

Senate Banking, Housing, and Urban Affairs Committee  
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# Secondary Sanctions Against Chinese Institutions: Assessing their Utility for Constraining North Korea

**HON. JUAN ZARATE**

**Chairman and Senior Counselor**  
*FDD's Center on Sanctions and Illicit Finance*

**Chairman**  
*Financial Integrity Network*

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Chairman Sasse, Ranking Member Donnelly, and distinguished members of the Senate Banking, Housing, and Urban Affairs Subcommittee on National Security and International Trade and Finance, I am honored to be with you today to discuss the urgent need to pressure North Korea and the utility of secondary sanctions against Chinese institutions in such a strategy.

This is a timely and important hearing. The international security challenge from North Korea has grown more dangerous and direct for the United States. The regime in Pyongyang remains intent on developing ballistic missile and nuclear capabilities that will allow it to reach and threaten the United States directly. In defiance of international sanctions and pressure, North Korea has quickened the pace of missile and nuclear tests, demonstrating ever-expanding capabilities and claiming to have the ability to place a nuclear warhead on the tip of an intercontinental ballistic missile. Despite recent missile launch failures, the regime continues its march toward these capabilities.

What was once seen solely as a threat to peace and stability on the Korean Peninsula and our regional allies has now become a looming, direct threat to the U.S. homeland.

All the while, North Korea proliferates its technology for profit, engages in illicit financial and commercial activity, exploits forced labor to make money for the regime, and has deployed cyber tools to attack adversaries and the private sector, including U.S. companies and the banking system. North Korea remains a threat to international security and to the integrity and stability of the financial system.

The threats from North Korea require a sober, more comprehensive, and urgent response, including the use of financial and economic tools and pressure. This in turn requires a more aggressive and imaginative approach leveraging new tools and mechanisms, including secondary sanctions against Chinese and other businesses, entities, and networks still doing business with North Korea.

China is North Korea's economic and diplomatic lifeline, and its principal interest is ensuring the stability of the North Korean government and avoiding regime collapse. As a result, China has maintained ties with North Korea and been unwilling to bring overbearing pressure on its ally in Pyongyang. Over the years, North Korea has found outlets and connectivity to the financial and commercial system through Chinese banks, companies, and agents – to circumvent sanctions, serve their economy, and enrich the regime.

Because China remains the regime's backstop, the United States needs Chinese cooperation and support to slow and stop North Korea's missile and nuclear programs. The Chinese calculus has not changed in the past and will not change unless its own interests are fundamentally threatened or affected. Chinese and American interests do not yet align with respect to North Korea.

This is a moment for China to assume its role as a great power and to influence its North Korean ally to stop its nuclear and missile programs and contain the threats from proliferation. This Administration and Congress will need to grapple with how best to obtain, coerce, and sustain Chinese cooperation in order to maximize pressure on North Korea. Ultimately, the United States must find a way to change Pyongyang's calculus and the trajectory of their nuclear



program. This testimony addresses how to leverage financial and economic pressure, including secondary sanctions, to increase the chances of changing the calculus in North Korea and China and avoiding conflict.

My testimony has benefited directly from the ongoing work and contributions of Anthony Ruggiero at the Foundation for Defense of Democracies, along with the scholarship of Victor Cha and Bonnie Glaser at the Center for Strategic and International Studies, John Park at the Harvard Kennedy School of Government, and the Council on Foreign Relations' Task Force on North Korea led by Chairman Mike Mullen and Senator Sam Nunn, on which I served.

### **Core Principles for a Financial and Economic Pressure Campaign**

There are fundamental principles that should drive any serious financial or economic pressure campaign. These principles should inform the design, choreography, and strategy deployed before launching any type of sanction or form of economic coercion.

1. *Strategy Matters.* To be effective, an attempt to use sanctions or financial measures of any sort must nest within a coherent strategy and cannot stand alone. Too often, sanctions have been seen as either the only retreat for action to address a thorny national security issue or as a silver bullet that can bend behavior and alter a threat landscape on its own. For any financial pressure campaign to work, it must be in service of an understood strategy and complemented by other tools of statecraft, power, and coercion. In this case, the strategic objective must be to slow, stop, and ultimately reverse the North Korean nuclear program and ensure that the regime never has the ability to threaten U.S. territory with nuclear weapons. The financial strategy must then follow and be crafted to achieve this core goal, in aid of diplomacy, coercion, and material disruption of the targeted programs.
2. *Coercive Tools in Concert.* The sanctions and economic toolkit must be seen as part of a broader set of coercive tools that are more effective when deployed in concert to shape the environment. Interdiction of suspect North Korean shipping, arrests of those involved in North Korean illicit financial activity, broad-based information campaigns to weaken the regime's control of the information environment, and an aggressive focus on the regime's human rights abuses are all complementary and functional parts of any campaign to isolate the North Korean economy. These are also tools that should target, impact, and deter those who do business or finance the regime's activities. Sanctions must be seen as part of a broader effort to disrupt the regime's ability to resource its nuclear and missile ambitions and access the key elements of the financial and commercial system.
3. *Constant, Consistent Pressure.* For a financial pressure campaign to work, it must be applied constantly to identify and isolate North Korea's rogue behavior. U.S. and international sanctions and pressure in the past have suffered from applying an escalatory model based on reactions to North Korea's provocations, tests, and violations of existing sanctions. Such sanctions have been perceived as important simply in aid of diplomacy. Although that is a critical use of these tools, in order to be effective, they must be seen as



their own form of pressure, coercion, and disruption that complements our diplomacy. As a result, the sanctions approaches of the past have been dictated more by what the regime in Pyongyang does as opposed to what an effective financial and economic pressure campaign looks like. Any use of sanctions must be part of a broader campaign to sensitize the international community and markets to exclude rogue actors involved with North Korea from the legitimate financial and commercial system. Like weeding a garden, such work has to be consistent and constant, to shape market and governments' behavior.

4. *Conduct-Based Focus.* A successful campaign against North Korea that enlists China and our allies would focus intently on conduct-based sanctions and measures that target the illicit, dangerous, and suspicious activities that violate international norms and principles and put the financial system at risk. A fundamental vulnerability for North Korea is that it is not only developing nuclear weapons capabilities in violation of international sanctions, but it is a criminal state. It is engaged in proliferation, massive human rights abuses, money laundering, corruption, sanctions evasion, counterfeiting, smuggling, drug trafficking, and other nefarious and suspect activities.

These activities are interwoven in how North Korea does business and should be isolated by the international community – governments and the private sector alike – regardless of the state of diplomacy. Such activities are the subject of sanctions, criminal laws, and financial regulations. At a time of heightened concern over transparency and accountability in the financial system, there should be no objection to doing so, especially in major economies like China, Japan, and South Korea. As long as the efforts to target North Korean networks and their financial and commercial infrastructure remain focused on the activities that violate accepted international norms and principles, they will prove more effective and be amplified by the actions of the private sector and actors concerned about real and reputational risk.

5. *Altering the Chinese Calculus.* China must play a central role in pressuring North Korea, but its interests do not align with those of the United States and it has not been willing to exert existential pressure against the regime to force it to stop its nuclear program. For the United States, for too long, trying to coerce China to exert more pressure on North Korea has appeared as the third-rail of the sanctions debate. But we have reached a moment where we need to align U.S. and Chinese interests with respect to pressuring North Korea. We cannot ignore the role that Chinese actors are playing to evade sanctions, enrich the leadership, and enable the regime to develop its dangerous capabilities across the board.

If this is an urgent international security issue, the Chinese dimension cannot be spared attention, and the Chinese calculus must be altered. Chinese interests and standing will have to be put at risk directly and indirectly. Of course, this needs to be a balanced approach, understanding direct financial and economic confrontation with China through sanctions will likely prove counterproductive. This balance can be drawn if China sees itself as a partner in these efforts and if the campaign is geared toward targeting and isolating rogue financial and commercial activity and those flouting legitimate authorities



and international norms. Getting the Chinese to realize that the continued, current path with North Korea is itself creating regime and regional instability – and putting its own reputation and economy at risk – will be a difficult but essential element of any campaign.

U.S. sanctions against North Korea have lacked both a comprehensive approach of this nature and a willingness to put China's interests on the table. The U.S. government's recent strategy of strategic patience and a prior pattern of lessening financial pressure or rewarding the regime in Pyongyang in the face of provocation have not forced the Chinese to make hard choices. The idea of pressuring China to alter its calculus is difficult, but if the problem of a nuclear armed and threatening North Korea is growing acute, then we need to apply a more aggressive approach.

It is in this context that the question of whether and how to use secondary sanctions and other types of financial tools and measures arises. Before treating the issue of secondary sanctions, it is important to understand the nature of North Korean financial activity and its dependence on the Chinese economic and financial system.

### **North Korean Financial Activity and Chinese Connectivity**

For years, the North Korean regime has found creative and often devious ways to run its economy. They have raised and moved capital into the Hermit Kingdom in order to prop up the regime and develop an expensive nuclear and missile program. It has adapted to sanctions and attempts to isolate the regime financially and commercially – relying on the Chinese economy, including Chinese banks, networks, and brokers, for most of its trade and connectivity to the commercial and financial world. The North Korean regime has consistently leveraged commercial relationships to its advantage and worked around existing sanctions and restrictions. Much of this has involved illicit financial activity and schemes to raise money for the government.

The North Korean schemes outside their borders rely heavily on front companies, layered transactions, opaque ownership structures, and trusted or corrupt relationships, making it difficult for legitimate banks and compliance systems to detect and stop its nefarious activities. The United Nations has issued annual reports that detail North Korea's aggressive efforts to evade financial sanctions.<sup>1</sup> In 2011, the Financial Action Task Force called for its members to impose countermeasures on the Kim regime due to its significant lack of anti-money laundering and counter-terrorism finance controls.<sup>2</sup> Last year, the United States Treasury labeled North Korea a jurisdiction of "primary money laundering concern," ordering that the country be cut off from the U.S. financial system and prohibiting foreign banks from providing indirect access.<sup>3</sup> In the

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<sup>1</sup> United Nations Security Council, "Reports of the Panel of Experts established pursuant to resolution 1874 (2009)." ([https://www.un.org/sc/suborg/en/sanctions/1718/panel\\_experts/reports](https://www.un.org/sc/suborg/en/sanctions/1718/panel_experts/reports))

<sup>2</sup> Financial Action Task Force, "Public Statement – 24 February 2017," February 24, 2017. (<http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-february-2017.html>)

<sup>3</sup> U.S. Department of the Treasury, Financial Crimes Enforcement Network, "Finding that the Democratic People's Republic of Korea is a Jurisdiction of Primary Money Laundering Concern," 81 Federal Register 35441, June 2, 2016. ([https://www.fincen.gov/sites/default/files/shared/2016-13038\(DPRK\\_Finding\).pdf](https://www.fincen.gov/sites/default/files/shared/2016-13038(DPRK_Finding).pdf))



designation, the Treasury Department described North Korea's financial activities as a "threat to the integrity of the U.S. financial system."<sup>4</sup>

The UN Panel of Experts has investigated Pyongyang's financial activities, noting that "circumvention techniques and inadequate compliance by Member States are combining to significantly negate the impact of the resolutions."<sup>5</sup> The Panel reported that North Korea generates "significant revenue" from its financial networks with most denominated in U.S. dollars, euros, and renminbi.<sup>6</sup>

The regime generates profits from all forms of illicit activity – from counterfeit cigarette smuggling to proliferation. The UN Panel of Experts noted that North Korean proliferation networks are expanding and blending to include arms trafficking in Africa and the manufacture and trade of military technologies. Such networks rely on trusted and sophisticated agents able to move people, goods, and money undetected across borders. Those networks and agents are growing more sophisticated in masking and layering corporate identities and records and play within the seams of the international system.

The North Koreans are profiting from their human rights abuses. Within the country, unpaid labor earns around \$975 million for the government each year, according to Seoul-based NGO Open North Korea.<sup>7</sup> The report estimates that 400,000 people make up the lowest class of forced laborers, or *dolgyeokdae*, who are put to work on construction projects throughout the country.

The regime also profits handsomely from forced labor outside its borders. UN Special Rapporteur on Human Rights in North Korea Marzuki Darusman estimated that there are approximately 50,000 North Koreans abroad, earning between \$1.2 billion to \$2.3 billion per year for the DPRK.<sup>8</sup> Countries like China, Poland, Qatar, and others allow their companies to use such labor and to make arrangements to pay North Korea.<sup>9</sup>

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<sup>4</sup> U.S. Department of the Treasury, Financial Crimes Enforcement Network, "Finding that the Democratic People's Republic of Korea is a Jurisdiction of Primary Money Laundering Concern," 81 Federal Register 35441, June 2, 2016. ([https://www.fincen.gov/sites/default/files/shared/2016-13038\(DPRK\\_Finding\).pdf](https://www.fincen.gov/sites/default/files/shared/2016-13038(DPRK_Finding).pdf))

<sup>5</sup> United Nations Security Council, "Report of the Panel of Experts established pursuant to resolution 1874 (2009)," S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>6</sup> Ibid.

<sup>7</sup> Steven Borowiec, "North Koreans perform \$975 million worth of forced labor each year," *Los Angeles Times*, October 6, 2016. (<http://www.latimes.com/world/asia/la-fg-north-korea-forced-labor-20161006-snap-story.html>)

<sup>8</sup> Christian Vonscheidt and Miriam Wells, "Cash for Kim: How North Koreans are Working Themselves to Death in Europe," *VICE News*, May 23, 2016 (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>); Edith M. Lederer, "UN investigator: North Koreans doing forced labor abroad to earn foreign currency for country," *AP*, October 28, 2015.

(<https://www.usnews.com/news/world/articles/2015/10/28/un-investigator-north-koreans-doing-forced-labor-abroad>)

<sup>9</sup> VICE News discovered that 14 Polish companies have used North Korean workers between 2010 and 2016. The workers were supplied to Polish companies Armex and Alxon by the Korea Rungrado General Trading Corporation. Working conditions in these shipyards meet the definition for forced labor, as laid out in the European Convention on Human Rights and the International Labor Organization. (Christian Vonscheidt and Miriam Wells, "Cash for Kim: How North Koreans are Working Themselves to Death in Europe," *VICE News*, May 23, 2016. (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>))



The workers are used in industries like shipyards, surface construction, furniture production, agriculture, metalworking, medicine, and finance. Wages are paid in foreign currency directly to the DPRK as a method of bypassing UN sanctions.<sup>10</sup> Workers are paid between \$120 and \$150 per month, but the employers “pay significantly higher amounts” directly to the North Korean government.<sup>11</sup>

With all this, China remains North Korea’s most important economic and trading partner. China accounts for approximately 90% of North Korea’s total trade volume, and Chinese-North Korean trade was up 37.4% in the 1<sup>st</sup> Q of 2017 when compared to 2016.<sup>12</sup> China has benefited from access to North Korean coal and minerals while North Korea has used Chinese networks and its economic system, in particular broker relationships and access to financial institutions, as a way of accessing hard capital and driving its economy.

Unfortunately, China has allowed its economy to be used by North Korea to evade sanctions and engage in illicit activity. In most cases when a new North Korean sanctions evasion network is revealed, inevitably it has a nexus to or in China. Given Beijing’s robust security services and sensitivities to exposure to North Korean activity, it is hard to believe the Chinese leadership is not aware of such exposure to North Korea and the Kim regime’s activities.

Recent examples of how North Korea’s financial and commercial activities are intertwined with the Chinese economy and financial system are illustrative:

- *Limac-Ryonbong Joint Venture*: This past weekend, *The Wall Street Journal* reported that Limac Corp, a Chinese state-owned company, has maintained a joint venture since 2008, with a North Korea’s Ryonbong General Corp, which has been under U.S. sanctions since 2005, for its involvement with weapons of mass destruction.<sup>13</sup> The North Korean firm has reportedly “tried to procure chemicals for solid-fuel for rockets” in the past, and several of its employees were sanctioned as recently as six weeks ago by the Treasury Department.<sup>14</sup> Meanwhile, the Chinese firm maintains a U.S. affiliate, and records show that in 2013, it shipped Canadian nuclear-power equipment to China via the U.S.<sup>15</sup> This represents just one node of the China-North Korea nexus. Sayari Analytics (which

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<sup>10</sup> Christian Vonscheidt and Miriam Wells, “Cash for Kim: How North Koreans are Working Themselves to Death in Europe,” *VICE News*, May 23, 2016. (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>)

<sup>11</sup> Jethro Mullen, “North Korea believed to earn a fortune from forced labor overseas, UN says,” *CNN*, October 29, 2015 (<http://www.cnn.com/2015/10/29/asia/north-korea-un-forced-labor-overseas/>); Edith M. Lederer, “UN investigator: North Koreans doing forced labor abroad to earn foreign currency for country,” *AP*, October 28, 2015. (<https://www.usnews.com/news/world/articles/2015/10/28/un-investigator-north-koreans-doing-forced-labor-abroad>). The Leiden Asia Center estimates that between 70-100% of the earnings go directly to the DPRK.

<sup>12</sup> Eleanor Albert, “The China-North Korea Relationship,” *Council on Foreign Relations*, April 26, 2017. (<http://www.cfr.org/china/chinanorth-korea-relationship/p11097>)

<sup>13</sup> Jeremy Page and Jay Solomon, “Chinese-North Korean Venture Shows How Much Sanctions Can Miss,” *Wall Street Journal*, May 7, 2017. (<https://www.wsj.com/articles/chinese-north-korean-venture-shows-how-much-sanctions-can-miss-1494191212>)

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*



discovered the link) “says it has identified more than 600 Chinese companies that trade with North Korea.”<sup>16</sup>

- *The Dandong Hongxiang Network*: Dandong Hongxiang Industrial Development Co., Ltd and four Chinese individuals created a mechanism to help North Korea evade financial sanctions.<sup>17</sup> The network was exposed in August 2016, in a ground-breaking study, *In China’s Shadow*, published by the Center for Advanced Defense Studies (C4ADS) and the Asan Institute for Policy Studies.<sup>18</sup> The Justice Department filed an indictment against the company and four individuals shortly after the publication of the C4ADS-Asan study.<sup>19</sup> From 2009 to 2015, the network allegedly routed at least \$75 million through the U.S. financial system, and from June to August 2016, the network routed \$8 million through the U.S. financial system. The Treasury Department also designated the four Chinese nationals and Chinese companies in September 2016, in coordination with the public unsealing of the indictment.<sup>20</sup>
- *Global Communications Co (Glocom)*: Pan Systems Pyongyang, a North Korean branch of a Singapore-based company, created Glocom claiming it was a Malaysia-based company to sell prohibited military equipment. The UN Panel of Experts reported that the company used bank accounts in China to transfer funds to suppliers located in mainland China and Hong Kong.<sup>21</sup> The Panel noted that a “series of transactions by Glocom initiated by companies registered in Hong Kong, China, and cleared through several

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<sup>16</sup> Jeremy Page and Jay Solomon, “Chinese-North Korean Venture Shows How Much Sanctions Can Miss,” *Wall Street Journal*, May 7, 2017. (<https://www.wsj.com/articles/chinese-north-korean-venture-shows-how-much-sanctions-can-miss-1494191212>)

<sup>17</sup> The four individuals are: Ma Xiaohong, a Chinese national who resides in Dandong, China and was the majority owner (80%) owner of DHID; Zhou Jianshu, a Chinese national who also resides in Dandong and was the general manager of DHID working directly for Ma; Luo Chuanxu, a Chinese national who is the financial manager of DHID and an assistant to Ma and Zhou; and Hong Jinhua is a Chinese national who also resides in Dandong and was the deputy general manager of DHID working for Ma. U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged with Using Front Companies to Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs,” September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>18</sup> “In China’s Shadow,” *The Asan Institute for Policy Studies and C4ADS*, August 2016. (<https://static1.squarespace.com/static/566ef8b4d8af107232d5358a/t/57dfe74acd0f68d629357306/1474291539480/In+China%27s+Shadow.pdf>) U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged with Using Front Companies to Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs,” September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>19</sup> U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged with Using Front Companies to Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs,” September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>20</sup> U.S. Department of the Treasury, “Press Release: Treasury Imposes Sanctions on Supporters of North Korea’s Weapons of Mass Destruction Proliferation,” September 26, 2016. (<https://www.treasury.gov/press-center/press-releases/Pages/jl5059.aspx>)

<sup>21</sup> United Nations Security Council, “Report of the Panel of Experts established pursuant to resolution 1874 (2009),” S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)



United States correspondent banks in New York.”<sup>22</sup> The UN noted that Pan Systems Pyongyang is controlled by the U.S.-designated Reconnaissance General Bureau (RGB), North Korea’s intelligence agency, and also received funds from U.S. and UN-designated Korea Mining Development Trading Corporation, a key proliferation entity.<sup>23</sup>

- *March 31, 2017 U.S. Designations:* The Trump administration’s actions against North Korea’s financial facilitators provided insight into the workings of Pyongyang’s financial network. The designations included the following: Han Jan Su, the Moscow-based representative of U.S.-designated Foreign Trade Bank; Jo Chol Song, the Dandong, China deputy representative of U.S. and UN-designated Korea Kwangson Banking Corporation; Kim Tong Ho, the Vietnam-based representative of U.S. and UN-designated Tanchon Commercial Bank; Kim Mun Chol, the Dandong-based representative of U.S. and UN-designated Korea United Development Bank; and Kim Nam Ung and Choe Chun Yong, the Moscow-based representatives for Ilsim International Bank.<sup>24</sup> These representatives were engaged in a variety of conduct including working with RGB on financial transfers, working with Moscow-based Tempbank that was designated by the U.S. for its activities with the Syrian regime, and weapons and missile-related sales.<sup>25</sup>
- *North Korean Banks in China:* The UN Panel of Experts reported that U.S.-designated Daedong Credit Bank (DCB) and U.S.-designated Korea Daesong Bank (KDB) are operating in China using representative offices in Dalian, Dandong, and Shenyang.<sup>26</sup> The UN reported that U.S.-designated Kim Chol Sam operated a financial network inside China, including millions of U.S. dollar transactions, without apparent repercussions from Beijing.<sup>27</sup>

These are some examples of how the North Koreans continue to engage in illicit commerce and financing by leveraging their ties, facilities, and agents in China. More research attention and disclosures of these kinds of networks will continue from the media and scholars like Anthony Ruggiero at the Foundation for Defense of Democracies and our Center on Sanctions and Illicit Finance and analytic firms like C4ADS and Sayari. The dependency of the North Korean economy on the Chinese system raises the difficult question of what more can be done to pressure China to crack down effectively on the regime in Pyongyang.

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<sup>22</sup> United Nations Security Council, “Report of the Panel of Experts established pursuant to resolution 1874 (2009),” S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>23</sup> Ibid.

<sup>24</sup> U.S. Department of the Treasury, “Press Release: Treasury Sanctions Agents Linked to North Korea’s Weapons of Mass Destruction Proliferation and Financial Networks,” March 31, 2017. (<https://www.treasury.gov/press-center/press-releases/Pages/sm0039.aspx>)

<sup>25</sup> U.S. Department of the Treasury, “Press Release: Treasury Sanctions Syrian Regime Officials and Supporters,” May 8, 2014. (<https://www.treasury.gov/press-center/press-releases/Pages/jl2391.aspx>) U.S. Department of the Treasury, “Press Release: Treasury Sanctions Agents Linked to North Korea’s Weapons of Mass Destruction Proliferation and Financial Networks,” March 31, 2017. (<https://www.treasury.gov/press-center/press-releases/Pages/sm0039.aspx>)

<sup>26</sup> United Nations Security Council, “Report of the Panel of Experts established pursuant to resolution 1874 (2009),” S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>27</sup> Ibid.



## **Killing the Chicken to Scare the Monkey: Secondary Sanctions and Beyond**

This Subcommittee has asked to focus on the potential use of secondary sanctions to impact those entities in China that continue to do business with North Korea. Secondary sanctions are not a common tool in the various U.S. sanctions regimes, but they have been employed or implicated recently in sanctions programs against Iran, Hizballah, and in the Russia/Ukraine context.

Secondary sanctions entail imposing sanctions or restrictions against third-country parties for transactions with no U.S. touch points or traditional nexus. The goal of secondary sanctions with jurisdictions or regimes is to force a foreign third-party to choose between doing business in the United States or doing business in the targeted jurisdiction. Such sanctions apply to all persons (natural and legal) on a global basis, regardless of the person's connection with the United States. Those sanctioned are then subject to various potential penalties that restrict their ability to access the U.S. market.

In the Iran context, U.S. secondary sanctions primarily targeted certain sectors and exports directly relevant to the Iranian economy and prohibited foreign financial institutions from conducting any significant transactions in Iranian currency. The United States used these sanctions to restrict Iran's activities and squeeze their economy. Their greatest effect may have been in the potential application of such sanctions and the resulting chilling effect on market and commercial activity – even absent designations.

Secondary sanctions are not without problems or controversy. Other countries and foreign parties see them as the most aggressive extra-jurisdictional application of American economic power and influence – leveraging access to U.S. markets as a tool of coercive economic statecraft. They are also effective only if they can be credibly threatened and applied. This is not the case when those engaged in the activity of concern have no desire to deal with the United States and no potential exposure making them subject to sanction or financial or economic isolation. These can also appear to be toothless sanctions if the categories of potential institutions or sectors targeted are “too big to sanction.”

To the Chinese, the potential application of primary or secondary sanctions to their citizens, companies, or interests will be seen as a challenge to their sovereignty. Consistently, the Chinese have objected to any form of unilateral sanctions that fall outside of the auspices of the United Nations, and any financial or commercial measure that has the effect of sanctioning a Chinese party will engender a negative reaction. In addition, China has tended to defend against more aggressive application of Chapter 7 UN sanctions, and it has often been lax in enforcing sanctions regimes when Chinese interests are at play, as in the case of North Korea.

In the current context, North Korea appears to rely less on major Chinese global banks and financial institutions directly for access to financing and banking services. North Korean financial and commercial activity has tended to concentrate in recent years with smaller Chinese banks and entities to facilitate financial and commercial activity and with many entities with little to no connectivity to the United States. Even so, more research and analysis is uncovering deeper and more entangled commercial, transport, and financial ties between the Chinese and



North Korean economies. The direct and indirect exposure by major Chinese companies and banks to North Korea may not be fully known or appreciated, perhaps not even to those institutions.

Though Chinese sensitivities have to be kept squarely in mind to ensure greater cooperation, there needs to be a more comprehensive set of tools that attempt to squeeze the Kim regime's access to financing and commercial outlets, sensitizes the markets to the risks of doing business with North Korea, and begins to demonstrate a willingness to expose and target key nodes and conduits of North Korean financial and commercial activity.

In that context, it is appropriate to consider creating secondary sanction authorities that target those entities – of whatever country of origin that continue to do business with North Korea in certain sectors of concern. The mere threat of secondary sanctions – regardless of sectors identified -- would condition governments and the private sector to engage in deeper due diligence to understand better where North Korean agents, networks, and entities are accessing capital and resources. It would result in North Korean accounts being shut down, activity locked out of the financial system, and agents attempting to recast their businesses and identities to avoid scrutiny.

The risk from direct or indirect exposure to North Korea would be a serious concern for the major Chinese banks -- the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agriculture Bank of China -- trying to establish legitimate and sustainable footholds in the United States and other Western markets. Even if these banks did not have direct business ties with North Korea, they would have to ensure that their counterparties, correspondents, and clients did not expose them to the threat of secondary sanctions or enforcement actions in the United States. The risk of being cut off from U.S. markets would be too great a risk to ignore for legitimate actors in the banking, shipping, and commercial worlds.

The mere existence of the authority does not mean it has to be used in each instance of a violation. The authority would open up economic and diplomatic dialogue with concerned actors that could result in changed behavior, more information, and the cut off of commercial relations with North Korea – even without designating any entities. The use of such authority may ultimately be shaped or constrained by diplomatic considerations, but this tool could provide diplomatic leverage that does not currently exist with North Korea and China.

Secondary sanctions authority, though important, would not be the only step the United States could take unilaterally and in concert with international partners and the private sector to pressure North Korea, including in and through China. As with any effective sanctions program, there needs to be a commitment of analysis, investigations, targeting, and follow-up – constantly undertaken to counteract the evasion and masking techniques used by nefarious actors. And such efforts cannot be left to the United States alone, though it will need to lead any such effort.

The following are other steps that should be taken to address the risks from North Korea and catalyze Chinese and other actors to do more to prevent North Korea from accessing the financial and commercial system.



- *North Korean “Class of Transaction” 311 Designation.* On November 9, 2016, the U.S. Treasury designated North Korea a “primary money laundering concern” and prohibited any correspondent accounts with North Korean financial institutions or the facilitation of any transaction from a North Korean financial institution. This was a very important step and a signal to the financial community of the seriousness of the risks to the integrity of the financial system and international community posed by North Korea. This step should be amplified by designating *any* North Korea financial and commercial transaction or activity as a class of transaction of “primary money laundering concern” and requiring specific enhanced due diligence, information collection, and reporting tied to any transactions touching North Korean activity – inside or outside of the country. This would put the onus on financial institutions, in particular Chinese banks with exposure to the United States and Western banking systems, to determine if they have direct or indirect exposure to anything that touches North Korea. This scrutiny goes beyond designated North Korean banks or entities – whose names and affiliations may change -- and more broadly to the suspect nature of any transaction that touches North Korea.
- *Dynamic Financial Information Sharing with Private Sector.* The U.S. government, in concert with Japan, South Korea, Australia, and other allies in Asia, should establish a dynamic information sharing mechanism with key private sector actors to explain and share where potential exposure to suspect North Korean activity lies. Financial intelligence units could be tasked with compiling data and reports that could be disseminated, with a goal of targeting and exposing more North Korean financial and commercial activity more quickly. Banks, shipping companies, and the insurance sector would welcome more information that would allow them to comply with relevant sanctions and understand where risk lies within their businesses. This could follow other models and platforms being created in the banking industry to share more specific information about specific risks and threats.
- *Regulatory and Enforcement Attention to Chinese Banks.* Authorities in the United States, Western, and Asian countries have begun to devote more regulatory and enforcement attention to Chinese banks operating abroad for failure to have adequate financial crimes and sanctions compliance risk management. This is an important shift in attention, as Chinese banks seek to meet international global standards for transparency, sanctions compliance, and financial crimes risk management. Billions of dollars of fines against European, American, and other Western banks have focused the attention of banks to improve their sanctions compliance. Scrutiny over Chinese banks’ lack of adequate financial controls and a culture of compliance – as has happened with other global banks – would further sensitize Chinese institutions to the risks presented by exposure to North Korea.<sup>28</sup>

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<sup>28</sup> Anthony Ruggiero, “Severing China-North Korea Financial Links,” Center for Strategic and International Studies, April 3, 2017. (<https://www.csis.org/analysis/severing-china-north-korea-financial-links>).



- *Anti-Corruption Initiative.* The United States should launch an anti-corruption initiative to investigate and build public cases against corrupt North Korean actors and those who are colluding with them, perhaps using a new executive order to focus targeted sanctions on North Korean kleptocracy. Such sanctions and any related cases exposed would focus attention on the amount of wealth and corruption within the regime leadership and the ties that they have with others outside of North Korea. The Chinese would be concerned about North Korean corruption bleeding into their system and implicating Chinese actors. This would likely prompt greater attention to North Korean ties and lead to more Chinese actions to shut down illicit or corrupt networks of concern.
- *Leadership Asset Hunt.* In conjunction with this, the United States should declare that it is launching a leadership asset hunt for assets stolen and held by the Kim leadership, using the tools and resources of the intelligence community, law enforcement, and regulators and working with international institutions like the World Bank's Stolen Asset Recovery Initiative. The goal would be to determine how the senior leadership of the regime in Pyongyang holds and stores its money outside of North Korea and with whom it is dealing and operating. This could have direct implications for China and could expose where North Korea and China maintain existing financial relationships. This would further shine a spotlight on suspect "Politically Exposed Persons" requiring additional due diligence and attention by the Chinese and other banking systems.
- *Human Rights and Sanctions.* The United States should expand the list of companies and entities subject to sanctions under Executive Order 13722 (March 15, 2016), including considering designating those companies employing North Korean workers and paying their fees directly to the North Korean regime. It should call on countries currently allowing this practice to shut it down and push for human rights designations at the UN and a prohibition on paying North Korea for overseas laborers.<sup>29</sup> This should be matched with a Treasury advisory to financial institutions warning against facilitating or engaging in any transaction related to this forced labor.
- *Shipping: Mapping & Interdictions.* The United States in concert with Japan, South Korea, Australia, and other allies should coordinate the sharing of North Korean shipping and transport data – along with private sector actors to track and map shipping interests doing business with or in North Korean ports or waters. The mapping and investigation of shipping tied to North Korea would allow for more robust information sharing and understanding where the proliferation and trafficking risks lie and would expose networks and business interests of concern. This would also enable more robust maritime interdiction strategies, which would put pressure on those countries or entities that continue to do business with North Korea.
- *North Korean Illicit Activities Enforcement Initiative.* The law enforcement and intelligence communities – in concert with the UN Panel of Experts and the private sector

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<sup>29</sup> Anthony Ruggiero, "Don't let North Korea's nukes overshadow human rights abuses," *The Hill*, April 28, 2017. (<http://thehill.com/blogs/pundits-blog/foreign-policy/331061-dont-let-north-koreas-nukes-overshadow-human-rights-abuses>)



- should concentrate on understanding and exposing North Korea’s continuing illicit commercial and financial activity. Smuggling, money laundering, arms trafficking, and sanctions evasion should all be subject to intense investigation and exposure and should be a priority for law enforcement in Asia and wherever North Korea engages in commercial activity. An illicit activity initiative would allow for more disruptions, designations, and identification where illicit networks are operating with impunity. This could be done in concert with the Chinese to underscore the need to attack illicit financing networks.
- *Cyber Litigation – Private Rights of Action.* To match existing sanctions targeting those involved in undermining cybersecurity, Congress should consider providing victims of North Korean cyber attacks the right to sue and seek damages from entities and actors that have facilitated or knowingly benefited from North Korean cyber activity. This is important as North Korea expands its cyber footprint and attacks. Though this may not reach into Pyongyang, this right of action would put private sector actors that deal with North Korean or other cyber belligerents on notice that they could be subject to private litigation and suits.

These are just some of the ideas that can be woven into a strategy that includes secondary sanctions. These tools – if leveraged and choreographed wisely and in concert – would not only squeeze the North Korean regime but also compel the Chinese to consider its own ties and the risks of exposure to North Korea.

### **Changing the Chinese Calculus**

There is reason to believe that the Chinese calculus and behavior can be affected if North Korean actions and taint threaten the fundamental interests and reputation of the Chinese economy, leadership, and system. There are hopeful signs in recent months and past episodes that provide a window into Chinese thinking and can be guideposts for any pressure campaign.

China has been willing to exert pressure and crack down on its trade with North Korea when it has faced public scrutiny over such ties, or when it wishes to express selective disapproval over North Korean actions. In September 2016, it was reported that China had opened an investigation into the Chinese citizen, Ma Xiaohong, who was indicted by the United States. She ran the *Dandong Hongxiang Network*, which had allegedly undertaken half a billion dollars in trade with North Korea between 2011 and 2015,<sup>30</sup> some of which “included materials that can be used in the production of nuclear weapons.”<sup>31</sup> China has reportedly frozen her assets.

In February and April of this year, China curbed its imports of coal from North Korea, likely in response to recent multiple missile tests Pyongyang carried out and in the wake of the

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<sup>30</sup> James Pearson, “China probes North Korea bank suspected of nuclear link – South Korea paper,” *Reuters*, September 26, 2016. (<http://www.reuters.com/article/us-northkorea-nuclear-bank-idUSKCN11W049>)

<sup>31</sup> Jane Perlez and Chris Buckley, “China Announces Inquiry into Company Trading With North Korea,” *New York Times*, September 20, 2016. ([https://www.nytimes.com/2016/09/21/world/asia/north-korea-china-inquiry-hongxiang.html?\\_r=0](https://www.nytimes.com/2016/09/21/world/asia/north-korea-china-inquiry-hongxiang.html?_r=0))



assassination of Kim Jong Un's half-brother in Malaysia via a VX nerve agent.<sup>32</sup> Furthermore, in May 2013, the Bank of China closed the account belonging to Foreign Trade Bank, "North Korea's most important financial institution", which had been sanctioned by the U.S. in March of that year.<sup>33</sup> These actions do not necessarily signal a fundamental shift in Chinese policy, but it reflects a willingness to take actions against North Korean interests and connections in China.

In addition, the Chinese Politburo held a study group last month focusing on "financial security," signaling that the Chinese leadership is attaching a high priority to this topic. The United States could work with the Chinese to focus on protecting the Chinese, U.S., and broader financial system from the collective threats of illicit activity, cyberfinancial attacks, and corruption that North Korea represents, especially to Chinese banks.

In the past, there have been key episodes that demonstrate the Chinese system's sensitivity to the risks North Korea represents to its own economy and reputation – and a willingness to cooperate and change their risk calculus as a result of a changed landscape.

1. *Banco Delta Asia (BDA)*. In September 2005, as part of a strategic pressure campaign, the Treasury Department ordered U.S. financial institutions to close correspondent accounts for a private bank in Macau -- Banco Delta Asia (BDA) – pursuant to Section 311 of the Patriot Act. This bank – designated as a "primary money laundering concern" – was facilitating money laundering, proliferation, and counterfeiting on behalf of the North Korean regime.

The regulation cut the bank off from the U.S. financial system. More important, the unilateral regulation unleashed a wave of financial isolation against North Korea. Banks in China, Asia, and Europe stopped doing business with North Korea, denying it access to the international financial system. North Korean bank accounts were closed, its transnational commercial transactions were canceled, and officials' financial activities were carefully scrutinized.

This hurt Pyongyang. The North Korean regime scrambled to regain access to money and accounts around the world while trying to undo the official damage done to its reputation in the international financial community. Key state actors, including China, had no incentive to block the full effect of the market reaction. On the contrary, they did not want their banks or financial reputations caught up in the taint of North Korea's illicit financial activity.

This pressure became the primary leverage for the United States to press for North Korea's return to the six-party negotiating table. Once the six-party talks reassembled, the financial pressure campaign against North Korea ended, resulting in a loosening of the financial squeeze.

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<sup>32</sup> John Ruwitch and Meng Meng, "North Korean ships head home after China orders coal returned," *Reuters*, April 11, 2017. (<http://www.reuters.com/article/us-china-northkorea-coal-exclusive-idUSKBN17D0D8>)

<sup>33</sup> Jane Perlez, "U.S. Sanctions Expected to Hit Small Banks' Business With North Korea," *New York Times*, June 3, 2016. (<https://www.nytimes.com/2016/06/04/world/asia/us-sanctions-expected-to-hit-small-banks-business-with-north-korea.html>)



Unlike traditional state-based sanctions, this kind of financial leverage relies more on the risk-based calculus of global financial institutions than the policy decisions of governments. For legitimate financial institutions, there are no benefits to the risk of facilitating illicit transactions that could bring high regulatory costs and damage to their reputations if uncovered. If financial institutions act according to their own interests, targeted actors and their suspected fronts will be denied access to the facilities of the international financial system. In this case, the Chinese financial institutions defended their own interests and reputations, not putting themselves at risk on behalf of the North Koreans.

2. *Kunlun Bank*. On January 31, 2012, the U.S. Department of the Treasury sanctioned Bank of Kunlun Co. Ltd., a Chinese bank under the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA) for providing “significant financial services” to at least six Iranian banks designated by the Treasury.<sup>34</sup> Bank of Kunlun transferred nearly \$100 million from accounts it held for Bank Tejarat and made at least one payment for an affiliate of the Iranian Revolutionary Guard Corps.<sup>35</sup> At the time, Chinese Foreign Ministry Spokesman Qin Gang urged the US to lift sanctions against the Bank of Kunlun, stating that the imposition of U.S. sanctions “violates the norms of international relations and damages China’s interests.”<sup>36 37</sup> Despite the protestations and fears of Chinese backlash, the Chinese quietly dealt with Kunlun Bank and directed it to stop such activities.
3. *Chinese Position Shift on Sudan ICC Indictment*. At a recent Harvard Law School panel discussion, the first Chief Prosecutor of the International Criminal Court (ICC), Jose Luis Moreno Ocampo, provided an instructive example of a Chinese policy shift during his tenure. Ocampo noted that the Chinese position regarding the ICC’s investigation of the Bashir regime in Sudan had always been to support and defend it because President Bashir guaranteed the stability of Sudan. The Chinese position changed in the face of the Bush Administration’s forceful support of the ICC’s indictment of President Bashir of Sudan, leading the Chinese to conclude that Bashir no longer represented stability and began to explore other options. According to Ocampo, the Obama Administration’s consolidation of Bashir’s stability led to the consolidation again of China’s support to the regime in Sudan.

Indeed, the Chinese will not want to react directly to pressure, but they will understand when their interests are directly affected by the taint, attention, and illicit activity of the North Koreans. We have seen this already with the discomfort China has felt and expressed with the deployment

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<sup>34</sup> “Treasury Sanctions Kunlun Bank in China and Elaf Bank in Iraq for Business with Designated Iranian Banks,” *Department of the Treasury Press Release*, July 31, 2012. (<https://www.treasury.gov/press-center/press-releases/Pages/tg1661.aspx>)

<sup>35</sup> “Exclusive: Iran uses China bank to transfer funds to Quds-linked companies – report” *Reuters*, November 18, 2014 (<http://www.reuters.com/article/us-iran-sanctions-china-exclusive-idUSKCN0J20CE20141119>)

<sup>36</sup> “China hits back at new US sanctions over Iran,” Kelly Olsen, *AFP*, August 1, 2012. (<https://www.yahoo.com/news/china-hits-back-us-sanctions-over-iran-063058172.html>)

<sup>37</sup> Wayne Ma, “China Scolds U.S. Over Iran-Related Bank Sanctions,” *Wall Street Journal*, August 1, 2012. (<https://www.wsj.com/articles/SB10000872396390444320704577562330527832056>)



of the THAAD missile defense system in South Korea and the increased U.S. maritime presence in Asian waters. If the Chinese see that their interests and credibility will be undermined fundamentally by connectivity and support to North Korea, the less likely they are to allow those financial and commercial ties to exist. If they understand that exposure to North Korea will bring greater scrutiny to issues like corruption, human rights abuses, and financial crimes in China and Chinese institutions, then the Chinese calculus will have to change.

This is a moment of growth and expansion for the Chinese banks and commercial brands, with many establishing footholds in Western economies. If protecting the North Korean economy or regime represents a real threat – direct or indirect -- to the credibility and strength of the Chinese banking sector and the future stability and growth of the Chinese economy, the Chinese may not elect to maintain suspect commercial and financial ties with North Korea. The potential application of secondary sanctions could affect this calculus and move the Chinese to place more serious pressure on Pyongyang.

### Caution and Caveats

When considering secondary or other types of sanctions with respect to China, policymakers and national security strategists have to take into account the size and significance of the Chinese economy. The second largest economy in the world, growing to become the leading economy in this century, with its deep trading and investment ties in the United States and the West cannot be isolated or treated as a target of a maximalist financial and commercial pressure campaign. In addition, our need to cooperate and compete with -- as well as confront -- China in many other arenas, including in the South China Sea and cyberspace, limits how far we may go with our financial and economic toolkit.

There are too many costs to U.S. interests if a maximalist approach were attempted, with boomerang effects on the U.S. economy, trade, and U.S. and allied interests in China and Asia. China could always retaliate with sanctions of its own against U.S. interests, as they have threatened recently after the announced sale of U.S. high-end military equipment to Taiwan. And China can use its own resources and economic power to express its diplomatic displeasure, as it has done in the recent past with Japan by restricting the export of rare-earth minerals in 2010, allowing bananas from the Philippines to rot in port in 2012, and placing sanctions on South Korean companies for allowing the deployment of the THAAD missile defense system in early 2017.<sup>38</sup> The Chinese dragon knows how to bite and to use financial and economic tools – in the physical and virtual worlds.

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<sup>38</sup> Tom Miles and Krista Hughes, “China loses trade dispute over rare earth exports,” *Reuters*, March 26, 2014 (<http://www.reuters.com/article/us-china-wto-rareearths-idUSBREA2P0ZK20140326>); Andrew Higgins, “In Philippines, banana growers feel effect of South China Sea dispute,” *Washington Post*, June 10, 2012 ([https://www.washingtonpost.com/world/asia\\_pacific/in-philippines-banana-growers-feel-effect-of-south-china-sea-dispute/2012/06/10/gJQA47WVTV\\_story.html?utm\\_term=.493ab5719154](https://www.washingtonpost.com/world/asia_pacific/in-philippines-banana-growers-feel-effect-of-south-china-sea-dispute/2012/06/10/gJQA47WVTV_story.html?utm_term=.493ab5719154)); Elizabeth Shim, “China sanctions, hacking threats eclipse South Korea THAAD deployment,” *UPI*, March 7, 2017. ([http://www.upi.com/Top\\_News/World-News/2017/03/07/China-sanctions-hacking-threats-eclipse-South-Korea-THAAD-deployment/9311488902166/](http://www.upi.com/Top_News/World-News/2017/03/07/China-sanctions-hacking-threats-eclipse-South-Korea-THAAD-deployment/9311488902166/))



In addition, any new pressure campaign has to consider the potential for asymmetric attacks from North Korea, especially attacks on the financial system. North Korea has increased its capabilities and increased the pace of its probing cyber attacks. The North Korean hacking group Lazarus has reportedly targeted organizations in 31 countries, including the November 2014 Sony hack in the United States, the \$81 million heist from the Bangladesh Central Bank,<sup>39</sup> and banks and broadcasting companies in South Korea.<sup>40</sup> North Korean hacking activity has increased this year, with reports that banks in the United States, Poland's biggest bank lobbying group ZBP, and banks throughout the world have been targeted by North Korean entities.

This is not an attempt to give credence to a heckler's veto. Instead, this is a cautionary note that any effective action taken in the financial and economic domain may result in reactions by those targeted or affected by U.S. actions. The United States – and the private sector -- must be prepared for such a reaction. In addition, there will be limits to what can be done in this domain, but the United States should always try to use the most effective and appropriate means to pressure the North Korean regime. The United States and her allies should not pull punches just because the effects of those actions may implicate China. If secondary sanctions can help squeeze the North Korean regime and help shift the Chinese calculus, then they should be authorized and used, in concert with other tools.

## **Conclusion**

It is time to test if China and the United States together can influence the North Korean regime – and stop its march toward nuclear weapons capabilities that threaten the U.S. homeland. China has the opportunity to prove its role as a great power and to use its influence with Pyongyang. The clock is ticking, and an effective financial pressure campaign with China on side is one way of helping to slow, if not stop, the clock.

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<sup>39</sup> Jim Finkle, "Cyber security firm: more evidence North Korea linked to Bangladesh heist," *Reuters*, April 3, 2017. (<http://www.reuters.com/article/us-cyber-heist-bangladesh-northkorea-idUSKBN175214>)

<sup>40</sup> Jim Finkle, "North Korean hacking group behind recent attacks on banks: Symantec" *Reuters*, Mar 15, 2017. (<http://www.reuters.com/article/us-cyber-northkorea-symantec-idUSKBN16M37J>)

