provides the characteristics of an effective system that applies these recommendations:

Persons and entities designated by the United Nations Security Council Resolutions (UNSCRs) on proliferation of weapons of mass destruction (WMD) [rounds] are identified, deprived of resources, and prevented from raising, moving, and using funds or other assets for the financing of proliferation. Targeted financial sanctions are fully and properly implemented without delay; monitored for compliance and there is adequate co-operation and co-ordination between the relevant authorities to prevent sanctions from being evaded, and to develop and implement policies and activities to combat the financing of proliferation of WMD.⁸¹

Thus far, in Southeast Asia, the FATF has only published the reports for Singapore, Malaysia, and Cambodia. Initial observation based on these reports indicates that the FATF team gives special priority to the time countries require to designate individuals and entities domestically after their designation by the Security Council, as well as the time needed to freeze designees’ assets and other

⁷⁹ For the FATF’s definition of “without delay,” See note 39, above.

⁸⁰ FATE, “Methodology: For Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems.”

⁸¹ Ibid.

resources. Therefore, Southeast Asian countries should consider these FATF priorities as they work to establish a legal and institutional basis for the implementation of UNSC measures.

FIGURE 2: FATF RATINGS FOR EFFECTIVENESS ASSESSMENT

EFFECTIVENESS RATINGS	
High level of effectiveness	The Immediate Outcome is achieved to a very large extent. Minor improvements needed.
Substantial level of effectiveness	The Immediate Outcome is achieved to a large extent. Moderate improvements needed.
Moderate level of effectiveness	The Immediate Outcome is achieved to some extent. Major improvements needed.
Low level of effectiveness	The Immediate Outcome is not achieved or achieved to a negligible extent. Fundamental improvements needed.

SOURCE: FATF METHODOLOGY

2.1.3. COMPLIANCE WITH US REGULATIONS

In addition to regulations established by international organizations, Southeast Asian countries should also consider US regulations when establishing a system to counter proliferation finance. US regulations allow the US Department of Treasury to impose sanctions on third parties intentionally or unintentionally involved in financing North Korean proliferation, so Southeast Asian countries and financial institutions should take care to ensure that they do not inadvertently become sanctioned due to inadequate protections against North Korean abuse.

The US North Korea Sanctions and Policy Enhancement Act (NKSPEA), enacted in February 2016 requires the US administration to impose sanctions on third parties that directly facilitate North Korea’s nuclear weapons program, and the Korean Interdiction and Modernization of Sanctions Act (KIMSA), enacted in August 2017, strengthens these US sanctions.⁸² KIMSA requires the imposition of sanctions on foreign financial institutions that the US President determines are maintaining correspondent accounts with any North Korean financial institution (unless authorized by the Security Council). The law also authorizes (but does not require) the sanctioning of financial institutions that facilitate a significant transfer of funds or property of the Government of North Korea that could materially contribute to the violation of an applicable UN Security Council resolution; conduct a

82 North Korea Sanctions and Policy Enhancement Act, Public Law 114-122 <<https://www.congress.gov/bill/114th-congress/house-bill/757/text>>; Korean Interdiction and Modernization of Sanctions Act, Title III of the Countering America’s Adversaries Through Sanctions Act, Public Law 115-44, <<https://www.congress.gov/bill/115th-congress/house-bill/3364/text>>. Although the President is required to sanction such parties as a general matter, he is also authorized under the law to waive sanctions on a case-by-case basis if the entity meets certain conditions.

significant transaction in North Korea's financial services industry; or facilitate the operation of any branch, subsidiary, or office of a North Korean financial institution.

Although few, if any, Southeast Asian financial institutions will fall into the category of directly facilitating North Korean proliferation, they can violate US laws if they provide financial services to parties that do fall into this category and are sanctioned by the United States (or by the Security Council, since US lists of sanctioned parties incorporate the Security Council lists). In order to avoid being penalized by designation, Southeast Asian private parties, including financial institutions, need to keep current about updates in US regulations, including additions to and removals from US sanctions lists. Southeast Asian countries must therefore ensure that their financial systems authorize them to implement US regulations and that their transaction-monitoring software enables them to screen against these requirements. If they find a positive match with one of their customers, they should take appropriate follow-up action: freezing the assets of the designated persons without delay and denying their access to the financial system of the bank's host country.

Unlike UN Security Council measures, Southeast Asian countries do not have a direct obligation to apply US countermeasures against financial support of proliferation. However, they should authorize their financial institutions to follow US designations in order to maintain their US correspondent accounts and good standing abroad.

2.2. DOMESTIC COORDINATION

In their FATF mutual evaluations, Southeast Asian countries will also need to specify governmental organizations' roles and responsibilities for countering proliferation finance. These regulations should also clearly specify the responsibilities of financial institutions in monitoring and reporting suspicious customers or transactions. Once a country establishes this institutional framework, regulatory authorities must monitor the financial sector effectively to ensure that financial institutions fulfill their counter-proliferation finance obligations.

Since export controls are closely linked to effective financial controls for WMD proliferation, Southeast Asian countries will need to implement export control systems, another requirement of UNSCR 1540.⁸³ Export control systems should include financial components to ensure that exporters provide adequate information for relevant licensing and shipping documents, enabling financial institutions to be confident that they are not facilitating proliferation-related transactions. These components will also allow export control authorities, financial institutions, and regulatory authorities to investigate information submitted by exporters. Overall, additional export controls increase the likelihood of detection of illicit trade, deterring such conduct.

83 FATF, "Combating Proliferation Financing: A Status Report on Policy Development and Consultation," 2010, <<http://www.fatf-gafi.org/media/fatf/documents/reports/Status-report-proliferation-financing.pdf>>.

Southeast Asian countries should also encourage effective coordination between export control authorities and financial institutions on both a case-by-case basis and more generally. Coordination mechanisms should include regular meetings to share expertise and exchange views on how to counter proliferation finance. Export control authorities and financial institutions should also establish open and accessible lines of communication for questions and concerns regarding proliferation finance and similar issues.

Southeast Asian financial institutions must also include counter-proliferation finance measures in their “Know Your Customer” practices and compliance programs, which include risk management, audits, internal controls, and training activities. Institutions should scrutinize financial activities of their customers trading in dual-use goods, striving to detect if such customers attempt to divert these goods toward proliferation-related purposes. Given the complexity of many proliferation-related transactions and the effort procurement networks undertake to disguise the true nature of their activities, financial institutions are unlikely to conduct these activities rigorously without a regulatory obligation to do so.

Southeast Asian governments need to include another critical obligation in their legal frameworks governing financial institutions: mandated reporting of suspicious activities to their respective financial intelligence units (FIUs). Specific regulations would provide a legal basis for suspicious activity reporting and legal immunity for the employees of financial institutions for disclosing customers’ financial data within SARs. Additionally, financial institutions will more likely report suspicious activity when they may face legal penalties if they fail to do so.

2.3. REGIONAL COORDINATION

Southeast Asian countries should consider establishing new regional initiatives or better utilizing existing ones for cooperation and coordination in countering proliferation finance. Given the absence of international standards to address the proliferation finance threat, regional organizations or initiatives can play a critical role in developing standards and model legislation, which may serve as guidance for countries before adopting their own frameworks. Model legislation should take into account regional dynamics and can assist other countries in the region to adopt similar countermeasures. Such arrangements might also provide forums to share expertise, exchange views, and, in turn, allow regional countries to coordinate their rules and regulations to address proliferation financing.

The ASEAN Regional Forum—established in 1994—could be used as a platform to discuss issues in combating proliferation finance since the forum seeks to enhance dialogue and consultation on political and security issues in the Asia-Pacific region. With its twenty-seven member states, the forum often engages members in the subjects of nonproliferation and disarmament among other major national security issues.⁸⁴

84 ASEAN Regional Forum, “About Us,” <<http://aseanregionalforum.asean.org/events.html?id=467>>.

The APG is another regional organization that mainly deals with AML and CFT.⁸⁵ However, the APG has shown considerable interest in proliferation finance issues and has conducted several projects and workshops to raise awareness among its members and assist them in improving their anti-proliferation finance systems. In the course of its activities, the APG identifies the vulnerabilities of its members and provides guidance on addressing their deficiencies. The organization also allows members to provide technical assistance to one another regarding the implementation of counter-proliferation finance systems.⁸⁶ Southeast Asian countries should thus request technical assistance from the APG before drafting their legislation on combating proliferation finance and establishing rules to implement these laws.

Southeast Asian countries can also use the Egmont Group of Financial Intelligence Units as another platform to discuss issues on proliferation finance. Established in 1995, the Egmont Group enables its members to reciprocally exchange information on ongoing cases and provides technical assistance to enhance members' AML/CFT systems. The Group has two tools for information exchanges among their members: Memoranda of Understanding (MoUs) and the Egmont Secure Web. Therefore, although the Egmont Group is not a regional organization, it can still provide a forum for Southeast Asian countries to communicate about regional proliferation finance concerns.

Southeast Asian countries may also consider signing Memoranda of Understanding with each other to show their willingness to cooperate with trusted partners, and they should include information exchanges for proliferation finance in the content of the MoUs. In addition, Southeast Asian countries should take advantage of their access to the Egmont Secure Web and share information confidentially with each other on proliferation finance both "upon request" and "spontaneously" when they encounter information that may be relevant to other Southeast Asian countries.⁸⁷

NEXT STEPS FOR SOUTHEAST ASIAN FINANCIAL INSTITUTIONS

Even if their respective countries do not specify the financial institutions' responsibilities to protect against proliferation finance, these institutions should still implement, to the extent possible, Security Council sanctions for the sake of their own benefit and reputations. Without violating their domestic regulations, financial institutions can monitor updates of the Security Council's lists of sanctioned parties and may be able to take action against designated persons promptly, even prior to receiving guidance from relevant national authorities.

85 Asia/Pacific Group on Money Laundering, "APG History & Background," <<http://www.apgml.org/>>.

86 Malaysia and Singapore are the only Southeast Asian countries that provide technical assistance to requesting Asia/Pacific Group countries.

87 Egmont Group of Financial Intelligence Units, "About," <<http://www.egmontgroup.org/about>>.

In addition, financial institutions in the region—particularly banks—should comply with US regulations in order to maintain their correspondent accounts with US financial institutions. Given the preference of the US dollar in international trade and transactions, Southeast Asian banks need access to the US banking system. Therefore, they should follow lists of sanctioned parties issued by the US Treasury Department’s OFAC, which includes more individuals and entities than Security Council lists, in order to cease processing transactions for named individuals and entities, freeze their assets, and decline to open new accounts for them. This step protects Southeast Asian financial institutions from facing third-party sanctions from US authorities.

Southeast Asian financial institutions should also investigate whether their customers include relatives or close associates of designated persons under the UN and the US lists. As the case *US vs. Tsai* demonstrated, the relatives of designated individuals can all too easily conduct financial transactions on behalf of designated family members.⁸⁸ Financial institutions can at least regard the relatives of the designated persons as high-risk parties and subject them to enhanced due diligence measures, such as more frequent monitoring.

In addition to implementing list-based controls, regional financial institutions should also attempt to detect and prevent proliferation-related activities that attempt to use their institutions. These institutions should first include proliferation finance risks among their existing risk assessments and CDD practices. Financial institutions must understand the proliferation finance risks they face and develop enhanced due diligence policies and processes to manage such risks; for instance, institutions can ask for additional information about sources and final destinations of funds or purposes of transactions when they encounter activity potentially related to proliferation finance.

These controls may also include more frequent and in-depth screening of accounts and transactions of high-risk customers. Given bank employees’ lack of technical expertise and knowledge about WMD-sensitive items, screening for trade involving such items might be difficult for financial institutions to conduct. However, institutions can carry out such screening in cases where the customer has other risk indicators along with engaging in dual-use trade, including having a relative designated for WMD activities or inconsistencies between a customer’s business activity and financial transactions. Because terrorism financiers who utilize legitimately obtained funds use similar techniques to disguise the true destinations of money transfers and ultimate end-users of sensitive goods, financial institutions should adapt measures for combating terrorism finance to combating proliferation finance.

Finally, Southeast Asian financial institutions should adopt internal controls to identify proliferation-related activities and take follow-up actions once they encounter suspicious financial activity. Even if the institution is not obligated to file a SAR or if they are prohibited from disclosing financial information of their customers, they should consider reporting the suspicious activities to

88 United States Court of Appeals, Ninth Circuit, UNITED STATES of America, Plaintiff-Appellee, v. Hsi Hwei TSAI, Defendant-Appellant, Decided: March 05, 2002, <<http://caselaw.findlaw.com/us-9th-circuit/1443350.html>>.

their FIUs voluntarily. These SARs comprise a critical component of authorities' ability to detect proliferation finance activity.

CONCLUSION

International groups, individual governments, and financial institutions must take action to create a comprehensive counter-proliferation finance regime. Action by Southeast Asian governments and their financial institutions would enable the region to fulfill its potential as an important component of that regime, as North Korea continues to exploit vulnerabilities in those countries' financial systems. Therefore, Southeast Asian countries must complete their national action plans drawn up at the August 2016 Seoul APG workshop, representing a significant potential improvement in the current regime. These countries should also incorporate the recommendations outlined in this study. Further assistance from states with more advanced financial controls will continue to be critical for achieving these goals, and Southeast Asian countries should seek technical guidance from regional leaders such as Malaysia and Singapore. Southeast Asian countries must therefore take swift action to protect themselves from North Korean abuse and potential loss of reputation and access to critical markets abroad.

CHINPO SHIPPING: A SINGAPOREAN FINANCIAL AGENT OF NORTH KOREA

1. BACKGROUND AND INTRODUCTION

North Korea has maintained and advanced its nuclear and ballistic missile programs despite more than a decade of extensive sanctions imposed by the UN Security Council, the United States, and the European Union. North Korea has used various techniques—including shell companies, indirect payment methods, and foreign intermediaries—to circumvent these sanctions and obtain required materials for its prohibited weapons programs.⁸⁹ Ocean Maritime Management (OMM), a North Korean shipping company controlled by the Korean Ministry of Land and Marine Transport, has employed sophisticated techniques to evade sanctions and played a key role in North Korea's WMD activities through the transport of conventional arms, a major source of revenue for the regime of Kim Jong Un.⁹⁰ Highlighting the critical role OMM plays in North Korea's prohibited activities, Adam J. Szubin, then acting US Under Secretary of the Treasury for Terrorism and Financial Intelligence, noted: "Arms shipments transported by OMM serve as a key resource for North Korea's ongoing proliferation activities. Sales from these shipments contribute to North Korea's other illicit programs."⁹¹

To circumvent monitoring by authorities around the world, OMM works through a number of companies and representatives in Southeast Asian countries, such as Malaysia, Thailand, and Singapore. One such intermediary, Singapore-based Chinpo Shipping Company (Private), Ltd, facilitated OMM's activities by acting both as OMM's shipping agent and as its payment agent for all purposes, including OMM's shipping business in Singapore.⁹² However, in July 2013, both OMM's and Chinpo's activities were exposed when Panamanian authorities seized the vessel *Chong Chon Gang*, which was carrying conventional arms and equipment to North Korea. The investigations pertinent to this case resulted in the UN Security Council belatedly designating OMM in July 2014 as a target of sanctions and revealed the financial transactions that Chinpo carried out on behalf of North Korean entities.⁹³

89 UN Security Council, 1718 Sanctions Committee (DPRK), "Panel of Experts Report for 2014," February 23, 2015, <http://www.un.org/ga/search/view_doc.asp?symbol=S/2015/131>.

90 UN Security Council, 1718 Sanctions Committee (DPRK), "Panel of Experts Report for 2015," February 24, 2016, <http://www.un.org/ga/search/view_doc.asp?symbol=S/2016/157>.

91 US Department of Treasury Press Release, "Treasury Sanctions Supporters of North Korea's Ocean Maritime Management Company and Updates Sanctions," July 23, 2015, <<https://www.treasury.gov/press-center/pressreleases/Pages/jl0130.aspx>>.

92 UN Security Council, "Panel of Experts Report for 2014."

93 The United States sanctioned OMM shortly after the Security Council. UN Security Council 1718 Committee, Ocean Maritime Management Company, Ltd, Reasons for Listing, October 29, 2014, p. 15, <<https://scsanctions.un.org/fop/fop?xml=htdocs/resources/xml/en/consolidated.xml&xslt=htdocs/resources/xsl/en/dprk.xsl>>. Department of Treasury Press Release, "Treasury Sanctions DPRK Shipping Companies Involved in Illicit Arms Transfers," July 30, 2014, <<https://www.treasury.gov/press-center/press-releases/Pages/jl2594.aspx>>.

The Chinpo Shipping case is the first known case in which the financing of proliferation-related activities was prosecuted and in which the concept of “proliferation financing” was interpreted by judicial authorities. This study will analyze this episode and demonstrate how improved implementation of suggested counter-proliferation finance measures could have prevented the shipment of arms at the center of this case.

2. CHINPO SHIPPING COMPANY (PRIVATE) LTD.

Chinpo Shipping was incorporated on August 11, 1970, as a Singaporean shipping agent and ship chandelling company.⁹⁴ This company was initially a small business run by Tan Cheng Hoe and his family. Tan originally set up the company to handle the business of a vessel that he had purchased, acting as the director and appointing his two daughters to roles in the operations and management side. In the early 1980s, Korea Tonghae Shipping Co (“Korea Tonghae”), one of the largest ship operators in the DPRK, appointed Chinpo as its shipping agent. Upon this appointment, Tan set up Tonghae Shipping Agency (Private), Ltd (“Tonghae”), in Singapore as a shipping agent for Korea Tonghae, while Chinpo acted as the shipping agent for other DPRK shipping companies.

In the late 1990s, the DPRK government set up OMM to both manage the North Korean commercial fleet, including the *Chong Chon Gang*, and provide DPRK shipping crews for Chinese ships. After OMM’s establishment, Chinpo and Tonghae began to provide transportation-related services to OMM. However, in 2005, after US warnings to international banks to avoid transactions with North Korea, OMM became unable to open a bank account in Singapore and realized that its transactions would trigger scrutiny from financial institutions.⁹⁵ Consequently, Chinpo Shipping, as OMM’s Singaporean agent, agreed to execute financial transactions for OMM through Chinpo’s account with the Singapore branch of Bank of China. Chinpo collected payments due OMM for its freight services, and after reimbursing its own costs for shipping services and paying OMM’s staff in Singapore, Chinpo remitted excess funds to various overseas entities as instructed by OMM.⁹⁶ Over the years, given its long-standing business relationship with OMM, Chinpo Shipping conducted financial transactions on behalf of OMM without apparently questioning the purpose of those remittances. Chinpo also created separate Excel sheets, including data titled “operation account, ship purchase

94 Singaporean Trade Registry, <<https://www.sgpbusiness.com/company/Chinpo-Shipping-Company-Private-Limited>>. Ship chandelling is the provision of supplies or equipment for ships.

95 The US warnings came after the United States designated Macao-based Banco Delta Asia, on September 15, 2005, as a financial institution of primary money laundering concern because of its involvement in North Korea’s illicit activities. The United States simultaneously announced a proposed ruling that would have excluded the bank from the US financial system. US Department of the Treasury Press Release, “Treasury Designates Banco Delta Asia as Primary Money Laundering Concern under USA PATRIOT Act,” 2005, <<https://www.treasury.gov/press-center/press-releases/Pages/js2720.asp>>; David Lague and Donald Greenlees, “Squeeze on Banco Delta Asia Hit North Korea Where It Hurt,” *International Herald Tribune*, January 18, 2007, <<http://www.nytimes.com/2007/01/18/world/asia/18iht-north.4255039.html>>.

96 *Public Prosecutor v Chinpo Shipping Company (Private) Limited*, [hereafter Chinpo Shipping case (District Court)] [2016] SGDC 104, Prosecution’s Submissions at the Close of Trial, December 14, 2015 [hereafter Prosecution’s Submissions].

account, and crew wages account,” to track incoming and outgoing payments, as well as other transactions related to its business with OMM.⁹⁷

In addition to his business activities with OMM and other North Korean entities, Tan built a close relationship with North Korean officials, even allowing the North Korean embassy in Singapore to use a portion of Chinpo’s office space as its diplomatic mission without cost. The embassy listed Chinpo’s address as its mailing address, and Tan was appointed as a “security guard” to enter the embassy’s office and collect embassy mail.⁹⁸ Furthermore, the DPRK embassy did not assign a permanent diplomat to run the embassy’s day-to-day work, so Tan often filled the void.

In addition to these affiliations, Tan acted as a primary contact for connecting North Korean and Singaporean companies. For example, he facilitated the employment of North Korean workers in Singapore, a practice that the Singaporean Ministry of Manpower later terminated. Additionally, North Korean and Singaporean business partners sometimes engaged Tan as an intermediary to resolve business disputes. Singtel—Singaporean Telecoms Company—for instance, asked for Chinpo’s help with a North Korean client’s unpaid bills.⁹⁹ Chinpo Shipping also acted as an intermediary between Chinese enterprises and a DPRK contact with regard to exploratory oil drilling activities in North Korea.¹⁰⁰

2.1. NORTH KOREA’S ATTEMPTED ARMS SMUGGLING AND CHINPO’S INVOLVEMENT

On July 13, 2013, Panamanian authorities interdicted the *Chong Chon Gang*—a DPRK flagged vessel operated by OMM—under suspicion of carrying drugs.¹⁰¹ Although the ship’s local agent declared that the vessel carried only sugar, Panamanian authorities found concealed military hardware on board after searching the vessel. Under 10,000 tons of sugar, the *Chong Chon Gang* held twenty-five containers and six trailers of military equipment, including two disassembled MiG 21 jet fighters, anti-tank rockets, and SA-2 and SA-3 surface-to-air missile systems, and their components.¹⁰² The US Department of Treasury noted that the hidden arms and related materiel aboard the *Chong Chon Gang* constituted the largest arms shipment to or from North Korea that had been seized

97 Ibid.

98 Ibid.

99 Jennifer Dodgson and Leo Byrne, “Court Case Reveals Chinpo Shipping’s Ties to North Korea,” *NK News*, September 10, 2015, <<http://www.nknews.org/2015/09/court-case-reveals-chinpo-shippings-ties-to-north-korea/>>.

100 Ibid.

101 BBC News, “Panama: North Korea Ship to Cuba Broke Arms Embargo,” August 29, 2013, <<http://www.bbc.com/news/world-latin-america-23873277>>.

102 Elena Chong, “Singapore Firm Convicted of Facilitating Payment to Ship Arms and Related Materiel to North Korea,” *Straits Times*, December 14, 2015, <<http://www.straitstimes.com/singapore/courts-crime/singapore-firmconvicted-of-facilitating-payment-to-ship-arms-and-related>>.

by authorities since 2006, following the passage of the first Security Council Resolution prohibiting shipments of arms to and from North Korea as part of a larger suite of sanctions.¹⁰³

Investigations revealed that the concealed military cargo was loaded in Cuba and bound for North Korea. Without explaining the reason for hiding the military goods under tons of sugar, Cuban authorities admitted that the ship was transporting 240 tons of “obsolete” defensive weapons.¹⁰⁴ Cuban and North Korean authorities argued that they transferred the weapons and equipment for repair in North Korea, and the weapons would be returned to Cuba. However, even if the military cargo was “obsolete,” the shipment itself violated relevant Security Council sanctions resolutions, which prohibit the transfer of any type of arms and related materials to North Korea.

Although a different DPRK company owned the *Chong Chon Gang*, OMM managed the vessel and arranged the attempted shipment of arms and related materiel to North Korea. OMM provided the captain and crew, instructed them to hide the military equipment under bags containing sugar, and provided them with false documentation to submit to Panamanian authorities.¹⁰⁵ Additionally, OMM instructed Chinpo Shipping to pay the vessel’s Panama Canal user fees. Upon this instruction, on May 28, 2013, Chinpo transferred US\$54,270 from its account in the Bank of China to a Panamanian shipping agent, CB Fenton and Co, SA, for the ship’s eastbound passage through the Panama Canal. For the vessel’s return passage, on July 8, 2013, Chinpo transferred US\$72,017 to the same shipping agent.¹⁰⁶ These details came to light as Panamanian authorities and UNSCR 1718 Committee Panel of Experts pursued their respective investigations of the case.

By arranging such a shipment, OMM violated the weapons embargo and other measures imposed against North Korea by UNSCR 1718 (2006) and modified by UNSCR 1874 (2009). Despite OMM’s violation of Security Council resolutions, the UN Security Council did not designate it on sanctions lists until a year later. Martin Uden, the former head of the UN Panel of Experts responsible for the incident’s investigation, described the failure of the 1718 Sanctions Committee to take action against OMM as “more regrettable” than its violation of UN sanctions.¹⁰⁷ Five days after Uden’s statement, on July 28, 2014, the 1718 Sanctions Committee added OMM to the UN Consolidated List of [Sanctioned] Individuals and Entities but failed to add other companies involved in the shipment, including Chinpo Shipping.¹⁰⁸ Two days after the Security Council’s designation of OMM, the US Department of Treasury imposed sanctions upon both OMM as the ship’s manager

103 US Department of Treasury Press Release, “Treasury Sanctions DPRK Shipping Companies Involved in Illicit Arms Transfers.”

104 Mariano Castillo, Catherine E. Shoichet, and Patrick Oppmann, “Cuba: Obsolete Weapons on Ship Were Going to North Korea for Repair,” CNN, July 17, 2013, <<http://www.cnn.com/2013/07/16/world/panama-north-korean-ship/>>.

105 US Department of Treasury Press Release, “Treasury Sanctions DPRK Shipping Companies Involved in Illicit Arms Transfers.”

106 Elena Chong, “Singapore Firm Convicted of Facilitating Payment to Ship Arms and Related Material to North Korea,” *The Straits Times*, December 14, 2015, <<http://www.straitstimes.com/singapore/courts-crime/singapore-firmconvicted-of-facilitating-payment-to-ship-arms-and-related>>.

107 Leo Byrne, “North Korea Likely Still Breaking UN Sanctions-Martin Uden,” *NK News*, March 17, 2016, <<http://www.nknews.org/2014/07/north-korea-likely-still-breaking-un-sanctions-martin-uden/>>.

108 Joshua Stanton, “North Korea: The Myth of Maxed-Out Sanctions,” *Fletcher Security Review*, January 21, 2015, <<http://www.fletchersecurity.org/#!stanton/c1vgi>>.

and Chongchongang Shipping Company as the ship’s owner.¹⁰⁹ However, the US Department of Treasury similarly declined to place Chinpo Shipping on its sanctions list.

3. LEGAL PROCEEDINGS REGARDING CHINPO’S MONEY TRANSFERS

However, after the disclosure that Chinpo had been involved in North Korea’s arms smuggling attempt, Singaporean authorities launched an investigation into the company’s activities. At the end of the initial investigation, on June 10, 2014, Singaporean police authorities indicted Chinpo and its director, Tan, on criminal charges.¹¹⁰ At the end of the trial, on December 14, 2015, the company was found guilty of both transferring funds that could have been used to support the DPRK’s nuclear program and running a remittance business without a valid remittance license. With respect to the first charge of financing proliferation, the district judge ruled that although Tan’s actions clearly surpassed simple negligence, he did not act “deliberately and with intent” to make prohibited payments on behalf of Chinpo’s clients to support their illegal activities. Rather, the court decided that Tan had irresponsibly disregarded the nature of the transactions at issue:

There were circumstances which called for enquiry but Chinpo took the position that it will pay to whoever the DPRK entities wanted them to pay and avoid any delays. They conducted no due diligence. Such irresponsible conduct must be effectively deterred. It was also relevant to consider the amount of arms and related materiel seized whose shipment would have been facilitated by the lack of due diligence.

As a result, instead of sentencing Chinpo to the highest possible fine, SD\$100,000 for each charge, the district judge sentenced Chinpo to an SD\$80,000 fine for the first charge and an SD\$100,000 fine for the second charge (a total of USD\$126,000).¹¹¹

However, as the following sections detail, the High Court of Singapore subsequently reversed the first conviction and cancelled the SD\$80,000 fine imposed by the district court. The appeals court decided that the lower court made a “large logical leap between transferring funds for the passage of a vessel through the Panama Canal (without knowing the presence of the Material on the vessel) and concluding that the transfer could contribute to the [nuclear program] of the DPRK.”¹¹² In short, the High Court found that Chinpo’s actions did not constitute financing of proliferation

109 US Department of Treasury Press Release, “Treasury Sanctions DPRK Shipping Companies Involved in Illicit Arms Transfers.”

110 Singapore Ministry of Foreign Affairs Press Release, “Joint MFA-MHA Press Statement in Response to Media Queries About the Criminal Charges Filed Against the Singapore-Registered Company Chinpo Shipping Company (Private) Limited,” June 10, 2014, <http://www.mfa.gov.sg/content/mfa/media_centre/press_room/pr/2014/201406/press20140610.html>.

111 *Chinpo Shipping Case (District Court)*, Written Judgment, April 29, 2016, paragraphs 161-167.

112 High Court of Singapore, *Chinpo Shipping Co (Pte) Ltd and Public Prosecutor, SGHC 108, 2017* [Hereafter *Chinpo Shipping Case (Appeal)*].

because financial transactions for Panama Canal passage did not contribute directly to North Korea's nuclear program.¹¹³

3.1. LEGAL PROCEEDINGS REGARDING VIOLATION OF UN SANCTIONS

The district court found Chinpo guilty of breaching Security Council sanctions on North Korea as incorporated into Singaporean law by transferring financial assets or resources that “may reasonably be used to contribute to” North Korea's nuclear weapons programs.¹¹⁴ The court imposed the fine on Chinpo pursuant to Article 12(b), titled “prohibition against provision of financial services and other resources” of Singapore's United Nations (Sanctions—DPRK) Regulations 2010. According to the article:

No person in Singapore and no citizen of Singapore outside Singapore shall—(a) provide any financial services; or (b) transfer financial assets or resources, or other assets or resources, that may reasonably be used to contribute to the nuclear-related, ballistic missile-related, or other weapons of mass destruction-related programs or activities of the Democratic People's Republic of Korea.

Therefore, to find Chinpo and its director, Tan, guilty of proliferation financing under Article 12(b), the court had to establish a link between the attempted transfer of the conventional weapons found aboard *Chong Chon Gang* and a potential contribution to the DPRK's WMD or related missile activities. In other words, if the concealed conventional weapons did not potentially support the DPRK's illicit WMD programs, then no legal basis existed for finding Chinpo guilty of a proliferation finance offense. This obstacle exists because of Article 12(b)'s narrow coverage, which prohibits the provision of financial services for WMD or related missile activities—but not the provision of financial services for other activities prohibited by Security Council sanctions resolutions, including those related to transfers of conventional weapons.¹¹⁵

A prosecution witness at Chinpo Shipping's trial in Singapore, Graham Ong-Webb, a research fellow at the S. Rajaratnam School of International Studies, testified that although the arms and related material found on the *Chong Chon Gang* were not directly nuclear-related, they could potentially protect North Korea's nuclear weapons program. According to Ong-Webb, the surface-to-air missile

113 Andrea Berger, “The Chinpo Shipping Case Implodes,” Arms Control Wonk, May 15, 2017, <<http://www.arm-controlwonk.com/archive/1203164/guest-post-the-chinpo-shipping-case-implodes/>>.

114 Singapore Statutes Online, “United Nations (Sanctions-Democratic People's Republic of Korea) Regulations 2010,” <<http://statutes.agc.gov.sg/aol/search/display/view.w3p?page=0;query=DocId%3A%221f31fe09-c485-462e-9c141bcb615d598a%22%20Status%3Ainforce%20Depth%3A0;rec=0>>.

115 Article 12(b) of the Singapore's UN Regulations 2010 is in line with the Paris-based Financial Action Task Force's (FATF's) “working definition” of proliferation financing but is far narrower than framework of Security Council Resolutions 2094 (2013) and 2270 (2016), which ban provision of financing to other North Korean activities, as well. The FATF restricted its prohibitions under countering proliferation finance to WMD or missile-related activities, similar to Singapore's above-mentioned legislation. The FATF is a 36-member intergovernmental organization that sets international banking standards with respect to money laundering, the financing of terrorism, and the financing of proliferation. See the FATF website, <<http://www.fatf-gafi.org/>>.

systems (SA-2’s and SA-3’s) found on the vessel can be employed to “guard nuclear production, storage, and missile sites.”¹¹⁶ He noted that North Korea often used these systems to protect its nuclear sites from adversaries and possessed an estimated arsenal of 179 SA-2’s and 133 SA-3’s.¹¹⁷ Additionally, with respect to the two disassembled MiG-21 warplanes and related components, Ong-Webb contended that the warplanes could be armed to take down enemy fighters despite their typical use for training purposes, noting that North Korea’s air force uses a substantial number of MiG-21’s.

As a result of Ong-Webb’s arguments, the district court judge hearing the case ruled that Chinpo’s provision of financial services related to these weapons systems amounted to the financing of WMD proliferation as prohibited by Singaporean law. As previously noted, Singapore’s regulations banned the provision of financial assets or resources that “may reasonably be used to contribute to” North Korea’s nuclear weapons programs.

On appeal, however, the High Court of Singapore rejected this finding, declaring that the connection between remitting funds to cover transit fees of a vessel carrying the conventional arms seized in Panama and North Korea’s nuclear and missile programs was too tenuous to meet statutory standard.¹¹⁸ Examining UNSCR 1718 (2006) and relevant Singaporean laws, the High Court declared that the law:

... regulates only transfers that can be used to acquire assets that have a direct contribution to the nuclear proliferation efforts of the DPRK, i.e., the development of nuclear weapons. This is borne out in para 8(a)(ii) of Resolution 1718 by which the UNSC directed Member States to prevent the “supply, sale or transfer to the DPRK” of the assets set out in two lists supplied by France and supported by 36 other Member States. The UNSC believed that the assets set out on the two lists “could contribute to the DPRK’s nuclear-related ... programmes. [Emphasis, spelling, and ellipsis as in original.]”¹¹⁹

The two lists supplied by France to which the High Court referred are those used by 37-member Nuclear Suppliers Group, one list containing items especially designed or prepared for nuclear use and the other list containing nuclear-related dual-use items. The Nuclear Suppliers Group uses these lists to control exports of these items to ensure they are not used for nuclear-weapon-related

116 David Iaconangelo, “How North Korea’s Merchant Ships Became a Target for UN Sanctions,” *CS Monitor*, August 28, 2016, <<http://www.csmonitor.com/World/Asia-Pacific/2016/0828/How-North-Korea-s-merchant-shipsbecame-a-target-for-UN-sanctions>>.

117 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 35. /0828/How-North-Korea-s-merchant-shipsbecame-a-target-for-UN-sanctions>. *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 35.

118 High Court of Singapore, *Chinpo Shipping Co (Pte) Ltd and Public Prosecutor*.

119 High Court of Singapore, *Chinpo Shipping Case (Appeal) Judgment*, paragraph 61.

purposes. The conventional weapons carried by the *Chong Chon Gang*, in contrast, could not be directly used in a nuclear program.¹²⁰

On this basis, the High Court found Chinpo Shipping not guilty of violating the anti-proliferation financing provision of Singapore's regulations and annulled the SD\$80,000 fine imposed by the district court judge.

3.2. LEGAL PROCEEDINGS REGARDING VIOLATION OF SINGAPOREAN FINANCIAL RULES

As noted, the district court also convicted Chinpo of running a remittance business without a valid remittance license in addition to its proliferation financing conviction.¹²¹ The High Court also considered this matter in Chinpo's appeal and affirmed the lower court's second conviction.

In its judgment on the case, the Singaporean district court revealed that between April 2, 2009, and July 3, 2013, Chinpo used its account in the Bank of China to conduct 605 outward remittances on behalf of various North Korean entities, which amounted to more than US\$40 million.¹²² Because of international banks' reluctance to deal with North Korea, the court noted, entities such as OMM could not open bank accounts in Singapore and conduct fund transfers there. Chinpo Shipping agreed to act as OMM's payment agent, charging DPRK entities US\$50 for each transaction.¹²³ Ship owners and ship operators, including OMM, transferred revenue received for their freight services to Chinpo's account in the Bank of China's Singapore branch, often disguising the origin of the funds, and then instructed Chinpo via e-mail to transfer various amounts to other parties. The prosecutor in the case argued that Chinpo's outward remittances constituted "one of the largest amounts ever remitted illegally" in a four-year period.¹²⁴

Chinpo, however, never obtained a license to conduct these remittances as required by the Monetary Authority of Singapore (MAS). This licensing requirement seeks to prevent money laundering and terrorism financing in addition to allowing MAS supervision of licensed institutions' implementation

120 The High Court also rejected the argument that the surface-to-air missiles among the vessel's cargo contributed to North Korea's nuclear program because they could be used to defend the country's nuclear sites. The court noted that the expert witness who had introduced this argument had acknowledged that the missiles and the other conventional armaments "do not perform a nuclear role..."; High Court of Singapore, *Chinpo Shipping Case (Appeal) Judgment*, paragraph 73.

121 Anna Fifield and Monica Miller, "Singaporean Company Guilty of Transferring Money for North Korea," *The Washington Post*, December 14, 2015, <https://www.washingtonpost.com/world/singaporean-company-guilty-of-transferring-money-for-north-korea/2015/12/14/e88f322a-a26a-11e5-8318-bd8caed8c588_story.html>.

122 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 152.

123 If Chinpo conducted more than one operation in a day for the same ship owner, it charged only US\$50; Andrea Berger, "Thanks to the Banks: Counter-Proliferation Finance and the Chinpo Shipping Case," *38 North*, December 16, 2015, <<http://38north.org/2015/12/aberger121615/>>.

124 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 169.

of obligations, including due diligence practices and reporting clients’ suspicious activities.¹²⁵ According to Singaporean regulations, such remittance companies must also conduct enhanced due diligence (EDD) on any person or company located in jurisdictions known to have inadequate AML/CFT legislation and practices in place. North Korea is one of these jurisdictions and had been declared deficient in this respect in “public statements” issued by the FATF.¹²⁶

In addition, EDD should have been applied to the high-risk situations associated with OMM and its activities in this case. Since Chinpo’s DPRK business partners, including OMM, were all North Korean companies operating in a high-risk industry, namely shipping, Chinpo had reason to know that it dealt with high-risk businesses, which EDD practices could have further illuminated. Performing EDD thus could have led Chinpo to question the activities of its DPRK clients and even consider terminating its business relationships with them. However, Chinpo failed to both obtain a license from the MAS and conduct all necessary financial controls before carrying out money transfers. Operating without a license allowed Chinpo not only to avoid supervision by MAS but also to violate Singaporean law.

Therefore, on appeal, the High Court affirmed the lower court’s conviction of Chinpo on the remittance charge and sustained the lower court fine of SD\$100,000. The High Court reinforced the point that Chinpo had realized financial gain from this activity, noting the lower court’s finding that Tan had received an interest free loan of more than SD\$1 million from a North Korean party linked to Tan’s remittance activities.¹²⁷

4. ANALYSIS AND LESSONS OF THE CASE

Investigations after the *Chong Chon Gang* incident revealed how Chinpo managed to use its bank account to facilitate North Korean entities’ sanctions evasions for many years without detection. Two key factors appear to have permitted these violations to occur for such a long period of time: first, Chinpo’s unquestioning execution of instructions from OMM and other North Korean entities along with its failure to inquire into the nature of the transactions it facilitated; and, second, the failure of the Bank of China to exercise appropriate scrutiny of Chinpo’s activities.

125 This entails reviewing customers and their transactions more closely at account opening and more frequently throughout the term of their relationship with the bank. For a general discussion, see “Customer Due Diligence— Overview,” *Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Infobase*, <https://www.ffc.gov/bsa_aml_infobase/pages_manual/OLM_013.htm>.

126 For the FATF’s latest Public Statement, which continues to list North Korea, see: “High-Risk and Non-Cooperative Jurisdictions,” June 23, 2017, <<http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-june-2017.html>>. For background on the FATF see note 27, above.

127 *High Court of Singapore, Chinpo Shipping Case (Appeal)*, paragraph 114.

4.1. ANALYSIS OF CHINPO'S ACTIONS

During investigations of the *Chong Chon Gang* incident, authorities observed that Chinpo Shipping had not conducted any due diligence, including questioning the purposes or sources of money transactions from the DPRK. The company also did not put forward evidence of any prior effort to understand the purpose of the financial transfers that it carried out based on OMM's instructions and the information OMM provided about cargo aboard its vessels. Although Chinpo claimed to have been unwittingly involved in OMM's arms smuggling attempt when it paid the *Chong Chon Gang's* costs of passage through the Panama Canal, the company had many reasons to suspect that the money transfers it carried out for OMM in this case could contribute to North Korea's illicit programs.

First, before the seizure of *Chong Chon Gang*, when the Bank of China reviewed the planned payment of the east-bound transit of the vessel through the Panama Canal, the bank asked for details of the cargo loaded on the vessel and its consignee, as well as for the bill of lading. Because Chinpo did not know the details about the cargo, OMM provided the bill of lading to Chinpo on which OMM declared the cargo as 10,201 metric tons of hot rolled steel plates.¹²⁸ The Bank of China rarely questioned the business activities of its long-standing client, Chinpo, but the bank's unusual enquiries about the cargo aboard the *Chong Chon Gang* should have alerted Chinpo that the vessel might be engaged in high-risk activities.

Additionally, OMM's requests for changing the vessel's name in financial transactions should have also prompted Chinpo to question OMM's money transfers. OMM asked Chinpo whether it had already listed the ship's name as *Chong Chon Gang* for the received freight, and if not, OMM asked Chinpo to declare the vessel name falsely as MV South Hill 2.¹²⁹ In this request, OMM attempted to conceal the prior activities of the *Chong Chon Gang* and obscure the source of the funds that Chinpo would transfer for the Panama Canal costs. Despite this request, Chinpo did not apparently make any effort to learn the purpose of the remittance transactions or conduct any due diligence regarding these transactions.

Third, concerning the two outward transfers to the Panamanian shipping agent, CB Fenton and Co, SA, the Bank of China asked Chinpo to provide the following information: "contract to support the remittance to CB Fenton, invoice to support the remittance amount, purpose of the remittance, information relating to Chinpo's role in this shipping arrangement."¹³⁰ Because Chinpo did not know the details of these payments, it asked OMM for further information. Chinpo had been a client of the Bank of China for 20 years, which knew of the company's North Korean business, but this was one of the few times that the bank inquired about Chinpo's outward remittances.¹³¹ Even after the bank's inquiries regarding the *Chong Chon Gang's* cargo and Chinpo's payments, however, Chinpo did not raise questions regarding the appropriateness of OMM's activities.

128 Ibid.

129 Ibid.

130 Ibid.

131 Ibid.

Chinpo claimed it simply maintained OMM’s funds by receiving its freight payments for OMM and using these funds pursuant to OMM’s instructions. Arguing that the monies it transferred for OMM did not belong to Chinpo, Tan asserted that Chinpo lacked the right to question the origin or uses of OMM’s funds, and Chinpo applied the same principle applied to other entities it serviced. Chinpo would only obtain supporting documents from the vessel managers if the bank involved in a transfer asked for them. The district judge in the Chinpo prosecution, however, found that Chinpo did have a legal duty to make due diligence inquiries and penalized it for failing to do so.

The investigations also found that beginning in 2010, Chinpo asked its DPRK clients to exclude vessel names in in-bound deposit forms to avoid Bank of China’s scrutiny. Similarly, Chinpo omitted vessel names in out-bound transfer forms when conducting fund transfers for DPRK companies. To explain this practice, Tan argued before the court that when ship names had been included, US banks (which became involved in processing US dollar transactions) would ask additional questions and seek documents regarding ship owners and the freight charges at issue.¹³² Tan further contended that, on some occasions, the banks he dealt with refused to process the transaction orders after long delays. To avoid such difficulties, Tan had ceased mentioning vessel names on transfer documents.¹³³

In addition, Tan also claimed that one of the employees of the Bank of China advised him not to include vessel names in remittance forms.¹³⁴ Whether instructed by an employee of the Bank of China or not, Tan and Chinpo clearly obfuscated the involvement of DPRK entities by not disclosing ship names in financial documents. However, the court did not find that Chinpo had engaged in this practice “deliberately and with intent” to advance North Korea’s prohibited programs.

4.2. ANALYSIS OF THE BANK OF CHINA’S ACTIONS

The investigation of the Chinpo case disclosed how the Bank of China’s weak implementation of financial controls directly contributed to the bank’s role as a conduit for financing North Korea’s shipping activities. The preventive measures that the bank failed to execute included those regarding customer due diligence, determination of beneficial ownership, special scrutiny of high-risk countries and businesses, and reporting of suspicious transactions involving Chinpo Shipping and Tan.

Although Tan had been a customer with the Bank of China for more than twenty years and, according to Tan, the bank knew of his North Korean business, the bank apparently did not subject Tan and Chinpo to even basic due diligence scrutiny. Considering Chinpo’s business and personal relationship with North Koreans and the rogue country’s deceptive techniques for sanctions evasion, the Bank of China had a duty to investigate issues, such as the beneficial ownership of Chinpo’s account at the bank. The investigation highlighted Chinpo and OMM’s unique business relationship when the prosecutor questioned one of Chinpo’s employees and she repeatedly referred to OMM

132 Ibid.

133 Ibid.

134 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 144.

as Chinpo's owners.¹³⁵ Later, the employee denied the existence of an ownership relation between the two companies by claiming a grammatical error in her earlier reference to OMM. However, as a practical matter, Chinpo undoubtedly acted as OMM's agent for all purposes, not merely for OMM's shipping activities in Singapore. If the bank had observed the intermediary role of Chinpo as a North Korean payment agent controlled by OMM, it might have taken action to curtail dealings with Chinpo. Furthermore, if the bank had scrutinized Chinpo's account activities and/or the pattern of its transactions, the bank might have discovered the firm's role as an agent for a number of North Korean entities in addition to OMM and acted to restrict its dealings in those cases.

Because of the bank's poor implementation of due diligence practices, it did not recognize (or simply ignored) the inconsistencies between Chinpo's economic profile and the massive circulation of funds in its account. As a result of Chinpo's position as a payment agent, the company held substantial amounts of funds belonging to DPRK entities, ranging from US\$3.6 million to US\$6.8 million between 2008 and 2012.¹³⁶ Moreover, Chinpo's outward remittances amounted to more than US\$40 million between 2009 and 2013. In contrast to the huge sums flowing into and out of Chinpo's accounts, Chinpo's provision of ship servicing activities fell off dramatically during this period, declining from supporting fifty-seven vessels in 2010 to supporting only four in 2013.¹³⁷ Chinpo Shipping was a small family-run company in the shipping services business and had experienced financial difficulties over the years, so its dealings with disproportionate amounts of money relative to its sector and economic conditions should have triggered concern at the Bank of China.

Moreover, the bank should have regarded Chinpo's business dealings with North Korean entities and its apparent friendship with North Koreans as high-risk, in themselves. These obvious red flags, even excluding any concerning the arms smuggling incident, should have been sufficient to cause the bank to frequently monitor and question Chinpo's account activities. Considering the risk associated with Chinpo, the bank should have regarded the company as a high-risk customer and conducted EDD, inquiring more deeply into the purposes and sources of Chinpo's transactions or subjecting its transaction requests to approval by a senior Bank of China officer. If the Bank of China could not mitigate the risks posed by Chinpo, it should even have considered terminating its business relationship with the firm and filing one or more SARs with relevant Singaporean authorities. Given the confidential nature of filing SARs, whether the bank took this step cannot be determined from public sources. However, the bank's poor implementation of other financial controls suggests that it did not do so.

During the trial, Tan did not specify which Bank of China employee advised him to strip vessel names from transactions, nor did the trial provide clarity as to whether the alleged information stripping resulted from a policy of the Bank of China or represented the actions of a rogue employee violating the bank's rules. Regardless, the Bank of China had the ultimate responsibility for the behavior of its employees and for ensuring effective implementation of its due diligence requirements.

135 Ibid.

136 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 141.

137 *Chinpo Shipping Case (District Court)*, Written Judgment, paragraph 157.

This history suggests there may have been a number of important inquiries for the MAS to pursue regarding the past and current effectiveness of the Bank of China’s preventive financial measures, including CDD procedures, beneficial ownership inquiries, EDD practices, and suspicious activity reporting.¹³⁸

4.3. ANALYSIS OF THE EFFICIENCY OF BANKS’ PREVENTIVE MEASURES

Proliferation finance specialist Andrea Berger has suggested that the Chinpo Shipping case reveals the success of worldwide financial institutions’ implementation of North Korean sanctions.¹³⁹ She argues that North Korean companies, including OMM and its staff, could not maintain bank accounts around the world because banks rejected North Korean business. Wells Fargo, she notes, declined to process Chinpo’s outward remittance to a North Korean ship owner, V-Stars Limited, for \$41,560 due to compliance concerns.¹⁴⁰ In another example, the United Overseas Bank in Singapore closed the bank account of Tan’s other company, Tonghae, on the grounds that Tonghae dealt with DPRK entities.¹⁴¹ Berger further adds that the delays and rejections of financial transactions by various banks, as Tan highlighted, also shows the disruptive impact of effectively implemented financial controls. As a result of such risk-minimizing practices and due diligence implementation, North Korean entities were forced to seek alternative ways to conduct money remittances, including employing Chinpo and other foreign companies and individuals as their payment agents.

This restriction of access to the financial system undoubtedly impacted DPRK entities as Berger argues. However, working through Chinpo, OMM and other North Korean entities performed over 600 transfers worth US\$40 million between 2009 and 2013. Thus, on the one hand, this case reflects success in that many financial institutions denied DPRK-related parties’ requests for financial services. On the other hand, however, the serious failure of the Bank of China to effectively implement financial control measures badly tarnished this success.

138 As for whether the Bank of China might be subject to US sanctions for allowing transactions on behalf of DPRK entities, see: Joshua Stanton, “Treasury Designates Singaporean Shipping Company for North Korea Weapons Trade, but What About the Bank of China?” *One Free Korea Blog*, July 24, 2015, <<http://freekorea.us/2015/07/24/treasurydesignates-singaporean-shipping-company-for-n-korea-weapons-trade-but-what-about-the-bank-of-china/>>.

139 Andrea Berger, “Thanks to the Banks: Counter-Proliferation Finance and the Chinpo Shipping Case,” *38 North*, December 16, 2015, <<http://38north.org/2015/12/ab Berger121615/>>. Ms. Berger is currently a Senior Research Associate at the James Martin Center for Nonproliferation Studies.

140 *Chinpo Shipping Case*, Written Judgment, April 29, 2016, Paragraph 61.

141 Prosecution’s Submissions at the Close of the Trial, Paragraph 71.

5. CONCLUSION

Thanks to the discovery of Chinpo's involvement in the *Chong Chon Gang* arms smuggling attempt and the Bank of China's Singapore branch's subsequent scrutiny of Chinpo's bank account, Chinpo's engagements additional DPRK entities also came to light, and Bank of China closed Chinpo's account.¹⁴² This case proved the investigative value of pursuing the financial dimensions of an illicit smuggling case, an important lesson for the future.

North Korea poorly disguised its clandestine banking activities through Chinpo and left numerous tell-tale indicators of illicit activity. Any financial institution with a capable CDD program would have observed multiple "red flags" that would have exposed Chinpo's North Korean connections and likely led to rejecting Chinpo's transaction requests, as seen in the case of Wells Fargo, and closing Chinpo's accounts, as seen in the case of United Overseas Bank. However, for whatever reason, the Bank of China failed to act on these indicators. Nonetheless, the Chinpo Shipping case suggests that if banks widely and consistently implement the customer and transaction monitoring tools recommended by the FATE, North Korea's ability to finance its proliferation activities could be significantly constrained.

The UN Security Council's financial sanctions strategy for addressing North Korean proliferation activity has mutated significantly since it first imposed sanctions in 2006. The Security Council no longer seeks merely to block transactions of concern and penalize parties directly involved in proliferation activities, but it now also aims to isolate the North Korean banking sector more generally to pressure the Kim regime to restrain its nuclear and missile programs. As highlighted in the 2016 report of the 1718 Committee Panel of Experts, North Korea has resorted increasingly to banking through entities based abroad, such as Chinpo Shipping, to defeat these restrictions.¹⁴³ Hopefully, compliance officers will further analyze this case as they seek to protect their financial institutions from future DPRK abuses. Regulatory authorities should also draw lessons from this episode. The most important lesson, perhaps, is the need for those authorities to carefully draft laws and regulations to cover all aspects of Security Council resolutions and effectively enforce the implementation financial controls in all institutions under their supervision.

142 As noted, the Chinpo Shipping case was partly reversed on appeal, and Tan was not found guilty of the proliferation finance offense. If Singapore's regulation providing for compliance with UN Resolutions had fully included UNSCR 1718, however, the regulation would have required a prohibition on the financing of conventional arms, which the resolution also prohibited. That, in turn, could have provided a solid foundation for convicting Tan on a separate count of facilitating a violation of that embargo.

143 UNSCR 1718 Committee (DPRK), "Panel of Experts Report for 2016," February 27, 2017, <http://www.un.org/ga/search/view_doc.asp?symbol=S/2017/150>.

DUE DILIGENCE AND THE PANAMA PAPERS EPISODE: LESSONS FOR PROLIFERATION FINANCE

1. INTRODUCTION

Despite extensive financial controls limiting North Korea's access to the global financial system, North Korea continues to successfully finance its nuclear and ballistic missile programs. North Korea utilizes a variety of techniques to circumvent sanctions, which includes using offshore jurisdictions with lax banking controls, shell companies, and foreign intermediaries. Southeast Asian countries are particularly vulnerable to North Korean abuse due to their relative geographic proximity to the DPRK and their comparatively weak export and financial control systems. Therefore, Southeast Asian countries must keep up to date with North Korea's methods of circumventing restrictions on the financing of activities prohibited by the Security Council and others. This study provides a detailed look at North Korea's creation of *de facto* banking institutions to disguise its financial activities and gain access to the international banking system.

The Panama Papers—a trove of documents obtained by a breach of the computer system of Panamanian law firm Mossack Fonseca and made available to a number of media outlets—highlight a number of North Korea's clandestine financing techniques, including the exploitation of confidentiality rules in offshore jurisdictions and services that law firms offer to clients who seek to disguise their financial dealings. The leaked documents also underline the significance of due diligence measures to counter proliferation finance, which should be applied by financial institutions and other relevant entities, such as law firms.

At the time of this writing, the media outlets with access to the Mossack Fonseca papers have disclosed and analyzed only a portion of the leaked documents. No instances of a Southeast Asian country's possible involvement in prohibited North Korean activities have yet been disclosed in the analyzed documents. Nonetheless, to protect themselves from unwittingly supporting such programs, Southeast Asian organizations, including law firms, need to take lessons from the revelations found in the Panama Papers thus far.

2. THE PANAMA PAPERS

In early May of 2016, the International Consortium of Investigative Journalists (ICIJ), a global network including more than 190 investigative journalists based in sixty-five countries,¹⁴⁴ gained

144 ICIJ, "About the ICIJ," <<https://www.icij.org/about>>.

access to 11.5 million leaked files—one of the largest information leaks to that date.¹⁴⁵ Initially, a leading German newspaper, *Süddeutsche Zeitung*, obtained the documents from an anonymous whistleblower and then shared them with the ICIJ in order to organize a collaborative global effort to analyze and report on the files. The leaked files contain massive e-mail chains, client records, invoices, bank accounts, scanned documents, transcripts, contracts, and other documents dating back four decades.¹⁴⁶ The documents revealed offshore assets and clandestine business activities of individuals and entities from over 200 jurisdictions, including prominent figures, such as heads of state, ministers, politicians, and members of the Ethics Committee of the Fédération Internationale de Football Association (FIFA).¹⁴⁷ Covering more than 210,000 companies, the Panama Papers disclose how many of these individuals exploited offshore jurisdictions to mask their financial wrongdoings, including tax evasion, financial fraud, money laundering, and bribery.¹⁴⁸

According to ICIJ reports, this misconduct centered on Panama-based law firm Mossack Fonseca, which has operated in more than thirty-five jurisdictions during the past forty years. The leaked documents reportedly provide a detailed account of how Mossack Fonseca incorporated and managed opaque offshore companies on behalf of its clients, concealing the ownership structures and purposes of these entities. Since offshore jurisdictions often require the presence of a local agent before permitting foreign organizations to operate, Mossack Fonseca acted as the local agent for the organizations it helped to set up in these jurisdictions.¹⁴⁹ As an agent of these newly created companies, the law firm often managed them and represented its clients before government agencies in offshore centers.

By registering companies under its name, Mossack Fonseca hid the identity details of the real owners of its companies in various public documents. In order to create companies, trusts, and foundations for its clients, Mossack Fonseca engaged with 14,000 law firms and financial institutions, including Deutsche Bank, HSBC, Société Générale, Credit Suisse, Commerzbank, and Nordea.¹⁵⁰ Mossack Fonseca set up more than 50 percent of the companies it incorporated in the British Virgin Islands (BVI), registering others in places such as Panama, the Bahamas, Anguilla, the Seychelles, Niue, and Samoa.¹⁵¹ Mossack Fonseca also created companies in the United Kingdom and in the US states of Delaware, Nevada, and Wyoming.¹⁵²

In addition to creating disguised corporate entities for celebrities and political leaders, Mossack Fonseca created anonymous shell firms or nominee companies for a range of notorious figures, including criminals, members of mafia groups, and sanctioned individuals. The leaked files demonstrate that

145 ICIJ, “Offshore Leaks Database,” <https://offshoreleaks.icij.org/#_ga=1.212057940.1178706368.1464897554>.

146 Frederik Obermaier, Bastian Obermayer, Vanessa Wormer, and Wolfgang Jaschensky, “About the Panama Papers,” *Süddeutsche Zeitung*, <<http://panamapapers.sueddeutsche.de/articles/56febff0a1bb8d3c3495adf4/>>.

147 Martha M. Hamilton, “Panamanian Law Firm is Gatekeeper to Vast Flow of Murky Offshore Secrets,” *The Organized Crime and Corruption Reporting Project (OCCRP)*, <<https://www.occrp.org/en/panamapapers/mossackfonseca/>>.

148 Ibid.; ICIJ, “The Panama Papers: An Introduction,” April 3, 2016, <<https://panamapapers.icij.org/video/>>.

149 Unitrust Capital Corporation, “Offshore International,” <<http://www.unitrustcapital.com/offshore-company/offshoreinternational.html>>.

150 ICIJ, “Explore the Panama Papers Key Figures,” <<https://panamapapers.icij.org/graphs/>>.

151 Martha M. Hamilton, “Panamanian Law Firm is Gatekeeper to Vast Flow of Murky Offshore Secrets.”

152 Emilia Diaz-Struck and Cecile Schilis-Gallego, “Beyond Panama: Unlocking the World’s Secrecy Jurisdictions,” *ICIJ*, May 9, 2016, <<https://panamapapers.icij.org/20160509-beyond-panama-secrecy-jurisdictions.html>>.

the Panamanian law firm worked with at least thirty-three individuals and entities designated by the US Treasury under programs sanctioning Iran, Syria, Zimbabwe, and North Korea.¹⁵³ Although some of those business relationships existed prior to the imposition of these sanctions, Mossack Fonseca continued to provide business services to those clients after the sanctions were imposed. Mossack Fonseca denied allegations that the company knowingly accepted clients with ties to rogue regimes, but the leaked documents indicate otherwise.

The law firm, for example, had even worked with infamous figures like Rami Makhlouf—Bashar al-Assad’s cousin. Makhlouf is one of the wealthiest businessmen in Syria and reportedly has assets of USD\$5 billion. The United States has described him as a “poster boy for corruption” and has black-listed him since 2008.¹⁵⁴ However, the Panama Papers contain documentation that Makhlouf used Mossack Fonseca to front six of his companies. Internal e-mail correspondence reveals that Mossack Fonseca’s compliance department had suggested that the law firm end its relationship with Makhlouf in early 2011, but Mossack Fonseca’s executives initially rejected the suggestion and only agreed to cease its relationship with him nine months later.¹⁵⁵

Other companies that Mossack Fonseca continued to deal with after their designation on sanctions lists included United Arab Emirates-based firms Pangates International Corporation Limited,¹⁵⁶ Maxima Middle East Trading,¹⁵⁷ and Morgan Additives Manufacturing Co.¹⁵⁸ A Dubai-based law firm, Helene Mathieu Legal Consultants, incorporated these companies through Mossack Fonseca in the Seychelles.¹⁵⁹ The US Treasury targeted these companies because they evaded sanctions imposed on the Assad regime by supplying Assad with significant quantities of petroleum products.

The Panama Papers have also disclosed Mossack Fonseca’s clandestine ties to individuals and entities linked to North Korea’s nuclear and related missile programs, such as DCB Finance Limited. At the time of these individuals’ and entities’ incorporation by Mossack Fonseca in 2006, neither the United States nor the UN Security Council had blacklisted them. However, Mossack Fonseca either failed to realize their apparent links to North Korea and their high-level positions in a North Korean bank, or it did not regard these factors as posing elevated risks. The leaked e-mail chains reveal that the law firm did not question its clients’ affiliations with North Korea nor subject them

153 Will Fitzgibbon and Martha M. Hamilton, “Law Firm’s Files Include Dozens of Companies and People Blacklisted by US Authorities,” *ICIJ*, April 4, 2016, <<https://panamapapers.icij.org/20160404-sanctioned-blacklistedoffshore-clients.html>>.

154 Simon Cox, “Panama Papers: Mossack Fonseca ‘Helped Firms Subject to Sanctions,’” *BBC News*, April 4, 2016, <<http://www.bbc.com/news/world-35959604>>.

155 Laura Pitel, “Mossack Fonseca ‘Worked with Assad Ally Rami Makhlouf Even after Syrian War Started,’” *Independent*, April 5, 2016, <<http://www.independent.co.uk/news/world/middle-east/mossack-fonseca-worked-with-assad-ally-rami-makhlouf-even-after-syrian-war-started-a6970276.html>>.

156 US Department of the Treasury Press Release, “Treasury Sanctions Companies for Aiding the Syrian Regime,” July 9, 2014, <<https://www.treasury.gov/press-center/press-releases/Pages/jl2558.aspx>>.

157 US Department of the Treasury Press Release, “Treasury Imposes Additional Sanctions against Syrian Regime Supporters and Sanctions Evaders,” December 17, 2014, <<https://www.treasury.gov/press-center/press-releases/Pages/jl9718.aspx>>.

158 US Department of the Treasury Press Release, “Treasury Targets Syrian Regime Energy Networks,” July 3, 2015, <<https://www.treasury.gov/press-center/press-releases/Pages/jl0137.aspx>>.

159 Salimah Shivji, “Panama Papers: Quebec Lawyer Based in Dubai Linked to Mossack Fonseca,” *CBC News*, April 4, 2016, <<http://www.cbc.ca/news/canada/montreal/panama-helene-mathieu-dubai-1.3519760>>.

to enhanced due diligence practices, which should have led Mossack Fonseca to reject their business well before it took action in 2010.

3. DCB FINANCE LIMITED (2006-2010)

In 2013, the United States sanctioned DCB Finance Limited, a Mossack Fonseca client from 2006 until 2010, on the grounds that the company had been used to finance North Korean proliferation activities.¹⁶⁰ The US Treasury Department claimed that DCB Finance Limited was a front company for Pyongyang-based Daedong Credit Bank. The United States blacklisted Daedong Credit Bank at the same time as DCB Finance Limited for providing financial services to the previously sanctioned Korea Mining Development Corporation (KOMID) and its financial facilitator Tanchon Commercial Bank (TCB).¹⁶¹ The US Treasury Department asserted that since 2006, Daedong Credit Bank had used DCB Finance Limited in order to carry out international financial transactions with foreign banks that avoid dealing with North Korea due to the inherent risks of dealings with that country.¹⁶²

After 2005, when the US Treasury Department designated a Macao-based bank, Banco Delta Asia, for laundering money that North Korea had acquired through illegal transactions, such as drug smuggling and counterfeiting US currency, foreign financial institutions curtailed their relationships with DPRK-related businesses and banks.¹⁶³ Foreign financial institutions chose not to risk unwitting involvement in North Korea's illegal activities that could lead to US penalties, including possible loss of access to the US financial system.¹⁶⁴ As a result of this de facto global financial embargo, North Korean banks could not readily conduct electronic fund transfers with foreign financial institutions. Open sources reveal that to circumvent such financial restrictions, Daedong Credit Bank turned to alternative payment methods, such as the employment of cash couriers to conduct its operations, making cash payments in amounts as high as to USD\$2.6 million.¹⁶⁵ Additionally, by registering DCB Finance Limited in the BVI, Daedong Credit Bank managers masked the bank's involvement—and thus North Korea—in its financial transactions. Indeed, the lawyer for DCB Finance

160 US Department of the Treasury Press Release, "Treasury Sanctions Bank, Front Company, and Official Linked to North Korean Weapons of Mass Destruction Programs," June 27, 2013, <<https://www.treasury.gov/press-center/pressreleases/Pages/jl1994.aspx>>.

161 In March 2016, the UN Security Council also sanctioned the Daedong Credit Bank for providing financial services to KOMID and TCB and knowingly facilitating transactions "using deceptive financial practices." See UN consolidated list of individuals and entities at: <<https://www.un.org/sc/suborg/sites/www.un.org.sc.suborg/files/1718.pdf>>; US Department of the Treasury Press Release, Treasury Sanctions Bank, op. cit.

162 US Department of the Treasury Press Release, "Treasury Sanctions Bank, Front Company, and Official Linked to North Korean Weapons of Mass Destruction Programs."

163 The Banco Delta Asia episode is discussed in greater detail below.

164 David Lague and Donald Greenlees, "Squeeze on Banco Delta Asia Hit North Korea Where It Hurt," *New York Times*, January 18, 2007, <http://www.nytimes.com/2007/01/18/world/asia/18ihtnorth.4255039.html?pagewanted=all&_r=2>.

165 Donald Greenlees, "Daedong Fights US-Imposed Sanctions on North Korea Banks," *New York Times*, March 7, 2007, <<http://www.nytimes.com/2007/03/08/business/worldbusiness/08iht-north.4848595.html>>.

Limited admitted that the company was “set up to enable DCB [Daedong Credit Bank] to continue to operate after correspondent banks had closed its accounts.”¹⁶⁶

3.1. RED FLAGS REGARDING DCB FINANCE LIMITED

At the time of its incorporation in 2006, DCB Finance Limited did not appear on UN or US blacklists. However, Mossack Fonseca should have considered the company’s apparent affiliation with North Korea as a red flag on several grounds.

First, the similarity of the name of DCB Finance Limited with Daedong Credit Bank should have drawn scrutiny from Mossack Fonseca. Many open sources even refer to Daedong Credit Bank as “DCB,” which should have alerted the firm to DCB Finance Limited’s North Korean ties.¹⁶⁷ After US sanctions led to a freeze of Daedong Credit Bank’s accounts at Banco Delta Asia in 2005, the sanctions had the effect of publicly linking Daedong Credit Bank to an institution designated by the United States as one of primary money laundering concern, and Daedong Credit Bank’s link to North Korea became publicly known.

A second indicator that should have raised concerns at Mossack Fonseca were the obvious affiliations of the founders of DCB Finance Limited—Nigel Cowie and Kim Chol Sam—with the DPRK. Both held high-level positions at the Daedong Credit Bank. At the time of the incorporation of DCB Finance Limited, Nigel Cowie, a British banker, was the CEO and general manager of Daedong Credit Bank. Cowie’s affiliation with North Korea was all the more apparent in that he openly supported the North Korean bank in published interviews.¹⁶⁸ A second founder of DCB Finance Limited, Kim Chol Sam, was also close to the North Korean regime. At time of registering DCB Finance Limited through Mossack Fonseca, Kim was the China-based representative and the treasurer of Daedong Credit Bank.¹⁶⁹ In addition to their positions in a North Korean bank, at the beginning of the business relationship with Mossack Fonseca in 2006, Cowie gave North Korea’s “International House of Culture,” in Pyongyang, as his address.

166 Juliette Garside and Luke Harding, “British Banker Set up Firm ‘Used by North Korea to Sell Weapons,’” *Guardian*, April 4, 2016, <<http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firmallegedly-used-by-north-korea-weapons-sales>>. For additional background on DCB Finance Limited and other off-shore operations, see UNSCR 1718 Committee, “Report of the Security Council Resolution 1718 Committee Panel of Experts,” February 27, 2017, paragraphs 223-229, <http://www.un.org/ga/search/view_doc.asp?symbol=S/2017/150>.

167 To avoid confusion between the bank name, DCB, and the company name, DCB Finance Limited, the authors preferred to name the bank exclusively as Daedong Credit Bank in this article.

168 Wall Street Journal Staff Reporter, “A Foreign Lender Gambles on Change for North Korea,” the *Wall Street Journal*, November 2, 2000, <<http://www.wsj.com/articles/SB973122408586345712>>.

169 The US blacklisted Kim Chol Sam in 2013 on the grounds that he played a significant role in the financing of North Korea’s proliferation activities through his position in Daedong Credit Bank. Treasury’s Office of Foreign Assets Control suspected that Kim Chol Sam facilitated numerous transactions and managed North Korea-related accounts. See, US Department of the Treasury Press Release, ““Treasury Sanctions Bank, Front Company, and Official Linked to North Korean Weapons of Mass Destruction Programs.”

A third indicator of DCB Finance Limited's links to North Korea was Cowie's affiliation with another company, Phoenix Commercial Ventures Limited. When Phoenix Commercial first established a business relationship with Mossack Fonseca, it was producing CDs and DVDs in a joint venture with North Korea's Ministry of Culture. As a founder and shareholder, Cowie registered this company through Mossack Fonseca. Despite the company's business relationship with North Korea, Mossack Fonseca did not hesitate to accept Phoenix Commercial as its client, nor did it question Cowie's close ties to the North Korean regime.

Despite these glaring warning signs, Mossack Fonseca either failed to recognize or chose to ignore the risks emanating from DCB Finance Limited. Neither alternative excuses the law firm's responsibility. Had the law firm conducted even a simple Google search, it would have easily detected the name similarities between DCB Finance Limited and North Korean Daedong Credit Bank, which, as noted, is often known as DCB. Additionally, Mossack Fonseca completely failed to recognize DCB Finance Limited's founders' obvious connections to North Korea.

3.2. RED FLAGS CONCERNING COWIE

Cowie has been a prominent figure in encouraging foreign investment in North Korea and gave several interviews on the subject to international media in the early 2000s.¹⁷⁰ Although he was the general manager and CEO of Daedong Credit Bank between 1998 and 2011, his relationship with the North Korean regime dates back to 1995, when he moved to North Korea. At the time, he was the chief representative of Peregrine Investments Holdings Ltd, a Hong Kong-based investment bank, which formed a joint venture with Korea Daesong Bank, a North Korean state-owned bank. The Asian financial crisis of the mid-1990s negatively impacted the joint venture and led to the collapse of Peregrine Investments Holdings Ltd. In 1995, Cowie set up North Korea's first foreign-owned bank named Peregrine Daesong Development Bank, whose ownership and name were changed in 2000. Cowie and three other investors bought a 70 percent stake in the bank's assets and renamed it Daedong Credit Bank.¹⁷¹ The remaining 30 percent remained in the hands of state-owned Korea Daesong Bank.¹⁷²

Daedong Credit Bank and Cowie first came to public attention in 2005 when the US Treasury designated a Macau-based bank, Banco Delta Asia, as "a financial institution of primary money laundering concern." At the time, Daedong Credit Bank had USD\$7 million in deposit with the Macao bank. Given that Daedong Credit Bank's total assets were then valued at USD\$10 million, this freezing action severely impacted Daedong Credit Bank, and its managers openly criticized the US Treasury Department when it took action against Banco Delta Asia.¹⁷³

170 Wall Street Journal Staff Reporter, "A Foreign Lender Gambles on Change for North Korea."

171 Bradley K. Martin, "Koryo Asia to Buy US-Sanctioned North Korean Bank," *North Korean Economy Watch*, 2006, <<http://www.nkeconwatch.com/2006/09/01/koryo-asia-ltd-buys-daedong-credit-bank/>>.

172 Daedong Credit Bank's website is hosted on the Phoenix Commercial Ventures site but is also available via its own URL, <<http://www.phoenixcommercialventures.eu/feature-tour/daedong-credit-bank/>>.

173 Donald Greenlees, "Daedong Fights US-Imposed Sanctions on North Korea Banks."

In 2007, Cowie sold his stake in Daedong Credit Bank to British-based Koryo Asia Ltd, the adviser to London-based Chosun Development & Investment Fund LP, which sought to raise funds for investments in North Korea.¹⁷⁴ Colin McAskill, a London-based businessman who had spent thirty-eight years in North Korean business, led Koryo Asia Ltd. McAskill’s experience included providing assistance to North Korea’s foreign gold exportation and consultancy services to North Korean banks on their debt negotiations.¹⁷⁵

Despite selling his stake, Cowie continued to act as the general manager and CEO of Daedong Credit Bank, 30 percent of whose shares have remained in the hands of Korea Daesong Bank. According to a 1995 document prepared by the US Embassy in Seoul regarding North Korean financial institutions, Bureau 39—an office of the North Korean ruling party suspected of printing counterfeit US currency—controlled Korea Daesong Bank. As an entity partly owned by Korea Daesong Bank, Daedong Credit Bank had indirect links to Bureau 39.¹⁷⁶

The above-mentioned open source information about Cowie should have raised Mossack Fonseca’s concerns. Had the law firm conducted appropriate due diligence on him, it would have detected his close relationship with North Korea, which, in turn, should have galvanized Mossack Fonseca into performing enhanced due diligence—more intensive investigations—on DCB Finance Limited and its founders. Although the leaked files have yet to disclose how DCB Finance Limited may have helped to finance or facilitate North Korea’s prohibited activities, they are sufficient to support the conclusion that the law firm failed to regularly monitor DCB Finance Limited’s activities, and it therefore failed to interrupt whatever financing of North Korea’s illicit WMD programs might have occurred.

3.3. DUE DILIGENCE BY MOSSACK FONSECA

Despite working with DCB Finance Limited and Cowie for approximately five years without any apparent hesitation, Mossack Fonseca decided to resign as agent for the company in September 2010. The leaked documents include a letter by the Financial Investigation Agency of the BVI inquiring about the details of DCB Finance Limited; this inquiry likely triggered Mossack Fonseca’s resignation, according to the investigators of the Panama Papers.¹⁷⁷

174 Bradley K. Martin, “Koryo Asia to Buy US-Sanctioned North Korean Bank.”

175 Donald Greenlees, “In North Korea, a Bank Battles US Sanctions,” *International New York Times*, March 8, 2007, <http://www.nytimes.com/2007/03/08/world/asia/08iht-north.4842741.html?_r=0>.

176 US Embassy Documents, “North Korean Financial Institutions,” *North Korean Economy Watch*, April 1995, <<http://www.nkeconwatch.com/2002/03/05/north-korean-financial-institutions-loads-of-info/>>.

177 Simon Cox, “Panama Papers: Mossack Fonseca ‘Helped Firms Subject to Sanctions,’” *Guardian*, April 4, 2016, <<http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firm-allegedly-used-by-north-koreaweapons-sales>, <http://www.bbc.com/news/world-35959604>>.

After extensive exposure of the law firm's confidential documents, Mossack Fonseca publicly declared that it "conducts exhaustive due diligence to verify the legitimacy" of each of its clients.¹⁷⁸ However, the e-mail communications disclosed by the Panama Papers between BVI authorities and the compliance department of Mossack Fonseca revealed otherwise. In 2013, BVI authorities asked which due diligence practices had been conducted on DCB Finance Limited before accepting it as a client in 2006. Mossack Fonseca's compliance department confessed, "We have not yet addressed the reason we maintained a relationship with DCB Finance Limited when we knew or ought to have known from incorporation in 2006 that the country, North Korea, was on the black list." They further noted, "We should have identified from the onset that this was a high-risk company."¹⁷⁹

Another chain of e-mails further demonstrates the law firm's lack of urgency in implementing its compliance rules. In 2013, although the company's compliance department admitted in a letter that Cowie's North Korean address should have been regarded as a red flag, the head of the firm's office in the BVI responded by saying: "it is not the ideal situation and it is not gratifying issuing a letter highlighting the inefficiencies of Mossack Fonseca BVI."¹⁸⁰

Despite the disclosure of the leaked documents, Mossack Fonseca's co-founder, Ramón Fonseca, has rejected allegations that the firm engaged in any misconduct. He claimed that after the establishment of a new corporate entity, any financial wrongdoing became the responsibility of the company's owners, not Mossack Fonseca. To support his argument, he compared Mossack Fonseca to a car factory that should not be blamed because the car it produced was used in a robbery.¹⁸¹ However, from October 14, 2006, onward, UN Security Council sanctions specifically required UN Member States to prevent any transfers of technical training, advice, services, or assistance related to the provision, manufacture, maintenance, or use of nuclear- and missile-relevant goods from any of its nationals or territories to the DPRK.¹⁸² Helping North Korea to establish front companies that could facilitate the acquisition of such goods would be a service that violated this standard. However, Panama and the BVI had not clearly adopted regulations prohibiting such Security Council-banned activities, and whether Mossack Fonseca knew or had reason to know if transactions involving DCB Finance may have supported sanctioned North Korean programs remains unclear.

178 Will Fitzgibbon and Martha M. Hamilton, "Law Firm's Files Include Dozens of Companies and People Blacklisted by US Authorities."

179 Simon Cox, "Panama Papers: Mossack Fonseca 'Helped Firms Subject to Sanctions.'"

180 Juliette Garside and Luke Harding, "British Banker Set up Firm 'Used by North Korea to Sell Weapons,'" *Guardian*, 4 April 2016, <<http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firm-allegedly-used-by-north-korea-weapons-sales>>.

181 ICIJ, "Giant Leak of Offshore Financial Records Exposes Global Array of Crime and Corruption," April 3, 2016, <<https://panamapapers.icij.org/20160403-panama-papers-global-overview.html>>.

182 UN Security Council Resolution 1718, S/RES/1718, October 14, 2006, OP 8(c), <[http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1718%20\(2006\)](http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1718%20(2006))>.

4. LESSONS FROM THE PANAMA PAPERS EPISODE

Constituting one of the largest data breaches in history, the Panama Papers offer lessons to many parties, including responsible governments in offshore financial centers and professionals in the fields of banking, law, and data security. These parties are in a position to protect themselves and their clients against the risks of illegal actions and therefore to take necessary countermeasures. The leaked files also taught lessons to parties involved in any improper behavior, ranging from criminal acts to failure to conduct appropriate controls in order to prevent violations or illegal activities. These parties should have understood that in today’s high-tech and digitized world, their improper behavior would ultimately be detected, damaging their reputations and inviting penalties for any misconduct.

From this perspective, offshore jurisdictions and legal professionals, such as law firms, can both be a performer/facilitator and a victim of illegal behavior. Since the investigations into Mossack Fonseca have not been finalized, unanalyzed documents could reveal whether the Panamanian law firm knowingly engaged in business relationships with or was abused by its sanctioned or questionable high-risk clients. Regardless of Mossack Fonseca’s intention, this episode provides lessons for offshore jurisdictions, law firms, and others owing a duty of due diligence in their business affairs.

4.1. LESSONS FOR OFFSHORE JURISDICTIONS

The Panama Papers expose offshore jurisdictions’ vulnerability to financial abuse and illicit activities, including financing of WMD proliferation. Certain characteristics of offshore jurisdictions, such as the absolute confidentiality of companies’ beneficial ownership and the anonymity of financial transactions and accounts, make these centers attractive for such misuse.¹⁸³ These features of offshore jurisdictions enable money launderers, tax evaders, or corrupt government officials to set up anonymous shell companies and hide their assets and the real owners of their companies through hired nominees. Additionally, because of the ease of setting up a new corporate entity and insufficient financial controls, individuals willing to evade anti-proliferation sanctions may consider establishing a business in these jurisdictions. Similarly, the confidentiality of financial transactions and accounts in offshore centers may provide a safe haven for WMD proliferation finance. Despite such weaknesses, offshore companies and offshore finance have many legitimate business advantages, such as low or nonexistent tax rates. What makes offshore enterprises illegitimate is their purpose or the specific business activities they conduct.

Working with Mossack Fonseca or setting up an offshore company through Mossack Fonseca does not necessarily imply that an individual or company engages in illicit business. However, the Panama Papers indicate that many offshore companies registered by Mossack Fonseca seem to have been used for illegal purposes, including sanctions evasion and proliferation finance. These parties used the law firm to add one more layer of complexity to obscure their malfeasance and avoid scrutiny of their activities.

183 International Monetary Fund, “Offshore Financial Centers: The Role of the IMF,” June 23, 2000, <<https://www.imf.org/external/np/mae/oshore/2000/eng/role.htm>>.

Adopting certain regulations to establish transparency in offshore jurisdictions would help to deter and prevent the abuse of offshore centers by sanctions evaders. Such a system might require the creation of registries regarding the beneficial ownership of companies, which would be accessible by both government authorities and the public.¹⁸⁴ A more transparent corporate and financial system in offshore jurisdictions would contribute to the reputation of both legitimate offshore companies and the offshore jurisdictions themselves.

4.2. LESSONS FOR LAW FIRMS

In addition to the potential misuse of offshore jurisdictions, the Panama Papers underline how legal professionals, such as lawyers, law firms, and notaries, can also become vulnerable to criminal abuse. Clients engaging in illegal activities, such as proliferation finance, may involve legal professionals in their financial wrongdoings. This involvement may be attributed to the services these professionals provide to their clients, which inherently pose criminal risks, including “the purchasing of real estate, the establishment of companies and trusts (whether domestically, in foreign countries or offshore financial centers), and passing funds through the legal professional’s client account.”¹⁸⁵ Law firms like Mossack Fonseca can play a critical role in offshore financial centers because the services they provide are confidential in nature. Additionally, since offshore centers obligate foreign companies to appoint a local agent to operate and represent them, law firms frequently act as the local agents of the companies they set up in offshore jurisdictions.¹⁸⁶

Because of legal professionals’ vulnerability to criminal abuse, the FATF listed them under the category of designated non-financial businesses and professionals in 2003. This inclusion obligates governments to require legal professionals to apply AML and CFT measures with respect to their clients. FATF’s Recommendation 22 requires legal professionals to conduct customer due diligence (CDD) with respect to their clients and retain records of their clients’ activities, typically for five years. Recommendation 22 applies the requirements of CDD and record keeping to certain situations, which the recommendation lists.¹⁸⁷

Another obligation that governments should impose on legal professionals is mandatory filing of suspicious activity reports (SARs). FATF’s Recommendation 23 requires legal professionals to report clients’ suspicious activities and transactions if they suspect that a client engages in illegal activities. However, Interpretive Note of Recommendation 23 provides an exception for legal professionals if they obtain that information under “professional secrecy or legal professional privilege.” Such an exception may, in some circumstances, allow law firms to ignore their clients’ financial misconduct

184 Ibid.; “The Lesson of the Panama Papers,” *The Economist*, April 9, 2016, <<http://www.economist.com/news/leaders/21696532-more-should-be-done-make-offshore-tax-havens-less-murkylesson-panama-papers>>.

185 Stephen Schneider, “Money Laundering in Canada: An Analysis of RCMP Cases,” *Nathanson Centre, Study of Organized Crime and Corruption*, March 2004, <www.csd.bg/fileSrc.php?id=560>.

186 Unitrust Capital Corp, “Offshore International.”

187 FATF, “International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations,” February 2012, <http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf>.

and wittingly continue to act as their representatives. Further, law firms might choose not to collaborate with investigators or public prosecutors by putting forward their “professional secrecy” or “legal professional” privilege.¹⁸⁸

In its report on legal professionals’ vulnerabilities in money laundering and terrorist financing, the FATF underlines the risks posed by such exceptions. The FATF argues countries’ differing interpretations of what constitutes “professional secrecy” and “legal professional privilege” discourages law enforcement from investigating legal professionals that they believe may be involved in their clients’ illegal activities or have turned a blind eye to clients’ financial misconduct.¹⁸⁹ The FATF classifies the involvement of law firms as “innocent involvement,” “unwitting,” “willfully blind,” “being corrupted,” or “complicit.”¹⁹⁰

In 2004, Stephen Schneider, a Canadian researcher, conducted a comprehensive study on the susceptibility and involvement of the legal sector in money laundering schemes. In his analysis, he identified two types of legal professionals that may be involved in their clients’ money laundering activities. One type of legal professional is innocently involved due to the absence of obvious red flag indicators regarding the activities of their clients. The other type of legal professionals continues to work with their customers despite overtly suspicious activities. Schneider attributes this continuation of business relationships either to law firms’ lack of awareness of red flag indicators or to their intentionally turning a blind eye to warning signs.¹⁹¹

Since the investigations regarding Mossack Fonseca are continuing, the degree of its involvement in any of its clients’ illegal activities remains unknown. However, given the ill repute of some of its clients, Mossack Fonseca could not have simply been innocently involved in its clients’ financial affairs. For example, at the outset of its business relationship with DCB Finance Limited, Mossack Fonseca should have known the company and its founders’ North Korean affiliations. Nevertheless, based on Schneider’s classification, investigations have not determined whether the law firm willfully turned a blind eye to such linkages despite obvious red flags or that it acted as an accomplice with its clients.

In order to avoid even innocent involvement in clients’ illegal activities, law firms should conduct appropriate due diligence as stipulated by the FATF Recommendations. Regulators should require

188 FATF, “Money Laundering and Terrorist Financing Vulnerabilities of Legal Professionals,” June 2013, <<http://www.fatfgafi.org/media/fatf/documents/reports/ML%20and%20TF%20vulnerabilities%20legal%20professionals.pdf>>. Many codes of legal ethics, however, permit disclosure of a client’s intent to commit a crime. See, “When Your Client Plans to Commit a Crime,” *New York Legal Ethics Reporter*, January 1, 2001, <<http://www.newyorklegaethics.com/when-your-client-plans-to-commit-a-crime/>>.

189 FATF, “Money Laundering and Terrorism Financing Vulnerabilities of Legal Professionals,” p.6.

190 Ibid, p.5. These FATF recommendations do not expressly apply to countering proliferation finance. However, effective implementation of Recommendation 22 would likely identify most transactions in this category because they have many of the same attributes as those involving money laundering and terrorism finance. See Emil Dall, Andrea Berger, and Thomas Keatinge, *Out of Sight Out of Mind: A Review of Efforts to Counter Proliferation Finance*, (London: Royal Uniformed Services Institute, June 20, 2016).

191 Stephen Schneider, “Money Laundering in Canada: An Analysis of RCMP Cases,” *Nathanson Centre, Study of Organized Crime and Corruption*.

that legal professionals operating in their countries file suspicious activities to their respective financial intelligence units and have relevant Know Your Customer (KYC) practices in place and effectively implement them. In addition, law firms should train their employees, who are dealing face-to-face with the firms' clients, about what constitutes suspicious activities regarding their customers. The latter is crucial because employees must understand what constitutes a red flag in order to conduct proper due diligence practices and thus alert their firms to take appropriate follow-up action. To ensure that law firms carry out necessary controls to verify the legitimacy of their clients, relevant authorities should supervise legal professionals at regular intervals. The Mossack Fonseca case points to the need for Panamanian and BVI authorities to strengthen their supervisory efforts on law firms in the future.

4.3. LESSONS FOR DUE DILIGENCE PRACTICES

The Panama Papers provide good reason for concern that Mossack Fonseca realized the criminal engagement of its notorious clients. Although Mossack Fonseca resigned as the agent of DCB Finance Limited in 2010, the company's activities should have been regarded as suspicious well before that time. Both Nigel Cowie and Kim Chol Sam's administrative positions in the North Korean Daedong Credit Bank and Cowie's North Korean address should have raised concerns at Mossack Fonseca. In addition, Daedong Credit Bank's USD\$7 million of frozen assets in Banco Delta Asia was widely reported by media outlets, should have further caught Mossack Fonseca's attention.

Involvement in criminal activity or circumvention of sanctions, irrespective of knowledge and intention, can damage the reputation of both the facilitating company and the jurisdictions where it operates. Even if found to be innocent of any knowledge of a client's behavior, many legitimate parties may hesitate to work with a company known to have a poor due diligence record. Similarly, the leaked documents further damaged the reputation of Panama, a well-known tax haven and offshore financial center.¹⁹² Since Mossack Fonseca is a Panama-based law firm, the leaked documents have become known as the Panama Papers. Panamanian authorities strongly objected to this name because of the shadow it casts over the country's international standing.¹⁹³ Although some media reports have consequently used the name "Mossack Fonseca papers" when they refer to the leaked documents, the damage has been done. A European Union official even proposed sanctions against Panama, and French authorities added Panama's name on its list of uncooperative nations regarding information exchange.¹⁹⁴

The Panama Papers underline the significance of robust CDD, which ensures that banks, law firms, and other organizations do not unwittingly entangle themselves in any criminal conduct or sanctions

192 International Monetary Fund, "Offshore Financial Centers: The Role of the IMF."

193 Joshua Partlow and Ana Swanson, "How Panama Ended up in the Middle of a Financial Scandal," *The Washington Post*, April 9, 2016, <https://www.washingtonpost.com/world/the_americas/where-the-papers-got-their-name/2016/04/09/f088582e-fcf8-11e5-813a-90ab563f0dde_story.html>.

194 Ibid.

evasions by their clients.¹⁹⁵ Appropriate due diligence practices, including the identification of companies’ beneficial owners, would contribute to efforts to combat proliferation finance, among other challenges to the integrity of the global financial system. Classifications of customers based on the risk they present would make an important contribution to detecting patterns of proliferation and proliferation finance in a timely fashion.

4.4. LESSONS FOR SOUTHEAST ASIAN COUNTRIES

The financial regulatory authorities of Southeast Asian countries need to provide clear guidance regarding compliance with AML, CFT, and counter-proliferation finance rules to help prevent financial institutions and other firms’ involvement in any illegal activities pursued by their clients. Regulatory authorities in Southeast Asia should specify the penalties for law firms’ contributions to such misconduct, based on their degree of knowledge, ranging from innocent involvement due to a lack of obvious red flags to willing involvement as an accomplice in exchange for benefits. In addition, Southeast Asian law firms should improve their due diligence practices to avoid serving individuals and companies with illegitimate intentions. They should offer their employees a thorough understanding of compliance issues by training them on possible red flag indicators when dealing with clients.

In order to mitigate the risks emanating from offshore jurisdictions, Southeast Asian financial institutions and designated non-financial businesses and professionals should apply enhanced due diligence practices to their offshore customers and offshore accounts. If they detect highly risky situations, they should terminate those business relationships and consider filing SARs with relevant authorities. In addition, offshore jurisdictions in Southeast Asia should strengthen their rules and regulations to avoid financial misconduct in their jurisdictions. Finally, those countries should improve transparency rules by obligating offshore companies to declare their beneficial ownership in publicly available documents.

195 Mary Breede, “Panama Papers and Trade Compliance: Do They Intersect?” *Tax & Accounting Blog*, May 20, 2016, <<https://tax.thomsonreuters.com/blog/onesource/panama-papers-and-trade-compliance-do-they-intersect/>>.

5. CONCLUSION

The Panama Papers shed light on the risks associated with law firms and offshore jurisdictions, and they underscore the importance of effective due diligence practices to counter financial crimes, such as proliferation finance. The disclosure of Mossack Fonseca's files reveals how effectively a North Korea-linked company, DCB Finance Limited, became established in the BVI through Mossack Fonseca. Because DCB Finance Limited acted as a front company of DPRK-based Daedong Credit Bank, which financed the Kim regime's prohibited activities, Mossack Fonseca, whether wittingly or unwittingly, entangled itself in the possible financing of WMD proliferation due to its lax compliance rules. In addition to exploiting Mossack Fonseca's poor controls on its clients, DCB Finance Limited also took advantage of the services Mossack Fonseca provided to the company and the confidentiality rules of the BVI.

To curb proliferation finance, due diligence practices by both banks and relevant companies, including law firms, play a key role. Robust due diligence implementation by Southeast Asian companies would hinder the formation of shell companies by sanctioned parties and thus their procurement activities and associated payments. Therefore, even simple due diligence may have a substantial impact by detecting a customer's unusual activities, which can enable Southeast Asian organizations to identify patterns of proliferation financing and take measures to limit such conduct.



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