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Financial Institutions May Face Increasing Pressure to Prevent Abuse of Legal Entities

Summary

Recent high-profile media investigations into the widespread use of anonymous legal entities have sparked renewed scrutiny of these arrangements and could put pressure on financial institutions to take measures to prevent their abuse. Legislators in the United States, European Union, and United Kingdom are discussing proposals to make company formation more transparent by requiring disclosure of beneficial ownership. But collection and reporting of beneficial ownership information is likely to remain limited, even as regulatory expectations for financial institutions are increasing.

- Leaks of thousands of documents from law firms involved in the creation of offshore legal entities, as well as the ongoing investigation into Russian meddling in the 2016 U.S. election, have shone a public spotlight on how obscuring beneficial ownership can facilitate tax evasion and fraud.
- In the United States, the House of Representatives and the Senate are considering bills that aim to close the beneficial ownership loophole. Neither bill has won committee approval.
- In the EU, the European Commission and the European Parliament in December 2017 agreed to require that all European corporations automatically disclose beneficial ownership information in a public, pan-European companies registry. The proposal is awaiting final approval.

Even though progress on addressing opaque formation practices has been slow and halting, regulatory expectations surrounding beneficial ownership for financial institutions are steadily increasing. Financial institutions bear the brunt of mitigating the risks associated with opaque company formation practices. They can more effectively mitigate these risks by using information collected and verified at onboarding throughout the life of the customer relationship and by sharing information with other financial institutions.

- A new rule promulgated by the U.S. Treasury Department, entering into effect in May, will require financial institutions to identify beneficial owners of legal entities as part of their standard customer due diligence process.
- Financial institutions should integrate information they collect on beneficial

ownership into their larger AML/CFT architecture, particularly risk rating, transaction monitoring, and sanctions screening to guard against money laundering risk and sanctions exposure.

- When carrying out high-risk transactions that raise concerns about the possible interests of unknown or undisclosed parties, financial institutions should conduct a beneficial ownership refresh and consider requesting beneficial ownership information on their customers' counterparties – i.e, for their correspondents' clients. Depending on the facts and circumstances of the transaction and the underlying parties, financial institutions may request such information from their originating or beneficiary customer, and/or from their correspondent about its underlying customer.

The Problem of Beneficial Ownership

The Financial Action Task Force (FATF) defines a beneficial owner as "the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted" as well as "those persons who exercise ultimate effective control over a legal person or arrangement."[1] Similarly, the U.S. Treasury has most recently defined a beneficial owner as "each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer," in addition to individuals with significant decision-making authority over a legal entity.[2] As these definitions make clear, beneficial ownership may involve, but does not require, legal ownership of an entity. It can equally mean the power to control that entity's actions, even if no formal relationship exists.

In many cases, the natural person forming a company will also be the beneficial owner. But in others, the natural persons who control a company's activities may be separated from it by layers of other companies or by attorney-client privilege, obscuring their identity. These persons are also protected by the fact that many jurisdictions do not collect any information about control or ultimate ownership of a company incorporated within their borders.

Because many jurisdictions allow the beneficial owners of a company to remain anonymous, persons who are in reality high-risk—or even sanctioned—can conceal their identities and present themselves to the system as low-risk by establishing opaque legal entities. These entities, often known as "shell companies," have no active business and no real assets. They are generally located at an accommodation address that may be home to hundreds or even thousands of other companies and may be nominally controlled by directors who have no knowledge of or connection to the business.

The ability of beneficial owners to hide behind corporate opacity undermines the core tenets of transparency, accountability, and traceability in the global counter-illicit finance (CIF) regime – and obscures the information necessary to identify and track suspect actors and transactions and apply an enterprise-wide risk-based approach. The global CIF regime relies on accurately assessing risks posed by customers and transactions. Competition among the numerous offshore jurisdictions seeking company formation and related business compounds the problem.

Beneficial owners may of course have legitimate reasons for maintaining secrecy—to conceal their involvement in a controversial business venture, for instance, or to hide an investment in an early-stage technology in order to avoid interest from competitors.

These and other important interests may warrant continued protection of beneficial ownership information from public disclosure; however, under no circumstances should such interests warrant protection of such information from disclosure to law enforcement or other competent authorities responsible for protecting the general public or national or collective security. For more than 25 years, global standards adopted by financial centers around the world have rejected these privacy interests as a basis for defeating beneficial ownership inquiries by law enforcement and other competent authorities. Various authorities and experts have provided numerous explanations of the need for access to such beneficial ownership information to combat illicit activity, safeguard the integrity of the international financial system, and protect national and collective security.

Recent FinCEN advisories and a review of OFAC's recent designations show that sanctioned parties and politically exposed persons (PEPs) continue to make heavy use of shell companies, exposing financial institutions to corruption and sanctions risks that they may be unwilling or unable to manage.

- A November FinCEN advisory on North Korea highlighted that country's use of shell companies, often based in China, to evade sanctions.
- An advisory on political corruption in Venezuela noted that high-ranking members of the regime use foreign shell companies they control to conduct import schemes, with much of the goods diverted to the black market.
- And an advisory on corruption in South Sudan also warned financial institutions that government officials use shell companies to hide assets they've looted from the state.[3]

FATF Recommendations

The FATF Recommendations prescribe a two-pronged approach to identification of beneficial ownership that requires transparency both at the point of company formation and at account opening. This approach aims to ensure that beneficial information is available both in the country in which the company was established and in the country in which the company's bank account is established. Recommendations 24 and 25, which cover transparency of legal persons and arrangements, call on countries to ensure that "there is adequate, accurate and timely information on the beneficial ownership and control of legal persons [and arrangements] that can be obtained or accessed in a timely fashion by competent authorities." Recommendation 10, covering Customer Due Diligence, stipulates that financial institutions should identify the beneficial owner of a client as part of standard procedures when opening an account and throughout the client relationship.

Growing Public Awareness

Revealing beneficial ownership is no longer purely a concern of illicit finance experts. Recent media exposés and high-profile criminal investigations have brought this issue into the mainstream, increasing pressure on governments to act and reputational risks for financial institutions. Ordinary citizens are becoming aware that corporate opacity facilitates activities—from tax evasion to real estate speculation—that have a negative impact on their lives. This increases the reputational risk to financial institutions that do business with shell companies, particularly those incorporated in jurisdictions renowned for secrecy.

The most prominent media inquiries into the use and abuse of corporate opacity have been the "Panama Papers"[4] and "Paradise Papers"[5] investigations. Both projects relied on leaks of files from international law firms that specialize in offshore transactions (Mossack Fonseca and Appleby, respectively). They exposed how political, economic, and other elites are supported by a tightly knit community of lawyers, accountants, and advisors who continue to operate with relative ease across an offshore maze of fragmented national and international laws and regulation. These professionals protect, obscure, and grow the wealth of clientele by building complex tax avoidance structures, protecting intellectual property, and hiding the true ownership of assets.

Media coverage of foreign investment in real estate in sought-after urban locations has put anonymity at the center of the debate over rising home prices. The director of economic crime at Britain's National Crime Agency (NCA) explicitly linked laundered money to the rise in home prices in the capital.[6] The NCA's first-ever unexplained wealth orders targeted not bank accounts but properties in London and Southeast England believed to be owned by a Central Asian politician.[7] In the United States, prompted in part by a *New York Times* investigation into anonymous purchases of prime New York City real estate,[8] FinCEN has launched and steadily expanded a program of Geographic Targeting Orders that require title companies to identify the beneficial owners of legal entities using cash to purchase high-end real estate in seven metropolitan areas.[9]

The ongoing Special Counsel investigation into Russian interference in the 2016 election is also uncovering the role corporate opacity played in facilitating various crimes. The indictment of Paul Manafort, President Trump's former campaign manager, for money-laundering and tax evasion alleges that Manafort used dozens of legal entities, incorporated in the United States and around the world, to launder profits from his work as an unregistered foreign agent and carry out tax evasion.[10] While some entities were openly linked to Manafort and his partner Rick Gates, in other instances Manafort and Gates deliberately obscured their involvement through the use of nominee directors. This enabled Manafort and Gates to disguise their consulting income earned overseas as loans from ostensibly unrelated foreign companies.

The Special Counsel's indictment of the Internet Research Agency, the Russian organization that used social media to promote certain Presidential candidates and foment discord, also alleges that the Agency used multiple anonymous companies to conceal its activities and that those controlling it also used anonymous companies to conceal their identities.[11] The Agency's funder, who was sanctioned by the Office of Foreign Assets Control (OFAC) in 2016 for providing services to senior Russian officials,[12] used 14 bank accounts held by 14 companies to conceal the source of the Agency's funding.

The poisoning of Sergei Skripal, a former Russian intelligence officer and agent for British intelligence who had been released to the United Kingdom in a prisoner swap, has given new life to the debate over beneficial ownership and shell companies in the United Kingdom. American and British commentators and politicians rapidly urged the U.K. government to strike back by tightening its beneficial ownership rules to prevent close associates of Putin from laundering or enjoying their wealth in the United Kingdom.[13] Prime Minister Theresa May has signaled that she is open to ending a company form known as Scottish limited partnerships, which are seen as particularly prone to abuse.[14]

Legislative and Regulatory Developments in the United States

Two separate legislative proposals – one in the Senate and one in the House of Representatives – address the need to collect beneficial ownership information at the point of company registration, often called "company formation reform," while a new Treasury Department rule will require similar information from all legal entities seeking to open an account at a bank or other types of covered financial institutions. While the bills take different approaches, they both adequately incorporate the most important principles of company formation transparency.[15]

The Senate bill, the "True Incorporation Transparency for Law Enforcement" or "TITLE Act:"[16]

- Places the burden on the states to require that those seeking to form a corporation under the laws of the state identify the natural person or persons who are the beneficial owners of the corporation.
- Requires identification, including a name, address, and unique ID number from a passport, driver's license, or other government-issued ID.
- Does not necessarily require that the state verify the information provided by applicants, but gives Treasury the authority to issue regulations regarding verification. The bill instead imposes substantial penalties (up to three years' imprisonment and $1 million in fines) for providing false or incomplete information.
- Allows states to decide whether to make information available to the public, although FinCEN and other law enforcement authorities must be able to access it through a written request or subpoena.

In contrast to the TITLE Act's narrow focus on beneficial ownership, the House proposal, titled the "Counter Terrorism and Illicit Finance Act," seeks broader reform of illicit finance efforts and includes corporate transparency among those reforms.[17]

- The draft bill amends federal law to require that those seeking to form a corporation file a report with FinCEN containing a list of the company's beneficial owners.
- Applicants must identify beneficial owners by name, address, and unique ID number from a passport, driver's license, or other government-issued ID.
- Existing corporations would be required to provide the same information to FinCEN within two years of the law coming into force, and all corporations must update the information annually or when their beneficial ownership

changes.

- FinCEN would be required to release the information upon the request of a federal agency, an appropriate foreign agency, or a financial institution (with customer consent) made as part of the institution's due diligence process.

- Fines under the House bill are capped at $10,000, far below the penalties in the Senate bill.

The future of these legislative proposals is difficult to predict. Past proposals have failed to gain traction, despite the support of law enforcement. Opponents of present and prior efforts argue that laws imposing transparency would create an additional regulatory burden and infringe privacy rights, without gleaning much meaningful information in return.[18]

If Congress does not act, full responsibility for mitigating risks arising from opaque corporate formation practices will remain with financial institutions. A new rule requiring financial institutions to collect beneficial ownership information from certain legal entities opening an account comes into force in May 2018.[19]

- The rule defines a beneficial owner as any individual who owns at least 25 percent of a legal entity.

- Ownership may be direct or indirect and can be exercised "through any contract, arrangement, understanding, relationship or otherwise."

- Identification in this context requires a name, address, and ID number.

- Financial institutions are allowed to rely on the information provided by the customer, unless they know anything that calls such information into question. They are also instructed to calibrate verification to the degree of risk associated with the relationship.

For the foreseeable future, financial institutions will be the keepers of the only comprehensive information on beneficial ownership in the United States.

Legislative Developments in the European Union and Beyond

The European Parliament's "Fourth Anti-Money Laundering Directive," issued in June 2015, came into effect in June 2017.[20] The Fourth Directive:

- Recognizes that "[t]he need for accurate and up-to-date information on the beneficial owner is a key factor in tracing criminals who might otherwise hide their identity behind a corporate structure."

- Requires member states to collect beneficial ownership information on certain legal entities created under their jurisdictional authority in a national register.
- Uses a broad definition of beneficial ownership.[21]
- Leaves it to member states to determine how the registry will be structured, where data will actually be held, and what is needed to prove identity.
- Requires that financial institutions not just identify the beneficial owners but also take "reasonable measures to verify that person's identity so that the obliged entity is satisfied that it knows who the beneficial owner is."[22]

Member states' response to the Fourth Directive was slow. According to a pan-European survey of law firms conducted in late summer 2017, only three states had fully implemented the requirements by both requiring companies to identify their beneficial owners and storing that information in a central register.[23] Perhaps most importantly, sanctions for non-compliance vary widely and in many cases are not dissuasive; in France, for instance, the penalty is capped at EUR 7,500 for a natural person and EUR 37,500 for a legal entity, although violators may receive a prison sentence.[24] In Germany, by contrast, fines can be as high as EUR 1 million, or twice the profit gained through the act of noncompliance.[25]

In December 2017 the European Commission and the European Parliament reached an agreement to amend the Fourth Directive, requiring states to create public registers that would then be linked to allow single-query searches of all national databases.[26] The proposal has not yet been officially enacted by the Parliament or the European Council, and it probably will require years both to build the various national databases and to link them.

The United Kingdom's publicly-accessible registry of beneficial ownership information came online in 2016, making it one of Europe's oldest such registries.[27] The U.K. experience makes clear that simply requiring companies to disclose information does not resolve corporate opacity concerns. A February 2018 analysis of the data by advocacy group Global Witness found that five persons were listed as beneficial owners of more than 6,000 corporations, suggesting that they may be straw owners.[28] In March 2018, a U.K. company, Always Efficient LLP, was publicly linked to the laundering of hundreds of thousands of bitcoins stolen from bitcoin exchange Mt. Gox in 2014.[29] Always Efficient's entry in the U.K. database includes directors in the Seychelles and the Marshall Islands but does not list any current beneficial owner; a previous listed owner is a Russian disc jockey who disavowed all knowledge of the company.[30] The U.K. government recently announced that draft legislation—set to be released this summer—will require the disclosure of beneficial ownership of all companies that own property in the country and will impose jail time and "unlimited" fines for false disclosures.[31]

In Canada, British Columbia is set to become the first province to require beneficial ownership information for any legal entity that owns land or real estate.[32] The decision was motivated by the soaring price of Vancouver real estate[33] as well as a 2016 report that found that 50 percent of the 100 most valuable real estate transactions involved an anonymous shell company.[34] A public-facing registry of land owners will be populated by including beneficial ownership information on the property transfer tax form.[35]

Recommendations: Risk Management for Financial Institutions

Global standards envision that financial institutions share with jurisdictional company formation authorities and business company formation agents the burdens of making legal entities' activities transparent. But because governments have not yet addressed company formation in a comprehensive manner, financial institutions own the risks associated with opaque company formation practices in full.

Though many transactions involving opaque legal entities are in fact unrelated to money laundering, corruption, or sanctions evasion, financial institutions must conduct extensive due diligence to make sure that they have a full understanding of the risks posed by use of a legal entity. Financial institutions must be prepared to manage these risks at onboarding, throughout the life of customer relationship, and when acting as an intermediary for higher risk transactions.

Onboarding

Verifying beneficial ownership at account opening will help financial institutions mitigate the risks associated with opaque legal entities and assess the risks of each legal entity customer.

- Financial institutions should incorporate the nationality of companies and beneficial ownership collected at onboarding into their country risk assessments. For entities incorporated in one jurisdiction but with beneficial owners in another jurisdiction, financial institutions should take into account the risks associated with both jurisdictions when determining the customer's risk profile. The customer's risk should in turn determine how often CDD should be refreshed.
- Financial institutions should consider defining beneficial ownership to

include a lower ownership threshold than the 25 percent stake set in the CDD rule in the case of high-risk relationships and transactions that may raise concerns about the interests of unknown parties.

- Regardless of beneficial ownership percentages of any legal entity on-boarded by a financial institution, financial institutions should obtain the beneficial ownership information of at least one natural person who controls the daily affairs of the legal entity, as required by Treasury's final CDD rule.

Managing the Customer Relationship

Beneficial ownership information should help guide financial institutions' decisions on how to manage the risks associated with each legal entity customer throughout the life of the customer relationship.

- Financial institutions should use beneficial ownership information to design alert parameters for each account holder, to determine how to respond to alerts that a customer's activity generates, and when to consider customer exit.
- When analyzed in bulk, beneficial ownership information for the bank's customers can help the bank better assess its risk profile and thus better tailor its bank-wide monitoring and alert systems.

Intermediated High-Risk Transactions

Financial institutions should seek to mitigate risks posed by counterparties that are legal entities when dealing with high-risk transactions, especially those that generate money laundering or sanctions alerts. This will often amount to knowing your customer's customer (KYCC), but because sanctions and money laundering exposure is often not readily apparent in intermediated transactions, financial institutions can only mitigate sanctions and money laundering by understanding the corporate structure of the entities involved in a transaction.

- Financial institutions should obtain beneficial ownership information for high-risk transactions from publicly available information and/or from its originating or beneficiary customer and/or from the respondent financial institutions involved in the transaction.
- To maximize the utility of publicly available information, financial institutions should research the addresses, officers, and directors of legal entities to uncover hidden relationships.

- Financial institutions should also use beneficial ownership information to better understand the relationships between parties to the transaction (including uncovering related-party transactions).

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