Credibility Gap: China's FATF Presidency

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Introduction

On July 1, China will become the next president of the Financial Action Task Force (FATF or GAFI), the global standard-setter for international anti-money laundering. After serving as the vice president of FATF over the last year, China's assumption of the presidency will provide Beijing with the unique opportunity to set the FATF agenda over the next year, when it will preside over the FATF plenary sessions and determine which financial crimes issues it considers most important.

Yet there are reasons to be concerned about China's presidency. First, China's own financial crimes compliance (FCC) house is not in order. While the exact amount of illicit financial activity occurring within China and exported by China remains difficult to quantify, some analysts estimate that the number of illicit financial outflows from China may be as high as one trillion dollars over a decade. According to a 2014 study undertaken by Global Financial Integrity, a group monitoring illicit financial flows, illicit outflows from China between 2002 and 2011 totaled approximately $1.08 trillion.[1]

Second, China has serious deficiencies in its own anti-money laundering/combating the financing of terrorism (AML/CFT) system that allow drug traffickers, money launderers, sanctions evaders, and other illicit actors to exploit the Chinese financial system. According to the FATF's most recent Mutual Evaluation Report of China, the country has failed to effectively implement measures designed to prevent shell companies from being used to launder money or finance terrorism; prevent terrorist organizations from raising and moving funds; require lawyers, accountants, and other professionals to abide by AML/CFT regulations; and impose measures to target proliferators of weapons of mass destruction.

While FATF assessors routinely find regulatory and compliance shortcomings in the countries they evaluate, China's AML/CFT regulatory regime was judged to have low effectiveness across a range of important issues – so low that a plausible case exists to recommend China into FATF's International Cooperation Review Group

1. Clark Gascoigne, "China's Illicit Outflows Were US$1.08 Trillion from 2002-2011," *Global Financial Integrity*, September 23, 2014. (https://www.gfintegrity.org/chinas-illicit-outflows-2002-2011-us1-08-trillion/)

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process, where it would be reviewed for these failures and be required to work with FATF to remedy these deficiencies.[2] Awkwardly, this could happen at the same meeting where China assumes the FATF presidency.

Third, there have been a number of high-profile instances in recent years of major Chinese companies engaging in clear violations of financial crimes laws and regulations, including economic sanction prohibitions, raising concerns about China's commitment to the anti-money laundering/combatting the financing of terrorism (AML/CFT) mission. U.S. law enforcement and regulatory agencies identified instances of Chinese firms intentionally evading and violating U.S. economic sanctions and export controls on Iran, including by knowingly shipping U.S. products to sanctioned jurisdictions and lying to U.S. investigators about the activity. This includes major Chinese companies such as ZTE and Huawei.[3] Such activities undoubtedly run afoul of AML/CFT global standards, which emphasize the need to prevent proliferation financing, sanctions evasion, and export control violations. Yet Beijing is very unlikely to take any actions against these entities for these violations. This raises serious concerns that the Chinese government is not sufficiently dedicated to the fight against illicit finance and financial crime, which is critical to leading the global standard-setting body.

China's shortcomings are made more pressing because of its upcoming role as the FATF president. FATF has become recognized as the standard-setter for international AML/CFT compliance global standards. Countries increasingly pay attention to – and care about – how they are evaluated and scored under FATF's standards. Law enforcement agencies, regulators, and the private sector worldwide have increasingly focused on the risks that AML/CFT shortcomings pose to national security, economic prosperity, and companies' bottom lines.[4]

2. Under FATF rules, a country will be subject to International Cooperation Review Group review when it achieves poor results on its Mutual Evaluation Report, specifically: it has 20 or more non-compliant (NC) or partially compliant (PC) ratings for technical compliance; it is rated NC/PC on 3 or more of the following Recommendations: 3, 5, 6, 10, 11, and 20; it has a low or moderate level of effectiveness for 9 or more of the 11 immediate outcomes (IOs), with a minimum of two lows; or it has a low level of effectiveness for 6 or more of the 11 immediate outcomes. China has 18 NC/PC ratings for technical compliance, two NC/PC ratings on two of the noted Recommendations, a score of low or moderate on 8 of the 11 immediate outcomes, and a low effectiveness rating on 4 out of the 11 immediate outcomes. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019, page 16. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf)

3. U.S. Department of Justice, Press Release, "ZTE Corporation Agrees to Plead Guilty and Pay Over $430.4 Million for Violating U.S. Sanctions by Sending U.S.-Origin Items to Iran," March 7, 2017. (https://www.justice.gov/opa/pr/zte-corporation-agrees-plead-guilty-and-pay-over-4304-million-violating-us-sanctions-sending); U.S. Department of Justice, Press Release, "Chinese Telecommunications Conglomerate Huawei and Huawei CFO Wanzhou Meng Charged With Financial Fraud," January 28, 2019. (https://www.justice.gov/opa/pr/chinese-telecommunications-conglomerate-huawei-and-huawei-cfo-wanzhou-meng-charged-financial); Note that the United States has asserted that China engages in a wide range of predatory economic practices, including export control violations. White House Office of Trade and Manufacturing Policy, "How China's Economic Aggression Threatens the Technologies and Intellectual Property of the United States and the World," June 2018, page 4. (https://www.whitehouse.gov/wp-content/uploads/2018/06/FINAL-China-Technology-Report-6.18.18-PDF.pdf)

4. Poor ratings during a FATF Mutual Evaluation Report can have significant impact. It can further increase political pressure on a country to clean up its AML/CFT regime, such as in the case of Iran. Yigal Chazan, "Sanctions Are Just the Beginning for Iran," *Foreign Policy,* December 21, 2018. (https://foreignpolicy.com/2018/12/21/sanctions-are-just-the-beginning-for-iran/). It can also impact a country's ability to secure financing from international financial institutions such as the International Monetary Fund. For example, see: International Monetary Fund, "IMF and the Fight Against Money Laundering and the Financing of Terrorism," March 8, 2018. (https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/31/Fight-Against-Money-Laundering-the-Financing-of-Terrorism). Finally, it can also have substantial economic impact, as companies are generally more wary of doing business with financial institutions in jurisdictions with poorly implemented AML/CFT laws.

China is taking on more than a titular role as FATF's president; countries serving as the FATF president have enormous power to set the FATF agenda for the next year, and presidents have used this power to define *which* challenges to the integrity of the international financial system they think most important, including trade-based money laundering,[5] the use of virtual currencies by terrorist organizations and other actors,[6] and the need to work more closely with the financial technology (FinTech) community to more effectively combat financial crime.[7]

For example, over the last year, under the leadership of the United States and FATF President and Assistant Secretary of the Treasury for Terrorist Financing and Financial Crime Marshall Billingslea, FATF has pursued meaningful efforts to set global standards related to virtual currency, terrorist financing, and the proliferation of weapons of mass destruction.[8] Under the U.S. presidency, FATF has focused on tackling AML/CFT challenges in the virtual currency space and, as part of these efforts, issued a revised interpretive note to Recommendation 15, which clarifies important requirements related to the regulation of virtual currency exchangers and others with respect to their AML/CFT obligations.[9]

China's own FCC failures and its assumption of the presidency threatens to undermine the premier status of the organization. Further, if China is not committed to the AML/CFT mission, it may fail to prioritize critical issues or ignore addressing critical deficiencies in the global financial system because they highlight shortcomings in its own compliance regime.

In addition, there are concerns about whether China can assume the FATF presidency without many of the typical political and diplomatic constraints that impact Chinese foreign policy. China's assumption of the presidency is another instance of the country taking a leadership role in an important international standards-setting body. But a significant reason for FATF's credibility is its technical nature, and there are good reasons to question whether China can avoid playing politics and letting its particular foreign policy concerns influence its presidency. For example, will the Chinese view the presidency as an opportunity to impact particular financial centers like Hong Kong in ways that serve its parochial interests? Likewise, how will China treat issues related to Taiwan, which is a member of the Asia/Pacific Group on Money Laundering (a FATF-style regional body associated with FATF)? How China addresses these political issues during its presidency will speak volumes about its maturity to helm the international standards-setting body.

China's assumption of the FATF presidency comes at a key moment for the organization. While FATF grows in importance, a number of key issues will challenge its continued, strengthened role. For example, while one of FATF's primary strengths since its inception has been its focus on technical evaluation of countries' AML/CFT programs, the organization risks being pulled into political debates about certain problem countries. The most notable example of this is Iran, which was subject to FATF countermeasures that were subsequently suspended

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5. Santiago Otamendi, "Objectives for FATF – XXIX (2017-2018)," *Financial Action Task Force*, 2017. (https://www.fatf-gafi.org/media/fatf/documents/Objectives%20for%20FATF%20XXIX%20(2017-2018).pdf)

6. Marshall Billingslea, "Objectives for FATF – XXX (2018-2019)," *Financial Action Task Force*, 2018. (https://www.fatf-gafi.org/media/fatf/content/images/Objectives-FATF-XXX-(2018-2019).pdf)

7. Juan Manuel Vega-Serrano, "Objectives for FATF XXVIII (2016-2017)," *Financial Action Task Force*, 2016. (https://www.fatf-gafi.org/media/fatf/documents/Objectives-for-FATF-XXVIII-2016-2017.pdf)

8. Marshall Billingslea, "Objectives for FATF – XXX (2018-2019)," *Financial Action Task Force*, 2018. (https://www.fatf-gafi.org/media/fatf/content/images/Objectives-FATF-XXX-(2018-2019).pdf)

9. Financial Action Task Force, Public Statement, "Public Statement – Mitigating Risks from Virtual Assets," February 22, 2019. (https://www.fatf-gafi.org/publications/fatfrecommendations/documents/regulation-virtual-assets-interpretive-note.html). For an in-depth assessment of the FATF's focus on virtual currency, see: Financial Integrity Network, "FATF Pushing to Strengthen Regulations on Virtual Assets," May 20, 2019. (https://www.financialintegritynetwork.net/uploads/8/7/8/0/87802750/2019.05.20_-_vcupdate.pdf) following the Joint Comprehensive Plan of Action (JCPOA) nuclear accord. While Iran has continued to fail to fulfill its Action Plan requirements under the FATF process, the organization has not yet re-imposed countermeasures.[10] Whether FATF re-imposes these countermeasures at the next plenary will be a major test of the organization's willingness to confront Iran's continued failure to meet global AML/CFT standards.[11]

China's credibility gap in its own AML/CFT structure creates additional concerns about how the pre-eminent standards-setter for AML/CFT issues can be led by a country whose track record is problematic.

China's AML/CFT Challenges

The FATF Mutual Evaluation Report of China issued earlier this year identified several areas of concern, including illegal fundraising, fraud, trafficking in illicit drugs, corruption and bribery, tax crimes, counterfeiting of products, and illegal gambling.[12] Beyond these money laundering and illicit finance concerns, China is also the world's largest market for the illicit wildlife trade, estimated globally at between $7 and $23 billion annually.[13] This trade is a source of revenue for money launderers, poachers, and terrorist organizations.[14] While the exact size of illicit financial activity in China is not known, it may reach into the tens or hundreds of billions of dollars annually given the size of the Chinese economy, historic estimates of illicit funds flows, and evidence of illicit activity in certain sectors.

In addition, senior members of the Chinese leadership, including the Chinese Communist Party (CCP), continue to be implicated in corruption schemes, including those identified by the International Consortium of Investigative Journalists, which found evidence of corruption and the use of front and shell companies to hide assets outside of China by family members of senior CCP leaders.[15] Troublingly, in 2018 the president of INTERPOL, a Chinese national named Meng Hongwei, disappeared mysteriously and was subsequently arrested for bribery.[16]

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10. At its most recent plenary in February, FATF issued a public statement noting, "If by June 2019, Iran does not enact the remaining legislation in line with FATF Standards, then the FATF will require increased supervisory examination for branches and subsidiaries of financial institutions based in Iran." Financial Action Task Force, "Public Statement - February 2019," February 22, 2019. (http://www.fatf-gafi.org/countries/d-i/iran/documents/public-statement-february-2019.html)

11. For a discussion of this dynamic, see: Katherine Bauer, "Pushing Iran to Take Steps Against Terrorist Financing," *Washington Institute for Near East Policy*, February 20, 2018. (https://www.washingtoninstitute.org/policy-analysis/view/pushing-iran-to-take-steps-against-terrorist-financing)

12. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019, page 6. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf)

13. Suzanna Stephens and Matthew Southerland, "China's Role in Wildlife Trafficking and the Chinese Government's Response," *U.S.-China Economic and Security Review Commission*, December 6, 2018, page 3. (https://www.uscc.gov/sites/default/files/Research/2018.12.06%20-%20Wildlife%20Trafficking%20-%20Final%20Version.pdf)

14. For example, see: United Nations, Office on Drugs and Crime, "Corruption and Wildlife Crime," accessed June 10, 2019. (https://www.unodc.org/documents/Wildlife/Corruption_Wildlife_Crime.pdf); United Nations, Office on Drugs and Crime, "Financial Flows from Wildlife Crime," accessed June 4, 2019. (https://www.unodc.org/documents/Wildlife/Financial_Flow_Wildlife_Crime.pdf); Attorney General Jeff Sessions, *Statement at the London Illegal Wildlife Trade Conference*, October 11, 2018. (https://www.justice.gov/opa/speech/attorney-general-sessions-delivers-statement-behalf-united-states-london-illegal-wildlife)

15. Marina Walker Guevara, Gerard Ryle, Alexa Olesen, Mar Cabra, Michael Hudson, and Christoph Giesen, "Leaked Records Reveal Offshore Holdings of China's Elite," *International Consortium of Investigative Journalists*, January 21, 2014. (https://www.icij.org/investigations/offshore/leaked-records-reveal-offshore-holdings-of-chinas-elite/)

16. Bill Chappell, "China Will Prosecute Former Interpol Leader On Bribery Charges," *NPR*, March 27, 2019. (https://www.npr.org/2019/03/27/707119539/china-will-prosecute-former-interpol-leader-on-bribery-charges)

This is not to say that significant anti-money laundering and combatting the financing of terrorism risks, along with other financial crime risk, must preclude China from leading the international standards-setter for these issues. For example, the United States, as the hub of the global financial system, is naturally exposed to significant FCC risk. Because most U.S. dollar transactions flow through the United States and the U.S. dollar serves as the backbone of most international transactions, money launderers, drug traffickers, tax evaders, and other criminals routinely try to exploit the U.S. financial system to move and launder funds and hide and spend the proceeds of their illicit activities.[17]

The difference is that the United States has taken significant steps to ensure that its financial sector has mitigated those risks by developing and implementing a complex and expansive list of laws and regulations to ensure that entities operating in the relevant sectors are equipped to detect, disrupt, and deter illicit financial crime.[18] According to FATF's 2016 Mutual Evaluation Report, "The AML/CFT framework in the U.S. is well developed and robust. Domestic coordination and cooperation on AML/CFT issues is sophisticated and has matured since the previous evaluation in 2006."[19]

China's Credibility Deficit

China, by contrast, does not appear to have taken sufficient steps to effectively mitigate that risk across a range of critical areas, as it is required to do under AML/CFT global standards. Indeed, China suffers from a credibility deficit. While past presidents have received certain low scores during their mutual evaluation process, including the United States for issues related to passing and implementing meaningful beneficial ownership legislation, the recently issued FATF Mutual Evaluation Report of China is significantly more concerning. During the FATF mutual evaluation process, assessors determined that China's AML/CFT regime had low effectiveness in a number of key areas,[20] including:

- **Designated non-financial businesses and persons (DNFBPs), such as lawyers and accountants, do not adequately apply AML/CFT preventive measures commensurate with their risks, nor report suspicious transactions.** According to the FATF Mutual Evaluation Report, China's AML/CFT supervisory system

17. For example, according to the Financial Action Task Force, "The U.S. dollar's global dominance and the large volumes of daily transactions through its banks expose the U.S. to substantial money laundering risks. It also faces significant terrorist financing risks due to the unique openness and global reach of its financial system, and the direct threat terrorist groups pose to U.S. interests." Financial Action Task Force, "United States' measures to combat money laundering and terrorist financing," December 1, 2016. (https://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-united-states-2016.html)

18. For example, when FATF rated the United States on the effectiveness of its implementation of the FATF Recommendations, it concluded that the United States was highly, substantially, or moderately effective in 10 out 11 areas. The United States was found to have a low effectiveness rating for its implementation of FATF recommendations related to legal persons and arrangements, in part because of the failure of the United States to pass and implement effective beneficial ownership legislation. Financial Action Task Force, "United States' measures to combat money laundering and terrorist financing," December 1, 2016. (https://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-united-states-2016.html)

19. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: United States," *Mutual Evaluation Report*, December 2016, page 3. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-United-States-2016.pdf)

20. A rating of low means that the immediate outcome – such as persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving, and using funds, consistent with the relevant United Nations Security Council resolutions – is not achieved or is achieved to a negligible extent and fundamental improvements are needed. For a discussion of the FATF methodology, see: Financial Action Task Force, "Methodology for Assessing Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems," February 2019. (https://www.fatf-gafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf) is almost exclusively focused on the financial sector and "there are no effective preventive or supervisory measures in respect of the DNFBP sector." DNFBPs "generally do not apply [preventive measures such as customer due diligence (CDD) and other important AML requirements] ... [and] reporting of suspicious transactions by DNFBPs is virtually non-existent." Likewise, the People's Bank of China (the Chinese Central Bank) has a low understanding of the risk in this sector, and "little work has been done."[21]

DNFBPs are well-known conduits of financial crime. Lawyers, accountants, and other gatekeepers of the international financial system often establish front and shell companies, and obscure the source of funds and wealth in ways that allow corrupt actors to easily move funds through the international financial system. DNFBPs have been directly implicated in major money laundering schemes in recent years, such as the 1MDB scandal in Malaysia.[22] As my colleague and former senior U.S. Treasury Department official Chip Poncy noted, "Failure to extend meaningful AML/CFT regulation to these non-bank financial institutions or vulnerable industries can allow illicit financing networks to obtain the financial services they need without detection. Once illicit actors gain access to any part of the financial system, the highly intermediated nature of the system facilitates their access to other parts..."[23]

According to FATF, the number of Chinese DNFBPs is vast. At the end of 2017, there were approximately 130,000 real estate agencies, 253 dealers in precious metals (with no data on unregulated dealers, which there are likely many), more than 26,000 law firms, more than 3,000 notaries, and more than 7,000 accounting firms operating in China. None of these are regulated for AML/CFT compliance.

- **Legal persons and arrangements are not required to have preventive measures in place to prevent money laundering or terrorist financing, and information on their beneficial ownership (BO) is not available to competent authorities without impediments.** Chinese regulatory authorities do not have an effective system in place for registering and retaining beneficial ownership information, which is critical to understanding the persons who own or control accounts. According to FATF, "The identification of BO is a challenge for FIs [financial institutions], many of which, including banks, did not demonstrate a proper understanding of the concept [and that] 'most banks do not carry out checks of ownership.' "[24]

  As China itself noted in its risk assessment, "between 2014 and 2016, illicit proceeds totaling RMB 8.64 billion were repatriated to China from over 90 countries. ... The abuse of legal persons has also been identified as a method of

21. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf)

22. Founded in 2009 by Indonesian Prime Minister Najib Razak, 1MDB was created as a development fund to boost Malaysia's economy. However, a multinational investigation involving the U.S. Department of Justice indicates that high-level officials at 1MDB and their associates misappropriated more than $3.5 billion from the development fund between 2009 and 2015, including using law firms and shell companies to launder significant amounts of misappropriated funds. Complaint, *United States of America v. Certain Rights to an Interests in the Viceroy Hotel Group*, No. CV 17-4438 (C.D. Cal. filed June 15, 2017). (https://www.justice.gov/opa/press-release/file/973671/download). See also: U.S. Department of Justice, Press Release, "United States Seeks to Recover More Than $1 Billion Obtained from Corruption Involving Malaysian Sovereign Wealth Fund," July 20, 2016. (https://www.justice.gov/opa/pr/united-states-seeks-recover-more-1-billion-obtained-corruption-involving-malaysian-sovereign)

23. Chip Poncy, "Combating Money Laundering and Other Forms of Illicit Finance: How Criminal Organizations Launder Money and Innovative Techniques for Fighting Them," *Testimony before the Senate Banking Subcommittee on National Security, International Trade and Finance*, June 20, 2018. (https://www.banking.senate.gov/imo/media/doc/Poncy%20Testimony%206-20-18.pdf)

24. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf). The Mutual Evaluation Report quotes China's National Risk Assessment.

laundering illicit proceeds. Such abuse is facilitated, in part, by ineffective arrangements in place for registering and retaining beneficial ownership (BO) information."[25]

Under Chinese law, beneficial ownership is not required to be obtained or registered at the time of company formation, and financial institutions only need to take reasonable measures to identify beneficial owners. According to FATF, "There are no requirements to collect, maintain or have beneficial ownership information available, except if this is collected as part of CDD [customer due diligence] (but CDD requirements are not fully compliant)."[26] This suggests that unless the beneficial ownership information was reasonable to collect by a Chinese financial institution, it would not be available to law enforcement, regulators, or the private sector.

The failure to effectively register and retain beneficial ownership information at the time of account opening or company formation presents serious money laundering and illicit financing concerns. Money laundering, tax evasion, corruption, sanctions evasion, and fraud are facilitated through the creation and use of anonymous legal entities.[27] Sanctioned parties and criminals use these anonymous legal entities to hide their true ownership and move money through the legitimate financial system.

For example, between 2011 and 2014, a number of wealthy and powerful Russians used shell companies that had accounts with more than 700 banks across almost 100 countries to move more than $20 billion out of Russia. These shell companies signed agreements between themselves and filed fake bankruptcies to obtain court orders and transfer money out of the country, as part of the so-called "Russian Laundromat" scheme.[28] Likewise, in the United States, an anonymous company owned part of a Manhattan office building and used it as a front for the sanctioned Iranian bank, Bank Melli, illegally funneling millions of dollars to the Iranian government.[29]

Based on the FATF Mutual Evaluation Report and China's own National Risk Assessment, it appears that Chinese regulators have not effectively implemented the necessary steps to obtain beneficial ownership information, and that financial institutions may not even understand the concept.

- **Terrorists, terrorist organizations, and terrorist financiers are not prevented from raising, moving, and using funds, and from abusing the nonprofit sector.**[30] An important element of a country's ability to prevent terrorist organizations from raising, moving, and using funds is the implementation of effective targeted financial sanctions.[31]

25. Ibid, page 17.

26. Ibid, page 230.

27. For example, see: Chip Poncy, "Beneficial Ownership: Fighting Illicit International Financial Networks Through Transparency," *Testimony before the Senate Committee on the Judiciary*, February 6, 2018. (https://www.judiciary.senate.gov/imo/media/doc/Poncy%20Testimony.pdf)

28. "The Russian Laundromat Exposed," *Organized Crime and Corruption Reporting Project*, March 20, 2017. (https://www.occrp.org/en/laundromat/the-russian-laundromat-exposed)

29. Julie Satow, "Seizing Iran's Slice of Fifth Avenue," *The New York Times*, September 24, 2013. (https://www.nytimes.com/2013/09/25/realestate/commercial/with-judges-ruling-seizure-of-650-fifth-avenue-grinds-on.html?smid=pl-share)

30. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf)

31. According to FATF, "Terrorists, terrorist organisations and terrorist support networks are identified and deprived of the resources and means to finance or support terrorist activities and organisations. This includes proper implementation of targeted financial sanctions against persons and entities designated by the United Nations Security Council and under applicable national or regional sanctions regimes." Financial Action Task Force, "Methodology for Assessing Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems," February 2019, page 120. (https://www.fatf-gafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf)

According to FATF, the overall implementation of targeted financial sanctions related to terrorism financing in China suffers from three fundamental deficiencies. First, Chinese regulators do not require all natural and legal persons to freeze the assets of UN-designated parties without delay.[32] As a result, the implementation of United Nations Security Council resolutions (UNSCRs) and designations may not be effective.

Second, Chinese authorities were unable to demonstrate that a range of assets – such as real estate, land, and cash – are effectively frozen when these UN designations occur.[33] This failure suggests that the implementation of key UNSCRs may be less effective, particularly if terrorists and related parties can continue to access their assets.

Third, and finally, Chinese authorities could not show that UN freezing actions were implemented without delay. Indeed, Chinese government agencies are slow to circulate the requirements among its agencies, let alone push them out to supervised financial institutions.[34] Such delays can be problematic, especially if the United Nations designates a terrorist who has assets in China. When those assets are not blocked immediately, the result is often asset flight.

These deficiencies exacerbate existing terrorist financing issues in China. According to FATF, China is a regular victim of terrorism, and Chinese terrorists are also active overseas, most recently in Islamic State-controlled territory in Syria and Iraq. The Eastern Turkistan Islamic Movement (ETIM), the purported terrorist group operating in Xinjiang province, was designated by the United Nations Security Council under UNSCR 1267 and successor resolutions.[35] However, China has not even taken the necessary steps to ensure that its financial sector is able to effectively disrupt this group's financing and activities.

- **Persons and entities involved in the proliferation of weapons of mass destruction are not prevented from raising, moving, and using funds consistent with the relevant United Nations Security Council resolutions.** As in the case of Chinese efforts related to terrorist financing, China's framework for effectively implementing sanctions related to proliferation financing are also lacking.

  In addition to China's lack of "a comprehensive general legal framework to deal with … proliferation financing," the shortcomings that impact Chinese efforts related to terrorist financing also undercut the effectiveness of China's efforts to combat proliferation financing. For example, China lacks obligations that require Chinese entities to freeze sanctioned persons' funds or other assets. Chinese authorities were unable to demonstrate that these deficiencies do not leave a gap in the effective implementation of North Korea- and Iran-related UNSCRs. Likewise, Chinese authorities were unable to demonstrate that the full range of assets are frozen when the UN designates proliferators or that blocking actions are taken in a timely manner.[36]

  Moreover, while Chinese authorities have focused on proliferation financing issues related to North Korea, according to FATF, "There is a lack of awareness of Iran-related sanctions, with an almost exclusive focus by authorities and private sector on DPRK [North Korea]."[37]

32. Financial Action Task Force, "Anti-money laundering and counter-terrorist financing measures: People's Republic of China," *Mutual Evaluation Report*, April 2019, page 100. (https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-China-2019.pdf)
33. Ibid.
34. Ibid, page 101.
35. Ibid, page 107.
36. Ibid, pages 107-108.
37. Ibid, page 90.

> Given Iran's significant, well-known illicit presence in China, including Chinese proliferation networks that supply dual-use goods and weapons to Iran in violation of United Nations Security Council resolutions and other global standards and Chinese financial institutions' processing illicit Iranian activity,[38] the failure of Chinese regulators to ensure widespread awareness of – and compliance with – United Nations sanctions on Iran is troubling. Indeed, China has often turned a blind eye to Iran's illicit activity in the country. For example, notorious WMD proliferator Karl Lee has been running a proliferation ring from China and providing materials and support to Iran for well over a decade. Lee has been designated by the Treasury Department and subject to a range of additional regulatory actions, yet the Chinese government has refused to take serious action.[39]

These weaknesses pose significant risks to the integrity of the Chinese financial system but also raise serious questions about China's fitness as the FATF president. China's Mutual Evaluation Report suggests that the country has not taken sufficient steps to address the most significant vulnerabilities in the global financial system.

Beyond the weaknesses identified during the FATF mutual evaluation process, China's AML/CFT credibility gap is widened by its treatment of its own financial sector. While U.S. and European banks have been subjected to significant regulatory scrutiny for AML/CFT over the last 20 years, the international community has only recently begun to focus on Chinese financial institutions, and there are reasons to be concerned that Chinese financial institutions do not abide by the same strict standards.

First, the Chinese financial system is characterized by a lack of transparency. For example, China makes it extremely difficult for U.S. auditors to check important financial information for Chinese companies that are listed on U.S. stock exchanges.[40] This practice significantly reduces transparency into these companies' operations and raises significant risks of fraud, particularly to U.S. investors.

Second, recent episodes of illicit activity by Chinese financial institutions raise real questions about China's willingness or capacity to enforce international AML/CFT laws and standards when they run counter to Chinese political and national security interests. For example, the U.S. Treasury Department issued a finding in 2017 that China-based Bank of Dandong was a primary money laundering concern because it served as a conduit for North Korea to access the U.S. and international financial systems, including facilitating millions of dollars of transactions for companies involved in North Korea's WMD and ballistic missile programs, in contravention of United Nations Security Council resolutions.[41]

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38. For example, see: U.S. Department of the Treasury, Press Release, "Treasury Sanctions Kunlun Bank in China and Elaf Bank in Iraq for Business with Designated Iranian Banks," July 7, 2012. (https://www.treasury.gov/press-center/press-releases/pages/tg1661.aspx)

39. U.S. Department of the Treasury, Press Release, "Treasury Designates Iranian Proliferation Network and Identifies New Aliases," April 7, 2009. (https://www.treasury.gov/press-center/press-releases/Pages/tg84.aspx); U.S. Department of Justice, Press Release, "'Karl Lee' Charged in Manhattan Federal Court with Using a Web of Front Companies to Evade U.S. Sanctions," April 29, 2014. (https://www.justice.gov/opa/pr/karl-lee-charged-manhattan-federal-court-using-web-front-companies-evade-us-sanctions)

40. Marco Rubio, "You Can't Trust a Chinese Audit," *The Wall Street Journal*, June 4, 2019. (https://www.wsj.com/articles/you-cant-trust-a-chinese-audit-11559687739)

41. Proposal of Special Measure Against Bank of Dandong as a Financial Institution of Primary Money Laundering Concern, U.S. Department of the Treasury, Financial Crimes Enforcement Network, 82 Federal Register 31537, July 7, 2017. (https://www.fincen.gov/sites/default/files/federal_register_notices/2017-07-07/2017-14026.pdf)

This Chinese bank had significant operations through China, including connectivity to other Chinese financial institutions. China's inability or unwillingness to stop Bank of Dandong from violating UN sanctions on North Korea casts doubt on the Chinese government's willingness to enforce strict AML/CFT laws and regulations when it may cut against its efforts to support or turn a blind eye to North Korean illicit activity.

China's enforcement of AML/CFT laws internally, its commitment to financial transparency, and the effectiveness of their regime are the lacunas that affect its credibility. Combined with the failure to implement required United Nations Security Council resolutions and sanctions obligations, as well as scoring low and moderate effectiveness marks across a range of important FATF recommendations and obligations, China limps into the FATF presidency with a spotty AML/CFT track record and an uncertain commitment to financial transparency.

China's Global FATF Priorities

Despite all of this, China will now have the opportunity as the FATF president to set the FATF agenda, drive important developments in AML/CFT compliance, and articulate its commitment to the AML/CFT mission. In this regard, the FATF presidency is an opportunity for China to demonstrate the effectiveness of its regime and its willingness to cast political considerations aside as it enforces AML/CFT laws and regulations, even if it is embarrassing or cuts against Chinese domestic or foreign policy.

When China assumes the presidency on July 1, it will not be easy to overcome its credibility gap, but it can begin by placing some of the most challenging, but critical, issue areas for AML/CFT compliance on the FATF agenda.

At the top of its agenda should be a new FATF recommendation on information sharing, both within particular jurisdictions and across institutions with offices, branches, and affiliates across different jurisdictions. One of the most significant challenges financial institutions face is sharing data within their enterprises across jurisdictions and with peer financial institutions.[42]

These limits have major implications for fighting financial crime. Illicit actors do not limit their efforts to access the international financial system to one bank or one jurisdiction. They access different financial institutions in the same jurisdiction or the same institution in different jurisdictions. Information sharing can be critical for identifying networks of criminal activity and help multiple financial institutions detect, deter, and disrupt illicit financial activity.[43]

42. FATF standards related to information sharing are spread across 25 different FATF Recommendations. These standards were consolidated in June 2016 to clarify these requirements and assist jurisdictions in implementing them. Financial Action Task Force, "FATF Guidance: Private Sector Information Sharing," November 2017, page 2. (https://www.fatf-gafi.org/media/fatf/documents/recommendations/Private-Sector-Information-Sharing.pdf)

43. According to FATF, "Information sharing is critical for combatting money laundering, terrorist financing and financing of proliferation. Multinational money laundering schemes do not respect national boundaries. Barriers to information sharing may negatively impact the effectiveness of AML/CFT efforts and conversely, inadvertently facilitate operations of such criminal networks. This underscores the importance of having rapid, meaningful and comprehensive sharing of information from a wide variety of sources, across the national and global scale." Financial Action Task Force, "FATF Guidance: Private Sector Information Sharing," November 2017, page 2. (https://www.fatf-gafi.org/media/fatf/documents/recommendations/Private-Sector-Information-Sharing.pdf)

At the same time, such information sharing can raise significant public policy concerns. For example, sharing information across financial institutions can raise the risk that malign actors figure out that they are under suspicion, allowing them to move their assets. Likewise, financial institutions are often reluctant to share significant amounts of information with peer institutions for fear that revealing such data may provide their competitors with an unfair commercial advantage or access to trade secrets.[44]

An important way to square this circle and ensure that financial institutions are able to share information across jurisdictions and between financial institutions, while continuing to safeguard privacy and avoid tipping off offenders, is through the use of new technologies. As FATF itself has recognized:

> A number of possible models are currently being developed which may encourage such voluntary sharing of information. It could include bilateral information exchange between financial institutions and/or shared KYC [know your customer] utilities and/or centralized data repositories, which capture key elements of customer and transaction information and disseminate such information to participating financial institutions with appropriate protocols and access controls. ... These utilities and databases can be hosted by the authorities or the private sector or both through a public private partnership.[45]

Key to the effectiveness of these models is new technology that enables sophisticated analysis of this data in ways that can expose illicit networks while limiting the exposure of private and sensitive information.

Jurisdictions are currently in the nascent stages of promoting this type of sharing and innovation. For example, the United States has historically relied on Section 314(b) of the USA PATRIOT Act to encourage information sharing between financial institutions and FinCEN. The Federal Banking Regulators recently issued a joint statement providing guidance to financial institutions interested in using new technologies to augment their compliance programs.[46] These steps are meant to provide financial institutions with some comfort in their efforts to share information. The guidance is crafted to encourage the incorporation of new technology that can greatly increase the effectiveness of information sharing efforts. Nevertheless, U.S. regulators are in the nascent stages of full-fledged encouragement and endorsement of new technologies to increase information sharing and combat financial crime.

Likewise, while FATF has recognized the incorporation of new technology as critical to fighting financial crime by facilitating information sharing, it has only issued nonbinding guidance for jurisdictions to consider as they decide how and whether to encourage efforts to deploy such technology.[47] While this guidance is useful, FATF should take further steps, including by developing a new recommendation or official guidance for countries to put into place mechanisms to facilitate the use of new information technologies to safely and effectively share information both across jurisdictions and between financial institutions. Such a recommendation or

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44. Ibid, page 22.
45. Ibid, page 24.
46. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Financial Crimes Enforcement Network, National Credit Union Administration, and the Office of the Comptroller of the Currency, "Joint Statement on Innovative Efforts to Combat Money Laundering and Terrorist Financing," December 3, 2018. (https://www.fincen.gov/sites/default/files/2018-12/Joint%20Statement%20on%20Innovation%20Statement%20%28Final%2011-30-18%29_508.pdf)
47. Financial Action Task Force, "FATF Guidance: Private Sector Information Sharing ," November 2017, page 24. (https://www.fatf-gafi.org/media/fatf/documents/recommendations/Private-Sector-Information-Sharing.pdf)

interpretive note would ensure that jurisdictions are required to promote the adoption of these technologies to better share information to fight financial crime.

Putting China's Own House in Order

China should also use its year as the FATF president to address significant gaps in its own AML/CFT framework. First, Chinese regulators should work quickly and independently – assuming China is not under review in FATF's International Cooperation Review Group process – to develop and implement a DNFBP compliance framework that meets its obligations under FATF recommendations and immediate outcomes. Second, Chinese companies, including nontraditional financial institutions, should be required to quickly implement the full requirements under United Nations Security Council resolutions for terrorist financing and proliferation financing. To date, China has been reluctant to champion proliferation financing regulations, in part because such an initiative is seen as directly impacting its relationship with North Korea. Whether China is willing to prioritize proliferation financing as the FATF president will be a key test of whether the country is able to take on a politically challenging issue in a way that puts international financial integrity before China's own foreign policy interests and concerns. Addressing these gaps while serving as the FATF president will illustrate China's commitment to the AML/CFT mission and serve as a model with similar deficiencies who want to join the fight against illicit finance worldwide.