

White Paper

# The challenges presented by beneficial ownership

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## Table of Contents

The harsh reality of life .....	3
Beneficial ownership: The issues .....	3
Beneficial ownership: The answers .....	5
Beneficial ownership: The reality .....	6
Conclusion .....	7
About the author .....	8

## The harsh reality of life

Terrorism kills. Transnational criminal organizations kill and cause economic distress. Corruption can lead to death and economic devastation. Major fraud causes personal anguish and economic collapse. A commonality shared by these nefarious groups is the use of anonymous shell companies as a facilitation tool. On October 9, 2012, Manhattan district Attorney, Cyrus R. Vance, Jr., stated “It is almost a certainty that, at this very moment, a terrorist cell, drug cartel, or corrupt government official is using an anonymous shell corporation to finance illicit activities.”

On that same date, Mr. Vance also stated “The average American likely knows very little about them (shell companies). But your average terrorist, drug trafficker, tax evader or money launderer is well versed in the art of legal anonymity. Every day they make or move illicit money, and America’s lax incorporation laws make it easy to hide the money behind anonymous shell companies... Criminals use layers of shell companies to frustrate investigators and protect themselves from prosecution.”

There are no Federal laws regulating incorporation. States play a central role in controlling access to corporate beneficial ownership information. States manage the corporate formation process. Corporate formation represents a significant revenue stream for states. Information gathering requirements vary widely from state to state. No state requires persons forming corporations to name beneficial owners at the time of corporate formation. Verification of accurate and complete beneficial ownership information will not be feasible until states are required to obtain and verify such information at the time of incorporation.

On June 30, 2012, former Assistant Attorney General Lanny A. Breuer stated “Shells are the number one vehicle for laundering illicit money and criminal proceeds. It’s an enormous criminal justice problem. It’s ridiculously easy for a criminal to set up a shell corporation and use the banking system, and we have to stop it.” To emphasize that point, consider that more than two million corporations are formed in the United States (U.S.) each year. The U.S. forms more corporations than any other nation in the world. Most corporations are legitimate. However, there is a tremendous opportunity for bad guys through the unimpeded anonymous formation of corporations for criminal purposes. Delaware, Nevada and Wyoming are locations where most shell companies are formed.

## Beneficial ownership: The issues

Anonymity is a money launderer’s best friend. The lack of beneficial ownership requirements feeds anonymity. Anonymity enables money launderers to raise, move, store and access their illicit funds. Funding enables bad guys to succeed with their illegal activities. Anonymity inhibits law enforcement.

The term “beneficial ownership” when used to refer to beneficial ownership of a bank account, in an anti-money laundering (AML) context, is conventionally understood as equating to ultimate control over funds in such account, whether through ownership or other means. “Control” in this sense is to be distinguished from mere signatory authority or legal title. Beneficial ownership should also refer to a natural person and not an entity. Anonymity obscures beneficial ownership. The ability to conceal beneficial ownership is extremely attractive to bad guys and detrimental to law enforcement.

The absence of beneficial ownership requirements is a global problem. It presents a significant vulnerability to the global financial system. The need for beneficial ownership requirements originates at the country specific level. The lack of beneficial ownership requirements facilitate:

- Flight capital from poor countries
- Tax avoidance or evasion from all countries
- Illicit proceeds from corruption and criminal activity occurring in any country

The U.S. poses a particular problem regarding beneficial ownership. There are a disproportionate number of corporations formed in U.S. states. Over two million corporations are formed in the U.S. annually. U.S. companies are perceived to have a lower risk of misuse and are more widely viewed as legitimate because of the U.S.'s otherwise strong rule of law. The perception of low risk makes U.S. shell companies attractive to both domestic and international criminals.

Poster children for anonymity include a diverse group of treacherous individuals, criminal organizations and state sponsors of terrorism. A sampling of which include:

- **Iran (Alavi Foundation).** Iran has been forced to rely on shell companies formed in offshore venues to circumvent sanctions. In one such case, Iran used nominees and shell companies to conceal ownership of a building in New York City. They controlled the Alavi Foundation through nominees and used the Assa Corporation, a Channel Islands shell company, to own 650 5th Avenue in Manhattan. The building was forfeited to the U.S. government.
- **Victor Bout.** Victor Bout was a notorious international weapons dealer who was long sought as a fugitive by the U.S. government. He was ultimately apprehended and convicted. Bout used at least a dozen shell companies incorporated in Delaware, Texas and Florida to operate an arms smuggling empire that fueled conflict around the world.
- **Los Zetas.** Los Zetas are the most powerful and dangerous Mexican drug cartel. As they have matured as a criminal organization, the Zetas have begun to diversify into licit and other illicit business activities. In one instance, they purchased and operated a quarter horse ranch in Oklahoma. The Zetas used a shell company formed in Texas to launder money to operate the ranch.
- **Scott Rothstein.** Scott Rothstein was a Florida attorney. He was responsible for carrying out a \$1.2 billion Ponzi scheme. Rothstein persuaded investors to buy stakes in what he said were payouts from court settlements. He relied on as many as 85 shell companies to facilitate his fraud. Rothstein was convicted for his criminal activities.

Although unrelated, Iran (through the Alavi Foundation and Assa Corporation), Victor Bout, the Los Zetas and Scott Rothstein shared certain commonalities. They all formed and had a reliance on shell companies. Their activities and the flow of funds from them could be traced to low and high risk jurisdictions. Such activities posed threats to the economy and/or national security. The poster children identified above are among the worst of the worst in their criminal endeavors. They each had the need to access money to succeed. They relied heavily on anonymity. Their use of shell companies caused investigative impediments. Shell companies are one of numerous facilitation tools bad guys rely on to move and access money.

Shell companies are non-publically traded corporations, limited liability companies (LLCs), and trusts that typically have no physical presence. Most shell companies are formed by individuals and businesses for legitimate purposes. However, shell companies have become common tools for money laundering and other criminal activities. Attributes that have made shell companies attractive to bad guys include anonymity, as discussed above; they can serve as a gateway to other facilitation tools, such as correspondent banks and wire transfers; they have a global reach; they are easy to set up; and they have limited oversight making it easy to hide beneficial ownership.

There is one constant and numerous variables identifiable with shell companies. The constant is that shell companies have long been a serious point of vulnerability for the financial services industry. Shell companies serve as a dependable criminal facilitation tool. The variables relate to how bad guys use shell companies. Their patterns of activity and trends are driven by a series of variables, which include world events, opportunity, technology, new products, regulatory actions, law enforcement focus and various other factors.

A form of shell company that is extremely attractive is a shelf company. Shelf companies are shell companies that are formed and placed on the shelf to age. Common reasons for purchasing shelf companies include saving the time involved in the process to establish a new corporation and creating an appearance of corporate longevity. The appearance of corporate longevity provides an aura of legitimacy and gives a shelf company easier access to investment capital and credit.

A nominee owner is a person who allows their name to be used for the purpose of recording legal ownership. A nominee enters into an agreement with the beneficial owner to confirm they will act on behalf of the beneficial owner. A nominee is usually paid a fee for their service. Nominees provide an added layer of anonymity for beneficial owners. This is an attractive feature to bad guys.

## Beneficial ownership: The answers

In order to address the challenges presented by beneficial ownership, a truly global response to the issue of corporate transparency is required. The starting point should be adherence to the Financial Action Task Force (FATF) guidance regarding beneficial ownership. Adherence must originate at the country specific level. Countries must implement consistent beneficial ownership reporting requirements. This must include establishment of a corporate registry process either at the national or state level. In the U.S. incorporation formation occurs at the state level. Registry requirements should be implemented at the point of incorporation.

FATF is an inter-governmental body which sets standards, and develops and promotes policies to combat money laundering and terrorist financing. FATF has 36 members, 34 countries and two international organizations. The FATF 40 Recommendations were updated in February, 2012. Initially developed in 1990, the 40 Recommendations provide a complete set of counter measures against money laundering covering criminal justice and law enforcement, the financial system and its regulation, and international cooperation.

Money laundering methods and techniques change in response to developing countermeasures. Bad guys have demonstrated more sophisticated exploitation mechanisms in exploiting systemic vulnerabilities. The new FATF Recommendations reflect current and emerging challenges facing the global community. The Recommendations call on all countries to comply. Particular emphasis was placed on risk, customer due diligence and beneficial ownership.

The Group of Eight (G8) refers to a group of highly industrialized nations. Member nations are France, Germany, Italy, United Kingdom, Japan, U.S., Canada and Russia. The G8 hold an annual meeting to foster consensus on global issues. The 2013 summit was held on June 17th and 18th in the United Kingdom. British Prime Minister David Cameron set the agenda. The British agenda was ambitious. Members agreed to the core principles fundamental to transparency of ownership and control of companies and legal arrangements. Members committed to preparing national action plans.

In response to the G8 commitment for members to publish national action plans on transparency of company ownership and control, the U.S. committed to:

- Update its national risk assessment
- Continue to advocate for comprehensive legislation to require identification and verification of beneficial ownership information at the time of company formation
- The U.S. is currently engaged in rulemaking to develop an explicit customer due diligence obligation for U.S. financial institutions, including a general requirement to identify the beneficial owners of legal entity customers
- Assess the effectiveness of existing means for complying with requests for mutual legal assistance and other forms of international cooperation related to beneficial ownership of companies

The Financial Crimes Enforcement Center (FinCEN) issued advanced notice of proposed rulemaking pertaining to development of customer due diligence (CDD) regulations. The cornerstone of a strong Bank Secrecy Act (BSA) AML compliance program is the adoption and implementation of internal controls, which include comprehensive CDD policies, procedures and processes for all customers, particularly those that present a high risk for money laundering or terrorist financing. FinCEN believes that issuing an express CDD rule that requires financial institutions to perform CDD, including an obligation to categorically obtain beneficial ownership information, may be necessary to protect the U.S. financial system from criminal abuse and to guard against terrorist financing, money laundering and other financial crimes.

The know your customer (KYC) program is an important element of an AML compliance program. A KYC program should have a sound process that includes verification and documentation. CDD should be the process of obtaining information from all customers that enables a financial institution to verify beneficial ownership of customer accounts and assess risks associated with that customer. The FATF Recommendations and FinCEN guidance both stress the importance of customer identification and the consequence of customer risk. Financial institutions should have policies and procedures to recognize and mitigate risk and assess the reasonableness of customer business activity. They must understand the adaptability of bad guys to adjust to controls and look for other vulnerabilities to exploit. Clients deemed to be high risk should require additional due diligence steps, which is known as enhanced due diligence (EDD). CDD requires a sense of vigilance and should be an ongoing process.

When dealing with shell companies, understanding risk is essential. Geographic risk should be assessed from a country specific, regional and global perspective. This should include an assessment of cultural vulnerabilities in terms of potential bribery, corruption and criminal activity, as well as the threats posed by criminal and terrorist organizations. It should also consider the regulatory and law enforcement capacity and will of the jurisdiction or region. In assessing business activity, financial institutions should consider the reasonableness of such activity and look to identify potential red flags.

## Beneficial ownership: The reality

Global beneficial ownership transparency is unlikely in the near term. Countries around the world are experiencing challenges in establishing criteria to collect and document beneficial ownership information. Beneficial ownership transparency in the U.S. is uncertain. There is considerable resistance at the state level and a lack of Congressional support for proposed beneficial ownership legislation. I have testified at numerous Congressional hearings. On two occasions, where I testified at hearings regarding terrorist financing, I testified that shell companies represented one of the most significant risks to the financial services industry. The first hearing was before the House Financial Services Committee on October 2, 2001. The second was before the House Committee on Homeland Security on May 18, 2012. Unfortunately, shell companies pose the same risk today that they did in 2001. Until such time that legislation is passed, the underlying issue of opaque beneficial ownership will remain a serious problem.

Senator Carl Levin (D-Michigan) has been a longtime proponent for beneficial ownership legislation and has sponsored bills to pass beneficial ownership legislation. A bill is currently pending in the Senate. Representative Carolyn Maloney has sponsored pending beneficial ownership legislation in the House. Beneficial ownership legislation is the appropriate action to deal with this serious systemic vulnerability. Most stakeholders inside and out of Congress privately agree that legislation is warranted. The key stakeholders are Congress and the Secretaries of State, who are represented by the National Association of Secretaries of State (NASS). Secretaries of State are not opposed to beneficial ownership legislation. However, they are opposed to legislation that would require them to collect and maintain beneficial ownership information at the point of incorporation. They believe the Internal Revenue Service (IRS) should be responsible to collect and retain beneficial ownership information. NASS contends that the IRS already collects beneficial ownership information on Form SS-4 in the form of responsible

parties. A responsible party does not have to be a natural person. The SS-4 is the IRS form used to apply for an Employer Identification Number (EIN).

The Levin bill would require beneficial ownership information to be collected and maintained by the state through the Secretaries of State. The legislation would require the identification of a natural person who was the beneficial owner, who was the controlling person over an account or asset. NASS has recommended that the IRS collect and maintain beneficial ownership information. As on the Form SS-4, NASS believes a responsible party should be identified. This could include an entity such as a shell company. The Secretaries of State have also raised concerns about the cost associated with collecting and maintaining beneficial ownership information, as well as the potential loss of revenue to the state that could result from collecting beneficial ownership information.

Congressional members are very unlikely to vote in favor of beneficial ownership legislation without the support of Secretaries of State. Secretaries of State will not support legislation where they have to collect beneficial ownership information. Thus an impasse has developed that is not likely to be resolved. Hence, there is little chance that legislation will be passed. In addition, Secretaries of State prefer to identify a responsible party versus the beneficial owner. They also offer other alternatives such as a contact person, who could be a formation agent. This contact person would be responsible to provide law enforcement with beneficial ownership information upon official request. Beneficial ownership would require a higher threshold of transparency than either a responsible party or contact person.

## Conclusion

There are select key words that have a significant impact in the discussion regarding beneficial ownership. They include:

- Anonymity
- Transparency
- Responsible party or contact person
- Beneficial owner
- Risk
- Mitigation

These key words present contradictions such as anonymity vs. transparency; responsible party or contact person vs. beneficial owner; risk vs. mitigation; wrong vs. right. Interestingly, the bad guys align with the words anonymity, responsible party or contact person, risk and wrong. On the other hand, the good guys align with the words transparency, beneficial owner, mitigation and right. Reasonable steps should be taken to ensure that the good guys prevail and that obtaining beneficial ownership information be straightforward and timely.

## About the author

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Dennis M. Lormel is a recognized subject matter expert in the anti-money laundering, terrorist financing, and fraud communities. Mr. Lormel is an accomplished speaker and is routinely engaged to provide training at industry conferences. In addition, he frequently participates in media interviews that reach both the U.S. and international markets. This exposure and his vast experience in the law enforcement and consulting fields have afforded him the opportunity to develop a unique and diverse network of colleagues and clients.

After the tragedy of 9/11, Mr. Lormel realized that the terrorists needed a financial infrastructure to accomplish the attacks. He immediately established an investigative organization within the FBI that, within days, identified the funding stream that supported these attacks. This is but one example of his expertise in assessing and establishing viable and effective recommendations that produce results.

In addition to Mr. Lormel's distinguished 31 year career in Government service, he has consistently delivered high quality consulting services to clients since 2004. The combination of law enforcement and financial services experience provides a comprehensive perspective on the issues that face individuals and corporate entities in today's complex world. Understanding the nexus between fraud and money laundering, especially on the heels of the financial crisis, allows Mr. Lormel to provide more comprehensive guidance to clients. The need for these services is increasing in the current economic environment.

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