

Preventing the misuse of shell companies by regulating corporate service providers

Corporate service providers supply the shell companies that are commonly used to launder illicit funds, including the proceeds of corruption. Effectively regulating these service providers is one important way to limit money laundering and therefore make corruption less profitable. Governments and international organisations must look beyond their current preoccupation with formal laws and regulations to concentrate on practical effectiveness and implementation. The case of the Seychelles provides useful insights and lessons learned for both developing countries and development practitioners.



In his highly influential work on how corruption hampers development, Paul Collier argues that there are three key parties to instances of major corruption: the person giving the bribe, the person accepting it, as well as a facilitator coordinating the exchange. The corporate service providers (CSPs) at the centre of this Brief too often play this key role in facilitating corruption. To the extent that such providers are well regulated, the likelihood of misusing shell companies, and thus the ease of laundering the proceeds of serious corruption offences, are reduced. The analysis of different approaches adopted by the US, the UK and the Seychelles provides interesting insights for development practitioners. Development agency staff can also improve the chances of policy reform in developing countries by encouraging policy coherence at home, e.g. by explaining the adverse consequences of the status quo with counterparts in treasury and finance ministries.

Background

One of the most important methods for laundering large sums of money from corruption is through the use of untraceable shell companies, i.e. companies without a substantive business purpose that cannot be traced back to the real person or people in control. A study of 150 grand corruption cases notes that “a vast majority” depend on the use of shell companies to hide the trail of dirty money.¹ Shell companies are generally supplied by financial intermediaries, known as corporate service providers. Although there are no plausible hard numbers

associated with shell company-enabled illicit financial flows, conservative estimates run into the tens of billions of dollars.²

CSPs may be large firms solely devoted to establishing and selling thousands of shell companies each year, law firms with a sideline in company formation, or even single individuals offering their services through a website. They are more often based in OECD countries and tax havens than in developing states. In each case, the main service they provide is to process and lodge the paperwork and government fee necessary to establish and maintain a company (or more rarely a trust or other form of corporate entity) on behalf of a client who will actually control the company, referred to as the beneficial owner. Although prices may vary widely, the company registration fee can be US\$250, while the CSP might charge another US\$1000. The provider may also act as a stand-in or front man for the beneficial owner in serving as the company director, secretary and/or shareholder (for an additional fee, of course). This stand-in function is important because it further obscures the beneficial owner’s connection with and control of the company, a key factor for successfully laundering the proceeds of corruption. Conversely, for those investigating corruption, revealing and establishing this link is crucial, and hence the importance of information collected (or not) by CSPs on beneficial owners in “piercing the corporate veil.”

Even where providers are regulated, this is no guarantee of their good behaviour. In 2012, two undercover journalists visited a CSP in the Seychelles - a country with quite strong regulation, as discussed later in this paper. One journalist impersonated a corrupt Zimbabwean official (“George”), and the other his lawyer (“Prince”). The provider assures George of absolute secrecy: “You will be the beneficial owner and we don’t even ask about your name or address or anything.” In a separate meeting with the same provider, the “lawyer” explains: “My client is from Zimbabwe and then he’s the liaison officer between the Zimbabwean government and the rich diamond mines.” The provider replies, “Yep, we don’t want to know that. That’s the sort of thing we can’t have

knowledge of. If we had knowledge of that we'd have to put it forward, so I haven't heard a word you've said in the last couple of minutes" (both sides laugh at this point).⁴

Addressing the problem: Key features of the regulatory regime

Although the nature and importance of the problem of untraceable shell companies and under- or unregulated CSPs is now quite widely appreciated, specific and practical solutions are less evident. The crux of the issue is regulating CSPs so that they screen out high-risk would-be clients and collect proper identity documentation on the clients they accept, i.e. information that can be made available to investigators and regulators. Regulating CSPs so that they know who really owns the companies they sell can either be an alternative to the more ambitious but as yet untested solution of making ownership publicly available through national company registries, or an intermediate step or complement to this approach.⁵ The most important elements of an effective regulatory regime would include the following:

- **Licensing CSPs:** The first essential step is to make sure that CSPs are licenced by a government regulator. Those without a license, or CSPs that have their licence revoked, should be forbidden from forming or administering companies on behalf of others. All EU countries and tax havens and some developing countries have such a licencing scheme in place; however, the United States does not. This is a major point of vulnerability: not only are more companies formed each year in the United States than in any other country, but US shell companies are also found to be used in serious cross-border corruption cases more often than those of any other jurisdiction.⁶
- **Require use of local CSPs:** The second component is to require foreigners forming a company to use a local, resident CSP acting as an agent or company director in that jurisdiction. In this way, those forming companies must go through a regulated gatekeeper. This measure incidentally helps to strengthen the legitimate CSP industry, and may offset any increased costs of regulation. Tax residents of that jurisdiction can be left the option to form companies directly in person or online (i.e. without a CSP). This exception is because jurisdictions already hold a great deal of information on their own tax residents, and can usually investigate and sanction them without the need for slow and labour-intensive mutual legal assistance requests.
- **Mandate confirmed identification of beneficial owner:** The most important aspect of regulating CSPs to reduce the facilitation of corruption is to establish beneficial ownership. Providers should be obliged to collect notarid copies of the picture page of clients' passports, supported by some proof of residence, typically a utility bill or bank reference. These documents should be held on file for as long as the business relationship lasts, plus a period of some years afterwards. Of course, it is possible to obtain fake passports, to buy notary stamps illegally and to forge bank references and utility bills, as no regulatory system is perfect. It is necessary to strike a balance between deterring criminals and minimising the costs borne by legitimate business and

Lacking regulation – “imagine the possibilities!”

The dangers of a lack of regulation can be illustrated by the example of a CSP from the US state of Wyoming, which supplied shell companies used by former Ukrainian Prime Minister Pavlo Lazarenko to embezzle tens of millions of dollars. This firm advertises its wares saying, “A corporation is a legal person created by state statute that can be used as a fall guy, a servant, a good friend or a decoy... a person you control... yet cannot be held accountable for its actions. Imagine the possibilities!” Another example is New Zealand-based GT Group, which has provided anonymous shell companies to the Mexican Sinaloa drug cartel, the corrupt officials behind the scandal leading to the death of Russian whistle-blower Sergei Magnitsky, North Korean arms smugglers and a variety of other criminals. Because neither Wyoming nor New Zealand law imposes any duty on CSPs to conduct due diligence on those to whom they sell shell companies, or even know these clients' true identities, neither provider has been punished and both remain in business.³

society more generally. Mandating that CSPs collect beneficial ownership information has been shown to significantly assist regulators and law enforcement at an acceptable cost (discussed below).

- **Reporting of suspicious transactions:** Licenced providers should be reporting entities within the national anti-money laundering system, meaning that they have an obligation to report suspicious activity to the national Financial Intelligence Unit (FIU). This also means that the FIU will be able to access information held on file by CSPs concerning their clients, while CSPs are both indemnified against legal action by clients for lodging such a report, and forbidden from tipping off clients that a report has been submitted. CSPs should apply a similar sort of risk-based approach (the Know Your Customer principle) as banks do in assessing whether to accept potential clients according to corruption and other risks (spelled out in the Financial Action Task Force (FATF) Methodology).⁷

The relevant international standard mandated by the FATF (but too often not met) is that, “Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.”⁸ Beyond the anti-money laundering authorities, law enforcement and tax officials should also have access to CSPs' files, both on their own behalf and in fulfilling requests from foreign counterparts. In practice, fulfilling this standard is rarely consistent with requiring authorities to obtain a court order to access CSPs' files; thus, beneficial ownership information should be available to authorities on request.

From window dressing to effective regulation

All the measures suggested so far relate to the formal content of regulations. However, international organisations, bilateral agencies and national governments too often focus only on rules on the books, and pay little attention to implementation and effectiveness, that is, to determine whether these rules make any difference in practice. The FATF has belatedly acknowledged this by shifting

its assessment programme to include some measure of effectiveness. Implementation and effectiveness are much more important than the technical content of rules: flawed rules that are implemented are better than the most perfect legislation that remains a dead letter. How can the rules above be made practically effective?

Rules do not enforce themselves: the regulator must conduct audits to ensure that CSPs are fulfilling their responsibilities and sanction those that do not. A cheap and effective way of doing this is to randomly pick companies formed by particular providers each year and to require the CSPs to supply the beneficial ownership file to the regulator within a few days. To the extent that CSPs cannot provide this information, or the information is incomplete or obviously false, they should be warned, fined or have their licence revoked. Regulators can also engage in “mystery shopping” online, posing as high-risk clients to check CSPs’ screening practices. Where there is evidence of negligence, willful blindness or active complicity in facilitating corruption or other offences criminal penalties can be applied as well (e.g. as part of a money laundering charge).

What works where?

Given these key legal components of a CSP licencing regime and some ideas on enforcement, what evidence do we have of effective regulatory systems?

Company law in the United States is the prerogative of the 50 state governments rather than the federal government. As noted, CSPs in the US are not regulated, and thus they have no duty to either establish beneficial ownership or to report suspicious activities to the financial intelligence unit. Britain has legally regulated its providers through the 2007 Money Laundering Regulations, which impose a legal duty on CSPs to establish beneficial ownership and comply with FATF standards via the EU’s Third AML Directive. Despite having this legislation in place, the UK has not actually implemented this policy. The regulator (Her Majesty’s Revenue and Customs) has yet to perform a single audit to find out whether providers are fulfilling their responsibilities.⁹ On the other hand, in the Seychelles, a small, middle-income country and a tropical tax haven, CSPs are regulated. The regulator, the Seychelles International Business Authority, conducts regular audits and takes enforcement action. The Seychelles’ comparatively robust regulatory regime and, more importantly its implementation, are mostly the consequence of international pressure the country has received at several points since 1996 to tighten its regulations. By contrast, major onshore financial centres like the US and UK have managed to avoid similar pressure.

How can we compare the actual effectiveness of the regulatory regimes (or lack thereof) in these three countries? Anecdotally, there are successes and failures in each. US authorities have vigorously sought to pierce the corporate veil in grand corruption cases like that involving the heir apparent of Equatorial Guinea, although no action has been taken against the CSP involved. British law enforcement has successfully prosecuted both corrupt Nigerian officials, and on at least one occasion the lawyer who created the chain of shell companies used to launder the criminal proceeds. The Seychelles government has provided beneficial ownership information to Australian law enforcement investigating the bribery of officials in 16

developing countries, as well as revoking the licence of the provider exposed in the sting perpetrated by “George” and “Prince” referred to earlier.¹⁰

Systematic evidence is provided by a large-scale mystery shopping exercise (or more formally, a field experiment) conducted by Michael Findley, Daniel Nielson and this author.¹¹ Here, we impersonated a range of high- and low-risk customers and solicited offers of shell companies from 3,773 CSPs in 182 countries, approaching each CSP in the guise of two different customers. The aim was to discover what identity documents, if any, providers required from customers to form a shell company.

Of the 705 replies received from US providers, only 10 asked for notarised identity documents (a little over 1%), while 274 (39%) were willing to sell shell companies with no requirement for the customer to provide any information at all (the remainder refused service or asked for non-notarised documents). In the Seychelles, the comparable figures from 55 replies were that 38 asked for notarised identity documents (69%), while not one was willing to provide a company without documentation (eight providers refused service and nine asked for non-notarised documentation). The UK is an intermediate case. From 97 replies received, 36 providers required notarised identity documents (37%), while 19 (20%) were willing to form a company in the absence of any documentation.

Hence, going beyond anecdotes, the systematic data presented above substantiate the common sense conclusion that while having laws on the books regulating CSPs (like Britain) is better than nothing (like the US), both are significantly worse than having laws that are actually enforced (like the Seychelles). The fact that the Seychelles is a small island state with significant constraints that nevertheless has a more effective regulatory regime for CSPs than both the US and the UK suggests that regulation can be effective even with a small government structure and very limited financial resources.

What are the implications for developing countries? Looking at the overall results, this field experiment shows that the conventional distinction between developed and developing countries, whereby the latter are assumed to have poor regulatory performance and a lack of capacity, does not hold when it comes to beneficial ownership. Beyond the case of the Seychelles, which cannot be used as a proxy for developing countries, developing countries in the study usually perform as well as OECD countries, and often actually better. What explains this conclusion? It seems that an unintended side-effect of OECD country reforms to make the process of forming a company more user-friendly has been to make it easier to form companies anonymously. In developing countries, forming a company is often a lengthy, bureaucratic process that seems to have unintended benefits in terms of establishing the owner’s identity. Stereotypical “tax havens” like the Seychelles have managed to steer a middle path: forming a company is quick, easy and cheap, but the requirement to establish beneficial ownership is more effectively enforced.

Conclusion

Major corruption poses a substantial obstacle to development. Some Corporate Service Providers act as crucial facilitators of corruption, in particular by offering untraceable shell companies, perhaps the most



U4 is a web-based resource centre for development practitioners who wish to effectively address corruption challenges in their work. The centre is operated by the Chr. Michelsen Institute – an independent centre for research on international development and policy – and is funded by AusAID (Australia), BTC (Belgium), CIDA (Canada), DFID (UK), GIZ (Germany), Norad (Norway), Sida (Sweden) and The Ministry for Foreign Affairs of Finland. All views expressed in this brief are those of the author(s), and do not necessarily reflect the opinions of the U4 Partner Agencies or CMI/U4. (Copyright 2013 - CMI/U4)

common mechanism by which the proceeds of corruption are transferred and laundered. Licencing CSPs and imposing a duty to establish the true identity of their customers can assist in greatly reducing the incidence of such untraceable shell companies, and thus corruption, if such regulations are implemented and monitored. To make this strategy effective, governments and international organisations must look beyond their current preoccupation with formal laws and regulations to concentrate on practical effectiveness and implementation.

Development agencies can play a key role in ensuring that developing countries' governments keep regulation of CSPs high on their development agendas, especially since some of them are slowly emerging as international financial centres. More importantly, however, development practitioners should think outside of the "development box" when it comes to gaining a better understanding of how to regulate CSPs and limit illicit financial flows in general. As discussed above, because of their highly liberalised financial markets

and loose regulation of CSPs, OECD countries make it easier to incorporate shell companies, and therefore to launder the proceeds of illicit funds often flowing out of developing countries. Consequently:

- Development agencies should ensure policy coherence at home. This can be done by strengthening the regulation of CSPs domestically and cooperating with other government agencies and within international standard-setting organisations, as these efforts can have significantly beneficial effects on developing countries.
- Development practitioners, both in donor agencies and developing countries, should look for best practices outside of OECD countries when it comes to the regulation of CSPs and its implementation. The Seychelles example shows that, when it comes to regulation, much can be learned even from the experience of a small tax haven with limited resources and significant capacity constraints.

Notes

1. van der Does de Willebois *et al* (see link under references) 2.
2. Ibid.
3. Findley *et al* (see references).
4. Al Jazeera, 'How to Rob Africa', 8 November 2012. <http://aje.me/SODyXt>
5. Immediately before and since the 2013 G8 heads of state summit, there has been an intensive policy debate concerning the desirability and practicality of requiring registries to collect beneficial ownership information. An associated issue is whether such information would then be publicly available or only open to law enforcement and regulators.
6. van der Does de Willebois *et al*, *The Puppet Masters* (see link under references). See also U.S. Senate Permanent Subcommittee on Investigation, *Keeping Foreign Corruption out of the United States: Four Case Histories* (see link under references).
7. FATF 2013 (see references).
8. See Recommendation 24, FATF 2012 (see link under references).
9. Global Witness 2012, (see references).
10. Author's interviews, Global Witness, London, 14 June 2013; Department for International Development, London, 17 June 2013; Department of Justice, Washington D.C., 27 April 2012; Australian Federal Police, Brisbane, 2 October 2012.
11. Findley *et al* (see references).

References

- FATF, *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*, Paris, 2012. <http://bit.ly/14yIEzn>
- FATF, *Methodology for Assessing Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems*, Paris, 2013. <http://bit.ly/10UDNDb>
- Findley, Michael G., Daniel L. Nielson and J. C. Sharman. *Global Shell Games: Experiments in Transnational Relations*. Cambridge: Cambridge University Press, 2013.
- Global Witness. *Grave Secrecy: How a Dead Man can own a UK Company and other Hair Raising Stories about Hidden Company Ownership from Kyrgyzstan and Beyond*. London, 2012. <http://bit.ly/1drBOiE>
- U.S. Senate Permanent Sub-Committee on Investigation, *Keeping Foreign Corruption out of the United States: Four Case Histories*. Washington D.C., 2010. <http://bit.ly/16zQEW1>
- van der Does de Willebois, Emile, Emily Halter, Robert A. Harrison and Ji Won Park. *The Puppet Masters: How the Corrupt Use Legal Structures to Hide their Stolen Assets and What to do About It*. Washington D.C.: World Bank, 2011. <http://bit.ly/18jdTtS>