THE HIDDEN WORLD OF BENEFICIAL OWNERSHIP

A DUE-DILIGENCE CHALLENGE FOR TOO LONG

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INTRODUCTION: THE BENEFICIAL OWNERSHIP TRAIL

One of the most challenging tasks for due-diligence teams on the lookout for connections to money laundering, bribery, corruption is to uncover the identities of ultimate beneficial owners of entities, properties, and third-party business partners.

The job of understanding who companies, and financial services organizations in particular, are doing business with has been made all the more difficult by complex ownership trails that cross geographical and legal boundaries. Criminal elements exploit such methods to obscure the real identities of the person or persons who ultimately benefit from financial transactions.

When the OECD reviewed 400-plus bribery cases across 41 countries for its 2014 report An Analysis of the Crime of Bribery of Foreign Public Officials, it found that one in four of them had involved illicit money channelled through shadowy secret companies. The World Bank has estimated that corrupt politicians used secret companies to obscure their identities in 70 per cent of more than 200 cases of grand corruption. The New York Times reported in 2014 that an estimated 8% – more than US$7 trillion – of the world's personal financial wealth is held in undeclared offshore deposits.

Opportunities to illicitly transfer or hide money through complex networks of companies deliberately created to mask the details of ultimate beneficiaries have been a central part of two of the most high-profile corruption scandals in recent years: alleged bribery among representatives of football's world governing body, FIFA; and allegations of political kickbacks involving the Brazilian energy giant Petrobras.

And, of course, the leak of 11.5 million files from the database of Panama-based law firm Mossack Fonseca in April 2016 has further highlighted the challenges due-diligence teams face.

Measures have been taken against hidden beneficial ownership in many individual jurisdictions, but the extent of the problem demonstrates the importance of all nations working together to align with a consistent approach.

This white paper explains what beneficial ownership is, why it is a problem; what is being done about it, and the measures companies can take to protect themselves against the potential implications of not knowing who they are ultimately doing business with.

AN ESTIMATED 8% – MORE THAN US$7 TRILLION – OF THE WORLD'S PERSONAL FINANCIAL WEALTH IS HELD IN UNDECLARED OFFSHORE DEPOSITS

THE NEW YORK TIMES

BENEFICIAL OWNERSHIP: WHAT IS IT? WHAT RISKS DOES IT POSE?

WHAT IS BENEFICIAL OWNERSHIP?

The Financial Action Task Force (FATF), an intergovernmental body established in 1989 by the G7 group of major economies, has defined '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. It also includes those persons who exercise ultimate effective control over a legal person or arrangement."

The FATF definition is an important one. In most countries, shareholders of a company need to report their details to government or regulatory authorities. This information typically includes the shareholder's full name, an identification number, and their date of birth, nationality and country of residence.

Challenges for financial institutions and, indeed, any company trading internationally, arise when there is a difference between this information and the real, ultimate beneficiary of a company or asset. In other words, when the person nominally listed as in control is, in fact, a proxy for the person wielding power or influence, or gaining financial benefit from the company or asset.

There is no central global standard for regulating how companies are governed. Devices such as nominee shareholders or directors – where a third party is appointed as a director or shareholder, but control remains with the beneficial owner – are not illegal in many countries and are, of course, difficult to regulate. Company law in most countries compels directors and shareholders to act in certain ways, or face fines or be banned from directorships. However, in many offshore territories, nominee directors or shareholders can still be used as a vehicle to mask the identity of a beneficial owner, and this is where it becomes difficult to identify the true beneficial owner of an entity.

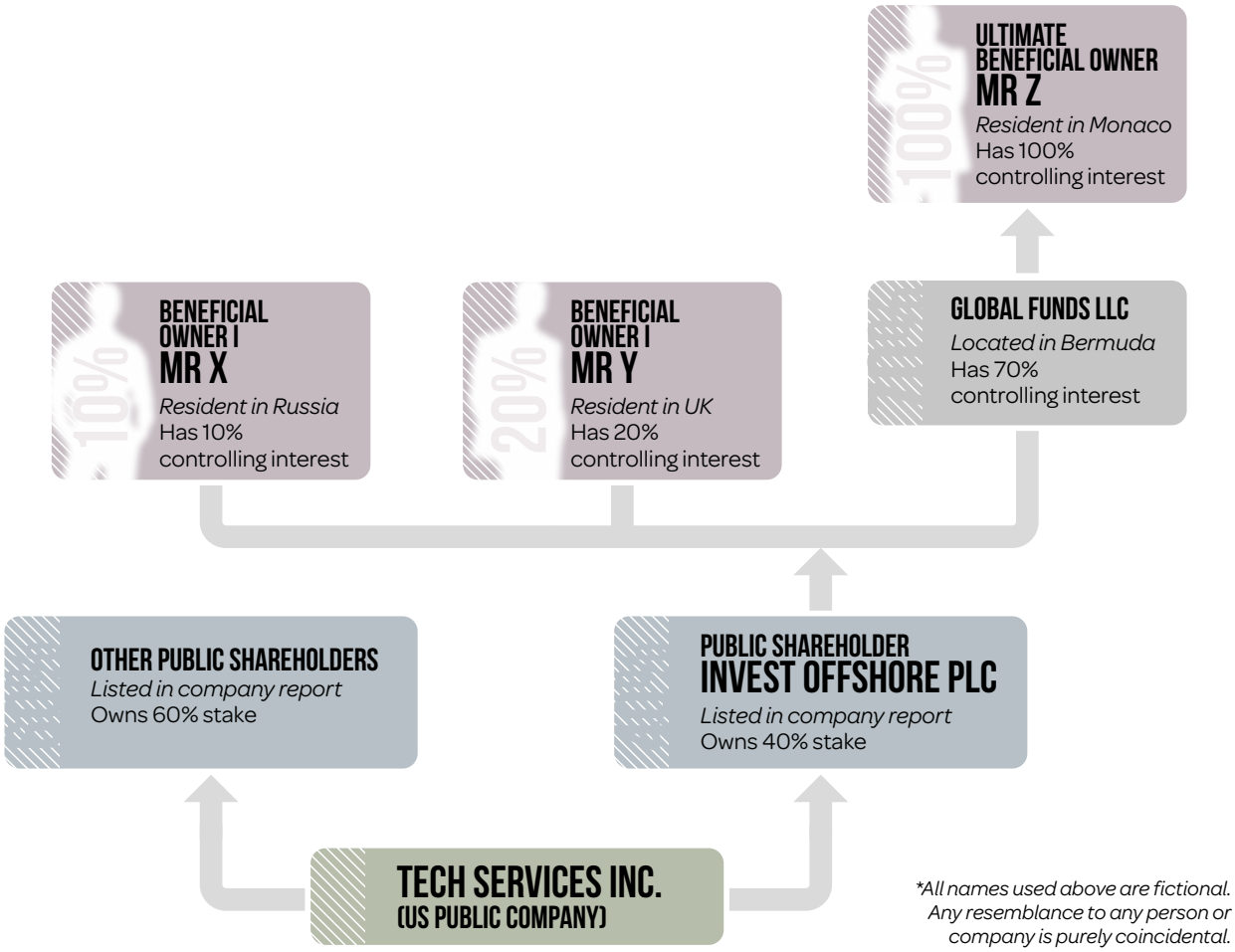
This issue is exacerbated by a myriad of different laws governing company registrations and management in different geographic territories. It is possible for a United States company to be partly owned by an offshore company, which in turn is part-owned by another company which has three shareholders all based in different countries. Depending on the geographical location of each company, there will be different disclosure requirements for each company and individual. This can make it impossible to know for certain who the beneficial owner really is.

IT IS POSSIBLE FOR A US COMPANY TO BE PARTLY OWNED BY AN OFFSHORE COMPANY, WHICH IN TURN IS PART-OWNED BY ANOTHER COMPANY WHICH HAS THREE SHAREHOLDERS ALL BASED IN DIFFERENT COUNTRIES

WHERE BENEFICIAL OWNERS FIT IN A CORPORATE OWNERSHIP STRUCTURE

Below is an example showing how beneficial owners might exist in a corporate structure.

In reality, such structures are often multilayered and very complex, involving many private companies:



**All names used above are fictional. Any resemblance to any person or company is purely coincidental.*

THE RISKS THAT OWNERSHIP UNCERTAINTY CREATES

Banks and financial services are required to comply with a complex set of global regulations relating to transactions conducted for customers. This includes monitoring for anti-money laundering (AML) and anti-bribery and corruption (ABC) purposes. Financial institutions are required to carry out thorough onboarding checks of new customers, often extending to ongoing regular checking, particularly for organizations deemed to be at substantial risk of AML or ABC breaches.

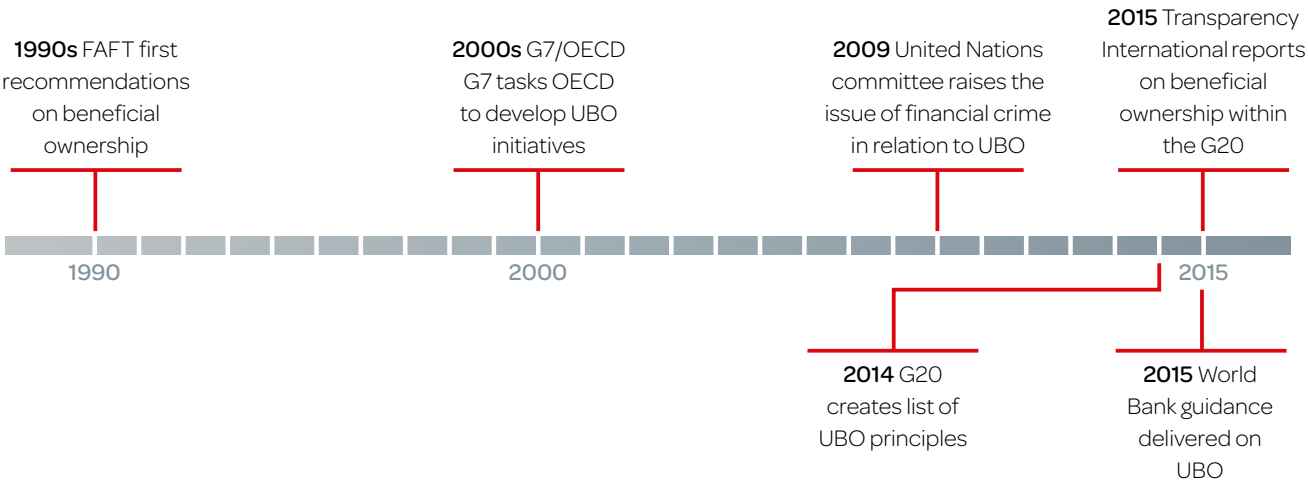
Financial institutions need to pay particular scrutiny to individuals who have a higher risk of corruption than the general population. These are typically people in positions of power (and their immediate family). Politically exposed persons (PEPs) involved in companies or financial transactions have to be carefully monitored.

A lack of clarity over who is the ultimate beneficial owner of a company or asset clouds the ability of banks and financial institutions to carry out these checks effectively, leaving them exposed to facilitating corruption or bribery, or unwittingly funding illegal or terrorist activities. The regulatory cost of such activities can include large fines and personal prosecution for directors of financial institutions.

There is no escaping the fact that knowing the ultimate beneficial owner of an asset or company is an important issue.

WHO OWNS BENEFICIAL OWNERSHIP? CONCERN AND LEGISLATION AT NATIONAL, INTERNATIONAL AND GLOBAL LEVELS

THE INTERNATIONAL INTEREST IN BENEFICIAL OWNERSHIP



A BRIEF HISTORY OF BENEFICIAL OWNERSHIP REGULATION

The link between ultimate beneficial ownership (UBO) and financial crime was first flagged in 1988 by the Bank for International Settlements. The bank created the first international instrument to focus specifically on anti-money laundering (AML). The principles it set out are the foundation of good practice for AML controls widely adopted across Europe and beyond.

1990s: FATF RECOMMENDATIONS

In 1990 the Financial Action Task Force (FATF) proposed 40 recommendations that would help combat money laundering. They represented a new international standard for AML regulation. FATF subsequently completely revised the recommendations, most recently in 2003, so they require members to:

- Implement relevant international conventions
- Criminalize money laundering and enable authorities to confiscate proceeds from it
- Implement customer due diligence (e.g. identity verification), record keeping and suspicious transaction reporting requirements for financial institutions and designated non-financial businesses and professions
- Establish a financial intelligence unit to receive and disseminate suspicious transaction reports
- Cooperate internationally in investigating and prosecuting money laundering

The objective of the 40 recommendations was to tackle misuse of corporate vehicles for financial and other criminal ends, as well as combatting the ability of criminals to disguise beneficial ownership.

2000s: G7/OECD

By May 2000, the risk criminal activity posed to global financial stability was so great that the G7 major economies tasked the OECD to develop a set of initiatives to combat the growing abuse of corporate vehicles.

The report recognized that, while many jurisdictions required shareholders and directors to submit up-to-date information, this was not necessarily a declaration of beneficial ownership. Meanwhile other jurisdictions required no reporting at all. The report

outlined a number of options that would improve access to beneficial ownership information.

Despite the global hunger for improved standards of information relating to company ownership, very little was actually achieved to enhance beneficial ownership transparency.

2014: G20

At a summit in November 2014, the G20 leaders adopted 10 high-level principles around beneficial ownership transparency, describing financial transparency as a high-priority issue. The G20 principles, built on the FATF recommendations from 2003, cover the following elements:

1. The definition of a beneficial owner
2. Risk assessments relating to legal entities and arrangements
3. Beneficial ownership information of legal entities
4. Access to beneficial ownership information of legal entities
5. Beneficial ownership information of trusts
6. Access to beneficial ownership information of trusts
7. Roles and responsibilities of financial institutions and businesses and professions
8. Domestic and international cooperation
9. Beneficial ownership information and tax evasion
10. Bearer shares and nominees

While several countries have taken significant steps to respond to each of these 10 points, there is still no global framework.

2015: CALLS FOR GREATER TRANSPARENCY

The World Bank aligns with the G20 approach, issuing guidance requiring greater beneficial ownership transparency in its contracting processes.

Transparency International publishes a report, Just for Show?: Reviewing G20 Promises on Beneficial Ownership. The document delivers a mixed report on the G20 nations' efforts to deliver improved UBO transparency to date.

ORGANIZATIONS WITH AN INTEREST IN LEGISLATION TO ENSURE TRANSPARENCY OF OWNERSHIP?

Despite the lack of a global standard for transparency in beneficial ownership, a host of different national, transcontinental and global entities contribute towards policy and best practice. They include:

- **THE GROUP OF 20** (G20) major economies. At a summit in 2014, it adopted high-level principles for each of its members around transparency in business ownership.
- **FINANCIAL ACTION TASK FORCE** (FATF) has mandated the collection of beneficial ownership data by national corporate registers. Beneficial ownership is a key aspect of FATF's regularly updated 40 recommendations for best practice to combat money laundering.
- **ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT** (OECD) In 2000, the G7 group of countries tasked the OECD with combatting financial crime.
- **UNITED NATIONS**. In 2009, the UN Committee of Experts on International Cooperation in Tax Matters raised the issue of a lack of clarity in beneficial ownership for follow-up.
- **THE EUROPEAN UNION**. The Fourth EU Anti-Money Laundering Directive introduces a central UBO register of companies and trusts. EU members have until June 2016 to make provision for this in national law.
- **INDIVIDUAL COUNTRIES**. Regulation of companies, corporate governance and financial services vary widely around the globe.

SCORE-CARDING THE G20

HOW THE MOST DEVELOPED COUNTRIES ARE INCREASING BENEFICIAL OWNERSHIP TRANSPARENCY?

In 2015, Transparency International (TI), the global coalition against corruption, published a report benchmarking the progress the G20 had made in improving transparency around beneficial ownership. The report, Just for Show? Reviewing G20 Promises on Beneficial Ownership, was the result of a thorough review of each country's efforts to implement the 10 principles agreed at a summit in November 2014.

As can be seen in the diagram below, the verdicts were very mixed. Fifteen of the 19 countries demonstrated either an average or weak legal framework for implementing the principles and only one country, the United Kingdom, had created a very strong framework.

The report made a number of criticisms of the progress the G20 countries had made, pointing out that, while all of them scored well on at least one principle, and each of the G20 principles was implemented well by at least one country, all but three rated 'very weak' against at least one of the 10 principles.

It was also reported that only two G20 countries (UK and India) require legal entities to identify and keep updated records of their own beneficial owners, and TI proposed that "companies must be required to identify their own actual beneficial owners, not just their legal owners. This information needs to be accurate and current, both at the time the legal entity is created and maintained over time."

The TI report recommended the sharing of best practice across countries and concluded: "G20 countries are not integrating comprehensive risk assessments into their policy process. Only four G20 countries have conducted a risk assessment in the last three years and published the results in full. Namely Canada, Japan, the UK and the US. Without understanding where the risks lie, such as how domestic and foreign legal entities and arrangements can be used for money laundering purposes, countries are not able to effectively regulate and detect money laundering-related offences. The risk assessments should be part of a longer policy process that provides a continuous update of the anti-money laundering regulatory framework and supervisory practices."

It is difficult to draw any conclusion from the report other than that there is a long distance to travel, even in the world's most developed economies, before there is a clear international overview of the ultimate beneficiaries of companies.

It didn't take long for TI's concerns to be justified by events. In April 2016, media around the world reported the leaking of the 'Panama files' – 11.5 million documents from the database of Panama-based law firm Mossack Fonseca – showing how clients of the firm had allegedly hidden billions of dollars in tax havens.

VERY STRONG FRAMEWORK	United Kingdom (UK)
STRONG FRAMEWORK	Argentina, France, Italy
AVERAGE FRAMEWORK	Germany, India, Indonesia, Japan, Mexico, Russia, Saudi Arabia, South Africa, Turkey
WEAK FRAMEWORK	Australia, Brazil, Canada, China, South Korea, United States (US)
VERY WEAK FRAMEWORK	–

In response to the scandal, the five largest EU economies (UK, France, Germany, Italy and Spain) immediately agreed to share information on ownership of businesses and trusts. These five countries have called on all G20 nations to do the same, potentially leading to a significant improvement in UBO transparency.

THE UK – A CASE STUDY OF PROGRESS?

THE UK WAS THE ONLY COUNTRY RATED IN THE TRANSPARENCY INTERNATIONAL REPORT AS HAVING A VERY STRONG LEGAL FRAMEWORK FOR THE IDENTIFICATION OF THE ULTIMATE BENEFICIAL OWNERSHIP (UBO) OF ASSETS OR COMPANIES.

This is at least due in part to the introduction of a register of People with Significant Control (PSC) of a company that is being implemented under the Small Business, Enterprise and Employment Act 2015.

The Act, which has applied to companies and limited liability partnerships since 6 April 2016, requires all UK companies (other than publicly traded companies, which were already subject to existing legislation) to maintain a register of people with significant control over them. An individual with significant control over a UK company will meet one or more of these five conditions:

- Direct or indirect ownership of more than 25% of the company's shares.
- Direct or indirect holding of more than 25% of the company's voting rights.
- Direct or indirect power to appoint or remove the majority of the company's board of directors.
- Otherwise has the right to exercise, or actually exercises, significant influence or control over the company.
- Has the right to exercise, or actually exercises, significant influence or control over a trust or firm that is not a legal entity, which in turn satisfies any of the first four conditions as they apply to the company.

The legislation's objective is to move beyond a simple register of shareholders and instead create a public record of anyone who exercises control over a company. As such, the PSC register could, in many cases, look significantly different to the register of shareholders and provide a more transparent overview of a company's UBO. A company's PSC register must be available for public inspection and be searchable via Companies House.

There are criminal sanctions for companies and their officers that do not comply with the PSC register's conditions.

This legislation has rightly positioned the UK in a role of leadership in enforcing UBO transparency in companies. However, the Transparency International report still identified concerns over UK overseas territories and Crown dependencies.

In particular, the report identified overseas territories such as the British Virgin Islands and the Cayman Islands as operating legal systems that "create a veil of secrecy to obscure the identity of those establishing companies, usually for the benefit and use of people or companies that are not resident there". The report commented that the UK "needs to do more to ensure that the overseas territories are not used as a safe haven for laundering illicit and corrupt wealth. If action is not taken, the UK's strong domestic implementation of the G20 Beneficial Ownership Transparency Principles risks being overshadowed."

MANY RECENT MAJOR CORRUPTION SCANDALS HAVE INVOLVED THE USE OF COMPLEX WEBS OF COMPANIES, TRUSTS AND OTHER LEGAL ENTITIES SITUATED ACROSS MULTIPLE JURISDICTIONS. THEY INCLUDE THE PETROBRAS SCANDAL AND CORRUPTION ALLEGATIONS AT THE INTERNATIONAL FOOTBALL FEDERATION, FIFA.

Despite being named in 2008 as the leading ethical oil and gas company in the world by Covalence, Petrobras has since been embroiled in Brazil's largest ever corruption and money laundering scandal.

Executives allegedly channelled bribes to politicians' personal bank accounts by using companies in multiple jurisdictions and filtering large sums of money through the global financial system to 'clean' it before the illicit payments were made.

The US Department of Justice's 164-page indictment of sports marketing officials and current and former Fédération Internationale de Football Association (FIFA) officials alleged that at least US$150 million was paid in bribes through the US, with various payments made through companies or trusts.

The department alleges that officials created shell companies in tax havens to pay bribes, often relying on 'nominee directors' or a lack of disclosure to conceal identities. It is alleged that most of the activity took place in jurisdictions where transparency is masked, enabling officials to hide identities and any bank accounts that held cash from their bribes.

BEST PRACTICE IN PROTECTING AGAINST BENEFICIAL OWNERSHIP RISKS

Various international and national regulators, bodies and governments have made efforts to create a more transparent regulatory environment to counter bribery, corruption and money laundering on a global basis. However, until a global standard is adopted, financial institutions and businesses need to ensure they comply with best practice to minimize the risk of being embroiled in corruption and scandal.

As the examples of Petrobras and FIFA demonstrate, the size of a company or its public brand profile is no guarantee against the potential for corruption.

All businesses, and particularly those involved in the exchange or transfer of large sums of money on a global basis, need to ensure they conduct thorough, ongoing due diligence to minimize their risk of being an accessory to bribery, corruption or money laundering. This process should be based not only on local legislation, but on best practice, such as the FAFT recommendations outlined earlier in this document.

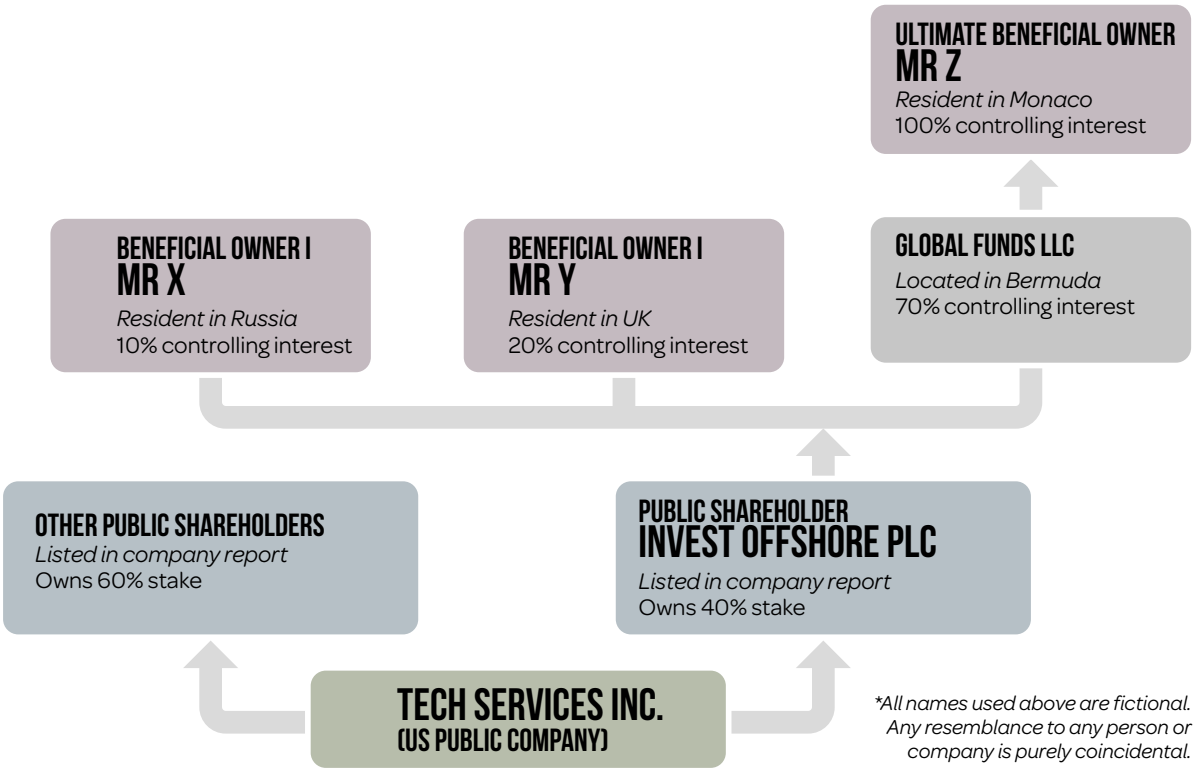
A REALITY CHECK

No single global register demonstrates the ultimate beneficial ownership of companies. Even the most advanced economies still have a long way to go before they can be seen as compliant with best practice around this issue.

Claims that comprehensive beneficial ownership data is available are incorrect and should be treated with suspicion. In reality, this is often shareholder data that could not identify an organization's ultimate beneficial owner. For comprehensive data to be available, a global accord would be required as demanded by the organizations listed in this document. This is true across the globe, but particularly relevant to territories that don't have strict beneficial ownership legislation – which currently includes most of the world.

> "NO SINGLE GLOBAL REGISTER OF BENEFICIAL OWNERSHIP EXISTS"

DUE DILIGENCE BEST PRACTICE: A STEP BY STEP EXAMPLE



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International anti-money laundering (AML) rules require companies to identify and verify the identity of beneficial owners with 25% or more controlling interest.

In the example above, this means that if Tech Services Inc. was being scrutinized in the AML customer due-diligence process, regulated companies would need to:

1. Ascertain the ultimate beneficial ownership of Invest Offshore LLC to understand the ownership of Tech Services Inc.
2. Ascertain the ownership of Global Funds LLC to understand the ownership of Invest Offshore LLC.
3. Identify and verify the identity of Mr Z as the ultimate beneficial owner with more than a 25% controlling interest in Invest Offshore LLC.

Here are the key points for anti-bribery and corruption (ABC) third-party due diligence:

1. Foreign public officials (FPOs) are deemed 'high risk' under ABC rules due to the many historical cases of senior government officials (particularly in emerging and developing markets) receiving bribes for helping companies win lucrative contracts.
2. Identifying and verifying the identity of beneficial owners, directors and shareholders of prospective third-party business partners is best practice for ABC due diligence to help establish whether there are close ties to governments and a high risk of bribery and corruption.

Financial institutions in particular need to carry out advanced due diligence when onboarding new customers, ensuring that they gain in-depth understanding of companies and individuals that interact with an organization, including clients, suppliers, contractors or partners.

Particular attention should be paid to watchlists and politically exposed persons (PEPs) to minimize business dealings being at risk of corruption through vulnerable third parties. A combination of global watchlists, individual biographies and proactive searching of news outlets to fully understand the nature of both the business and the individuals behind it is essential before carrying out financial transactions with any new customer.

Due diligence should not stop there. Companies would be wise to implement an ongoing process, regularly updating the monitoring of customers, suppliers and other third parties to ensure ongoing compliance and good practice. Where risk is deemed to be particularly high, businesses should engage a full and thorough risk assessment program with a respected third party consultant.

The ability to achieve this is enhanced by access to plug-in databases of sanctions lists, watchlists and PEP lists that are automatically updated in real time. This significantly reduces the risk of missing key information.

No company is immune to the risk of financial misadventure. The recent FIFA scandal engulfed small sports marketing consultancies, while Brazil's ongoing Petrobras investigation has had implications for international brands such as Maersk, Rolls-Royce, Samsung, Skanska and Toshiba. Every company has a responsibility to do all it can to minimize this risk.

FIVE TIPS FOR DELIVERING A MORE EFFECTIVE DUE-DILIGENCE PROGRAM

1. **KNOW YOUR CUSTOMER/SUPPLIER/PARTNER BETTER**

While it is relatively simple to get basic financial and ownership information on companies in developed countries, this may mask an organization's ultimate beneficial owner. When onboarding new customers, it is essential to carry out a thorough check using all available resources. Companies should ask their prospective clients and third parties to disclose the name(s) of their beneficial owner(s). This information should be a condition of doing business. The names can then be investigated to check for negative news, other corporate connections, political exposure, legal cases and sanctions.

2. **UNDERSTAND THE REGULATORY ENVIRONMENT**

The regulatory environment governing company ownership varies greatly around the globe. Even developed economies lack common reporting information. Companies need to understand what is required by law in any territory where a business is headquartered. The UK is perceived as having one of the most thorough legal frameworks for delivering clear understanding of who is the ultimate beneficiary of a business. Comparing local regulation to that of the UK will help to shape the level of due diligence required on an organization.

3. **FOLLOW THE TRAIL**

It is critical that companies look beyond immediate partners, suppliers or customers and gain a full understanding of who the organization is controlled by. Often one company will be partly owned by a trust in another territory, necessitating further due diligence on that particular trust. A UK company, for example, may be happy to do business with another UK company, but issues may arise if the second company is owned by a third company based in Panama. Effective due diligence is about following the trail until the identity of the ultimate beneficiary is clear.

4. **CONSIDER EXTERNAL SUPPORT**

In cases where there is a degree of uncertainty or a lack of clarity about ultimate ownership, companies can seek support from external consultants. This leads to a far more thorough investigation. Good due-diligence programs will automatically flag when this is necessary and trigger a further, more effective, audit.

5. **DUE DILIGENCE IS NOT A ONE-TIME ACTIVITY**

The most effective due-diligence programs don't assume that when an individual or company is deemed to be safe to do business with, this will remain the case forever. Annual or even quarterly due diligence on a company may miss important red flags that can emerge between audits. If companies are involved in complex transactions where the risk of money laundering or corruption is high, continuous auditing for risk is essential.

HOW LEXISNEXIS CAN HELP

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