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

## 1. INTRODUCTION

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

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

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

## 2. THE PANAMA PAPERS

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

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

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

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

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

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

145 ICIJ, "Offshore Leaks Database," <https://offshoreleaks.icij.org/#_ga=1.212057940.1178706368.1464897554>.
146 Frederik Obermaier, Bastian Obermayer, Vanessa Wormer, and Wolfgang Jaschensky, "About the Panama Papers," *Süeddeustche Zeitung*, <http://panamapapers.sueddeutsche.de/articles/56febff0a1bb8d3c3495adf4/>.
147 Martha M. Hamilton, "Panamanian Law Firm is Gatekeeper to Vast Flow of Murky Offshore Secrets," *The Organized Crime and Corruption Reporting Project (OCCRP)*, <https://www.occrp.org/en/panamapapers/mossackfonseca/>.
148 Ibid.; ICIJ, "The Panama Papers: An Introduction," April 3, 2016, <https://panamapapers.icij.org/video/>.
149 Unitrust Capital Corporation, "Offshore International," <http://www.unitrustcapital.com/offshore-company/offshoreinternational.html>.
150 ICIJ, "Explore the Panama Papers Key Figures," https://panamapapers.icij.org/graphs/.
151 Martha M. Hamilton, "Panamanian Law Firm is Gatekeeper to Vast Flow of Murky Offshore Secrets."
152 Emilia Diaz-Struck and Cecile Schilis-Gallego, "Beyond Panama: Unlocking the World's Secrecy Jurisdictions," *ICIJ,* May 9, 2016, <https://panamapapers.icij.org/20160509-beyond-panama-secrecy-jurisdictions.html>.

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

The law firm, for example, had even worked with infamous figures like Rami Makhlouf—Bashar al-Assad's cousin. Makhlouf is one of the wealthiest businessmen in Syria and reportedly has assets of USD$5 billion. The United States has described him as a "poster boy for corruption" and has blacklisted him since 2008.[154] However, the Panama Papers contain documentation that Makhlouf used Mossack Fonseca to front six of his companies. Internal e-mail correspondence reveals that Mossack Fonseca's compliance department had suggested that the law firm end its relationship with Makhlouf in early 2011, but Mossack Fonseca's executives initially rejected the suggestion and only agreed to cease its relationship with him nine months later.[155]

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

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

153 Will Fitzgibbon and Martha M. Hamilton, "Law Firm's Files Include Dozens of Companies and People Blacklisted by US Authorities," *ICIJ*, April 4, 2016, <https://panamapapers.icij.org/20160404-sanctioned-blacklistedoffshore-clients.html>.
154 Simon Cox, "Panama Papers: Mossack Fonseca 'Helped Firms Subject to Sanctions,'" *BBC News*, April 4, 2016, <http://www.bbc.com/news/world-35959604>.
155 Laura Pitel, "Mossack Fonseca 'Worked with Assad Ally Rami Makhlouf Even after Syrian War Started,'" *Independent,* April 5, 2016, <http://www.independent.co.uk/news/world/middle-east/mossack-fonseca-worked-withassad-ally-rami-makhlouf-even-after-syrian-war-started-a6970276.html>.
156 US Department of the Treasury Press Release, "Treasury Sanctions Companies for Aiding the Syrian Regime," July 9, 2014, <https://www.treasury.gov/press-center/press-releases/Pages/jl2558.aspx>.
157 US Department of the Treasury Press Release, "Treasury Imposes Additional Sanctions against Syrian Regime Supporters and Sanctions Evaders," December 17, 2014, <https://www.treasury.gov/press-center/press-releases/Pages/jl9718.aspx>.
158 US Department of the Treasury Press Release, "Treasury Targets Syrian Regime Energy Networks," July 3, 2015, <https://www.treasury.gov/press-center/press-releases/Pages/jl0137.aspx>.
159 Salimah Shivji, "Panama Papers: Quebec Lawyer Based in Dubai Linked to Mossack Fonseca," *CBC News*, April 4, 2016, <http://www.cbc.ca/news/canada/montreal/panama-helene-mathieu-dubai-1.3519760>.

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

## 3. DCB FINANCE LIMITED (2006-2010)

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

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

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

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

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

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

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

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

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

## 3.1. RED FLAGS REGARDING DCB FINANCE LIMITED

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

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

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

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

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

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

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

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

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

## 3.2. RED FLAGS CONCERNING COWIE

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

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

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

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

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

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

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

Despite selling his stake, Cowie continued to act as the general manager and CEO of Daedong Credit Bank, 30 percent of whose shares have remained in the hands of Korea Daesong Bank. According to a 1995 document prepared by the US Embassy in Seoul regarding North Korean financial institutions, Bureau 39—an office of the North Korean ruling party suspected of printing counterfeit US currency—controlled Korea Daesong Bank. As an entity partly owned by Korea Daesong Bank, Daedong Credit Bank had indirect links to Bureau 39.[176]

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

## 3.3. DUE DILIGENCE BY MOSSACK FONSECA

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

174 Bradley K. Martin, "Koryo Asia to Buy US-Sanctioned North Korean Bank."
175 Donald Greenlees, "In North Korea, a Bank Battles US Sanctions," *International New York Times*, March 8, 2007, <http://www.nytimes.com/2007/03/08/world/asia/08iht-north.4842741.html?_r=0>.
176 US Embassy Documents, "North Korean Financial Institutions," *North Korean Economy Watch*, April 1995, <http://www.nkeconwatch.com/2002/03/05/north-korean-financial-institutions-loads-of-info/>.
177 Simon Cox, "Panama Papers: Mossack Fonseca 'Helped Firms Subject to Sanctions,'" *Guardian,* April 4, 2016, <http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firm-allegedly-used-by-north-koreaweapons-sales, http://www.bbc.com/news/world-35959604>.

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

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

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

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

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

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

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

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

# 4. LESSONS FROM THE PANAMA PAPERS EPISODE

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

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

## 4.1. LESSONS FOR OFFSHORE JURISDICTIONS

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

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

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

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

## 4.2. LESSONS FOR LAW FIRMS

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

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

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

184 Ibid.; "The Lesson of the Panama Papers," The Economist, April 9, 2016, <http://www.economist.com/news/leaders/21696532-more-should-be-done-make-offshore-tax-havens-less-murkylesson-panama-papers>.
185 Stephen Schneider, "Money Laundering in Canada: An Analysis of RCMP Cases," *Nathanson Centre, Study of Organized Crime and Corruption*, March 2004, <www.csd.bg/fileSrc.php?id=560>.
186 Unitrust Capital Corp, "Offshore International."
187 FATF, "International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations," February 2012, <http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf>.

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

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

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

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

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

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

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

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

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

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

## 4.3. LESSONS FOR DUE DILIGENCE PRACTICES

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

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

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

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

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

## 4.4. LESSONS FOR SOUTHEAST ASIAN COUNTRIES

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

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

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

# 5. CONCLUSION

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

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