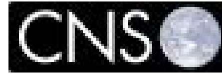

James Martin Center *for*
Nonproliferation Studies

NEEDED NEXT STEPS TO STRENGTHEN MEASURES TO COUNTER PROLIFERATION FINANCE

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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)>.

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.fatfgafi.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 establishing such a definition, states may not be able to determine a framework of forbidden

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.

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

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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 countering 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 FATF, "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%20 Methodology%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 FATF, "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.

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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.

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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 Huei 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.

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