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Beneficial Ownership Transparency: A Critical Element of AML Compliance

Debevoise & Plimpton

Matthew L. Biben

For criminals trying to circumvent anti-money laundering and counter-terrorist financing measures, corporate vehicles – such as companies, trusts, foundations, and partnerships – are an attractive way to disguise illicit proceeds before introducing them into the financial system, further obscuring their origins and maximising the criminals' payment options.

Governments around the globe have concluded that this misuse of corporate vehicles could be significantly reduced if information regarding their beneficial owners was readily available to authorities, and many are amending their incorporation processes to capture and document this information. In the United States, however, the incorporation process takes place at the state level under the direction of each individual Secretary of State. The state Secretaries of State are opposed to legislation that would require them to collect beneficial owner information, claiming that such requirements present an unnecessary administrative burden.

This article discusses the evolution of the mandate for governments to establish and maintain reliable corporate registries and examines the particular forces complicating this issue in the United States.

The Misuse of Corporate Entities

In the United States, the notion that a corporation has a legal personality distinct from the natural persons who comprise it reaches back to the early days of U.S. constitutional law. As defined by the United States Supreme Court in a case involving Dartmouth College, whose corporate charter was granted by the British crown in 1769, a corporation is "an artificial being, invisible, intangible, and existing only in contemplation of law."[1]

However, without laws requiring disclosure of its owners, the "invisible, intangible" nature of a corporation can easily be used by bad actors to maintain their anonymity while enjoying the proceeds of their crimes. News events provide a steady stream of colourful examples. For example, Victor Bout, a Russian arms dealer who was convicted in 2011 of conspiring to sell millions of dollars of weapons to the Revolutionary Armed Forces of Colombia, used at least 12 companies incorporated in Texas, Florida, and Delaware to carry out his activities.

In 2016, the release of the so-called Panama Papers, leaked from the Panamanian law firm of Mossack Fonseca, disclosed the extensive use of shell companies to hide beneficial ownership interests in bank accounts. According to the International Consortium of Investigative Journalists, the network of investigative journalists and media organisations that published the documents, the Panama Papers included files on 140 politicians from more than 50 countries who were connected to offshore companies in 21 tax havens.[2] While the use of shell companies is not unlawful, the way in which they were used, as documented in the Panama Papers, led to significant political disruption: the disclosures are thought to have contributed to the 2016 resignation of the Prime Minister of Iceland and the 2017 indictment of Pakistan Prime Minister Nawaz Sharif, as well as numerous corruption and tax fraud investigations worldwide.[3]

The Risk for Financial Institutions

Historically, governments have delegated much of the responsibility for policing money laundering activity to financial institutions, arguing that they are better suited for the task. However, corporate accounts pose unique compliance challenges not just for the financial institutions opening and maintaining these accounts, but also for firms acting as intermediaries, particularly correspondent banks processing wire transfers to or from these accounts. When these transactions trigger automated alerts based on their unusual size or frequency, ascertaining the purpose of the transactions is often difficult if not impossible. The explanations provided to the correspondent banks by their customers – that is, the banks initiating or receiving the transfers – frequently fail to satisfy the concerns of internal compliance officers. If these concerns remain unresolved, the bank acting as intermediary often must file one or more suspicious activity reports or risk facing substantial fines from regulators for a failure to maintain an effective AML compliance programme. Such fines exceeded $2 billion globally in 2017.[4]

A Global Consensus with Diverse Solutions

In recent years, however, a global consensus has emerged that transparency of beneficial ownership is a powerful means of reducing the misuse of corporate vehicles. In 2012, the Financial Action Task Force ("FATF"), the primary inter-governmental body that sets standards for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system, issued revised standards on corporate beneficial ownership.[5] In 2013, the G-8 countries[6] endorsed core principles on beneficial ownership consistent with the FATF standards and published action plans setting out the steps they will take to enhance transparency. In 2014, FATF issued additional guidance[7] and the G-20 countries adopted a high-level policy on beneficial ownership transparency.[8]

In May 2015, the European Union ("EU") enacted the Fourth Anti-Money Laundering Directive, setting goals for its 28 member countries. The Fourth Directive introduced measures to provide enhanced clarity and accessibility of Ultimate Beneficial Owner ("UBO") information for companies by requiring companies to

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hold information about their beneficial ownership and to make this information available to third parties via a public register. European states had until June 26, 2017 to enact the changes put forth in the Directive, and they are currently in varying stages of compliance and implementation.

In July 2017, the United States Library of Congress ("LOC") issued a report which surveyed the laws related to registration of beneficial owners and disclosure of information on corporate data in jurisdictions representing all major geographic regions of the world.[9] Most of the countries in the survey had recently amended their legislation (e.g., Argentina, Brazil, Costa Rica, France, Germany, Italy, Jamaica, Jordan, Pakistan, Singapore, South Africa, Sweden, United Kingdom) or were working on amending their laws (Afghanistan, India, Netherlands). Among the G-7 countries,[10] only Canada and Japan had not changed their national laws, even though both countries had committed to meeting FATF requirements. At the time, Canada reported that it did not "require that the beneficial ownership and company formation of all legal persons organised for profit be reported".[11] Japan also did not have a law that requires companies to disclose their beneficial ownership, but a new rule providing for disclosure of major shareholders was reportedly adopted in 2016.[12]

The countries surveyed that address corporate beneficial ownership do so through a variety of legal mechanisms, including corporate laws, registration rules, regulations implementing EU directives, and anti-money laundering legislation.[13] They require companies to report information on beneficial owners to the registering authorities, which are usually state or local governments. In some unitary states, this function is performed by a designated national institution. According to the survey, corporate beneficial owner information is collected by business registrars (Afghanistan, Argentina, India, Sweden, United Kingdom), national tax authorities (Brazil), securities regulators (Australia, Pakistan), a securities exchange (South Africa), central banks (Armenia, Costa Rica), local courts (France) and, in the EU, by a designated central registry in each Member State.

One major difference among the countries surveyed was in the definition of "beneficial owner".[14] The EU and its Member States follow FATF guidance, which defines a beneficial owner as a "natural person who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted". Other countries add to the definition individuals with a "relevant interest" (Australia) or a "person with significant control" (United Kingdom), as determined by percentages of shares owned and the total number of shareholders. Some countries, such as Israel and Spain, exempt from reporting requirements individuals who own less than a particular percentage of company's shares; other countries exempt specific groups of individuals or companies working in select business sectors.

Access to the corporate data reported in registration documents is determined differently in each country.[15] At the time of the survey, some jurisdictions had created or were working on establishing open access to public registers of beneficial ownership (Afghanistan, Argentina, Australia, France, Israel, Jamaica, Netherlands, United Kingdom), although some may require the payment of fees (Australia, Jamaica, Netherlands). The EU Member States and Japan provide access to government institutions, obliged entities, and all who may have "legitimate interests" without defining the parameters of these interests. Others limit access to law enforcement (Singapore), monitoring government authorities (Armenia, Brazil, Costa Rica, Mexico), or members of the company (India).

The Scope of the Problem in the United States

In the United States, corporations are exclusively creations of state law, with each of the 50 states retaining control of the incorporation process in their respective jurisdictions through the offices of their Secretaries of State. However, few states have made collecting beneficial owner information a priority. Findings in recent federal legislation summarise the consequences of this arrangement:[16]

- Nearly 2,000,000 corporations and limited liability companies are being formed under the laws of the states each year.
- Very few states obtain meaningful information about the beneficial owners of the corporations and limited liability companies formed under their laws. Indeed, a person forming a corporation or limited liability company within the United States typically provides less information to the state of incorporation than is needed to obtain a bank account or driver's licence.
- Terrorists and other criminals have exploited the weaknesses in state formation procedures to conceal their identities when forming corporations or limited liability companies in the United States.
- Many states have established automated procedures that allow a person to form a new corporation or limited liability company within 24 hours of filing an online application, without any prior review of the application by a state official.
- Dozens of internet websites promote states with particularly lax beneficial ownership transparency requirements as attractive locations for the formation of new corporations, essentially inviting terrorists and other wrongdoers to form entities within the United States.

Not surprisingly, FATF has called the United States framework "seriously deficient" and has urged the United States to take corrective action.[17] Federal officials have long urged the states to develop their own solutions to effectively reform their corporate formation practices. Unfortunately, solutions proposed by the states through the National Association of Secretaries of State ("NASS") have failed to address fundamental issues. For example, a NASS proposal issued in 2007 did not require states to obtain the names of the natural individuals who would be the beneficial owners of a U.S. corporation or LLC; instead, states could obtain a list of a company's "owners of record" who can be, and often are, offshore corporations or trusts.[18] The NASS proposal also did not require the states to maintain the beneficial ownership information themselves, or to supply it to law enforcement in response to a subpoena or summons.[19]

Why have the individual states not taken a more aggressive stance on beneficial ownership? A 2008 statement by Senator Carl Levin introducing legislation that would create a nationwide transparency framework called on the states to "recognize the homeland security problem they've created".[20] Senator Levin went on to identify two sets of forces preventing them from doing so:[21]

Part of the difficulty is that the States have a wide range of practices, which differ on the extent to which they rely on incorporation fees as a major source of revenue, and differ on the extent to which they attract non-U.S. persons as incorporators. In addition, the States are competing against each other to attract persons who want to set up U.S. corporations, and that competition creates pressure for each individual State to favour procedures that allow quick and easy incorporations. It's a classic case of competition causing a race to the bottom, making it difficult for any one State to do the right thing and request the names of the beneficial owners.

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Current U.S. Proposals

In May 2016, FinCEN expanded its customer due diligence ("CDD") rule by requiring financial institutions to establish procedures to identify the beneficial owners of legal entity customers when a new account is opened. FATF pointed out, however, that this move failed to require the disclosure of beneficial owners at the time that legal entities are formed and rated the United States with the lowest possible score in its efforts to prevent criminals from using legal entities to hide and move money.[22]

On June 28, 2017, the True Incorporation Transparency for Law Enforcement Act ("TITLE Act") was introduced in the Senate with bipartisan support.[23] Under the TITLE Act and subject to certain exemptions, each applicant to form a new corporation or limited liability company under the laws of a state would be required to provide to the state information on the beneficial owners of the corporation or limited liability company. The term "beneficial owner" is defined as each natural person who, directly or indirectly: (i) exercises substantial control over a corporation or limited liability company through ownership interests, voting rights, agreement, or otherwise; or (ii) has a substantial interest in or receives substantial economic benefits from the assets of a corporation or the assets of a limited liability company.

Under this bill, it would be up to each state to decide whether to make beneficial ownership information publicly available. However, disclosure would be required in response to:

- a subpoena from a local, State, or Federal agency or a congressional committee or subcommittee;
- a written request from FinCEN or a Federal agency on behalf of another country; or
- a written request made by a financial institution, with the consent of the customer, for purposes of compliance by the financial institution with CDD requirements.

The bill includes provisions for corporate formation agents licensed by the states and adds those businesses to the list of entities required to establish anti-money laundering programmes.

The state Secretaries of State, through NASS, have said they oppose this bill as well as any other proposal that would require them to collect beneficial ownership information – a position they have held since 2008.[24] NASS claims the TITLE Act is unnecessary because it would require states to collect information that is already being collected by the federal government in various forms and processes,[25] or will soon be collected by financial institutions pursuant to FinCEN's new CDD rule. However, none of these alternatives – either alone or in combination – would satisfy the global standard set by FATF that requires the disclosure of beneficial owners at the time that legal entities are formed.

Two other bipartisan bills introduced in 2017 attempt to address what seems to be the states' primary objection – the burden of expanding their incorporation processes. Both bills, one in the House of Representatives (HR. 3089),[26] and one in the Senate (S.1717),[27] are titled the "Corporate Transparency Act of 2017". Under these bills, if a state does not have a system of incorporation that collects the requisite beneficial ownership information, FinCEN would bear the burden of collecting and managing the additional information. However, in December 2017, NASS issued a statement in opposition to both HR. 3089 and S.1717.[28]

Financial institutions support such legislation but stress the importance of being able to obtain access to reported beneficial ownership information. They note, appropriately, that under the current AML regime, many if not most of the resources devoted to identifying money laundering and terrorist financing are provided by financial institutions, and that denying them access to this important information would significantly undermine the goals of any bill.[29]

Conclusion

The United States is one of many nations that has concluded that the misuse of corporate vehicles could be significantly reduced if beneficial owner information was collected at the time of corporate formation and was made available to authorities. While the U.S. has imposed a new CDD rule requiring financial institutions to establish procedures to identify the beneficial owners of legal entity customers, there is recognition that more must be done. In the absence of collective action by the states, the U.S. federal government has appropriately stepped in to legislate a solution, but with no success thus far.

While many elements of anti-money laundering responsibilities fall to financial institutions, beneficial ownership is a distinct component of corporate formation – and thus responsibility for its transparency should fall to the government, which, in the United States, means the individual states.

To put things in perspective, it is helpful to recall a similar issue years ago involving Nauru, a small island nation in Micronesia. After allowing its primary natural resource, phosphate, to be depleted through strip mining, the island resorted to selling offshore banking licences. Four hundred banks listed the same 1,000 square foot wooden shack as their headquarters though none had a physical presence in Nauru or, for that matter, in any other country. The resulting banking activity did not have any adverse impacts on Nauru, but it did create significant risk to the global financial system, leading FATF to place Nauru on the Non-Cooperative Countries and Territories' list in June 2000, and FinCEN to designate Nauru as a country of primary money laundering concern in 2002.[30] When considering their corporate formation policies, jurisdictions would be well advised to weigh the global effects of local actions – particularly when those actions affect money laundering enforcement efforts across nations.

Endnotes

1. Trustees of *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819).
2. *See*, International Consortium of Investigative Journalists, Panama Papers, www.icij.org/investigations/panama-papers/.
3. *Id*.
4. *See, e.g.*, Debevoise & Plimpton LLP, 2017 Anti-Money Laundering Year in Review (Feb. 2, 2018), *www.debevoise.com/insights/publications/2018/02/2017-anti-money-laundering-year-in-review*.
5. FATF, Int'l Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation (2012) (updated Feb. 2018), http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf.
6. At the time, the G-8 countries were Canada, France, Germany, Italy, Japan, the United Kingdom, the United States and Russia. In 2014, Russia was suspended following the annexation of Crimea, whereupon the group's name reverted to the G-7.
7. FATF, Transparency and Beneficial Ownership (2014), http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-transparency-beneficial-ownership.pdf.
8. The G-20, or Group of Twenty, is comprised of Argentina, Australia, Brazil, Canada, China, European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States.

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9. United States Library of Congress, Disclosure of Beneficial Ownership in Selected Countries (July 2017), https://www.loc.gov/law/help/beneficial-ownership/chart.php [hereinafter LOC Survey].
10. At the time, the G-7 countries were Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
11. LOC Survey at 1.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. True Incorporation Transparency for Law Enforcement Act, S. 1454, 115th Cong. (2017) [hereinafter *S. 1454*].
17. FATF, Mutual Evaluation Report, Anti-money laundering and counter-terrorist financing measures of the United States (December 2016) [hereinafter *FATF 2016 U.S. Mutual Evaluation*].
18. Congressional Record, *Introducing the Incorporation Transparency and Law Enforcement Assistance Act*, 110th Cong., Vol. 154, Pt. 6, at 7621 (May 1, 2008) (statement of Sen. Carl Levin, S. Comm. on Homeland Sec. and Gov't Affairs), https://www.gpo.gov/fdsys/pkg/CRECB-2008-pt6/pdf/CRECB-2008-pt6-Pg7617.pdf [hereinafter *Senator Levin Statement*].
19. *Id*.
20. *Id*.
21. *Id*.
22. FATF 2016 U.S. Mutual Evaluation.
23. S.1454.
24. See National Association of Secretaries of State (NASS) website at www.nass.org/initiatives/state-incorporation-collection-company-ownership-info [hereinafter *NASS Website*].
25. See NASS Website. The federal forms and processes referenced by NASS are the Internal Revenue Service's (IRS) Revised Form SS-4, which requires certain disclosures when applying for an Employer Identification Number (EIN), and the U.S. Treasury Department's Report of Foreign Bank and Financial Accounts Report (FBAR), which must be filed yearly by U.S. persons with a financial interest in or signature authority over financial accounts located outside of the U.S., subject to a minimum threshold. FATF has specifically outlined why the EIN mechanism does not satisfy the requisite beneficial ownership standard. FATF 2016 U.S. Mutual Evaluation, at 154, 158, 224–226.
26. Corporate Transparency Act of 2017, H.R. 3089, 115th Cong. (2017).
27. Corporate Transparency Act of 2017, S. 1717, 115th Cong. (2017).
28. Chris Marquette, *Congress Targets Shell Company Laws that Lure Global Criminals to US*, Congressional Quarterly Inc., 2017 WL 6379121(December 14, 2017) [quoting a statement from the executive director of the NASS].
29. The Clearing House, A New Paradigm: Redesigning the U.S. AML/CFT Framework to Protect National Security and Aid Law Enforcement (February 2017).
30. See FinCEN, Imposition of Special Measures Against the Country of Nauru (April 17, 2003), https://www.fincen.gov/resources/statutes-regulations/federal-register-notices/imposition-special-measures-against-country.

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