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

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CONTENTS

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

1. BACKGROUND AND INTRODUCTION	1
2. THE ROLE OF FINANCIAL MEASURES IN COUNTERING PROLIFERATION ACTIVITIES	3
3. INTERNATIONAL LEGAL FRAMEWORK: UN SECURITY COUNCIL RESOLUTION 1540 ESTABLISHING REQUIREMENTS FOR ALL STATES	4
4. INTERNATIONAL LEGAL FRAMEWORK: UN SECURITY COUNCIL SANCTIONS RESOLUTIONS -- NORTH KOREA SANCTIONS AND OVERVIEW OF FINANCIAL PROVISIONS	8
4.1. TARGETED FINANCIAL SANCTIONS	9
4.2. ACTIVITY-BASED FINANCIAL SANCTIONS	10
4.3. VIGILANCE MEASURES	12
4.4. OTHER FINANCIAL PROVISIONS	12
5. INTERNATIONAL LEGAL FRAMEWORK: FINANCIAL ACTION TASK FORCE	15
5.1. MUTUAL EVALUATIONS.....	16
6. INTERNATIONAL LEGAL FRAMEWORK: US LAWS AND REGULATIONS	19
7. CONCLUSIONS	23

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 counter-funding 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 or

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>>.

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 United 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/uns-cr-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.



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