Executive Summary

- In 2002, the government of Kenya invited bids to replace its passport printing system. Despite receiving a bid for €6 million from a French firm, the Kenyan government signed a contract for five times that amount (€31.89 million) with Anglo-Leasing and Finance Ltd., an unknown U.K. shell company, whose registered address was a post office box in Liverpool. The Kenyan government's decision was taken despite the fact that Anglo-Leasing proposed to subcontract the actual work to the French company. Material leaked to the press by whistle-blowers suggested that corrupt senior politicians planned to pocket the excess funds from the deal. Attempts to investigate these allegations were frustrated, however, when it proved impossible to find out who really controlled Anglo-Leasing.
- In March 2010, Daimler AG and three of its subsidiaries resolved charges related to a Foreign Corrupt Practices Act (FCPA) investigation in the U.S. In part, Daimler AG's Russian subsidiary, DaimlerChrysler Automotive Russia SAO (DCAR), which is now known as Mercedes-Benz Russia SAO, pleaded guilty to one count of conspiracy to bribe foreign officials and one count of bribery of foreign officials. The Statement of Facts agreed to by Daimler as part of the Deferred Prosecution Agreement in US v. Daimler AG noted that "DCAR and DAIMLER made over €3 million [US$4,057,500] in improper payments to Russian government officials employed at their Russian governmental customers, their designees or third-party shell companies that provided no legitimate services to DAIMLER or DCAR with the understanding that the funds would be passed on, in whole or in part, to Russian government officials." The Statement of Facts details 25 sets of improper payments involving (in addition to cash payments) payments to bank accounts held in Latvia, Switzerland, the United States and unnamed jurisdictions; the accounts were held in the name of some of the 27 involved companies (16 named and 11 unnamed) registered or having addresses in 7 different jurisdictions: the Bahamas; Costa Rica; Cyprus; Ireland; Seychelles; United Kingdom; and in United States in California, Delaware and Florida.

A Significant Challenge

Both the Anglo-Leasing and Daimler AG scandals described above graphically illustrate the central role played by corporate vehicles (companies, trusts, foundations, and others) in concealing the abuse of public trust for private financial gain. In neither case has any individual or company been convicted of a corruption offense, despite the millions—even billions—of dollars of illicit payments allegedly involved.

Research carried out for this report shows that these cases of "grand" (that is, large-scale) corruption are not untypical. Such cases can be found around the world, in both industrial and developing countries, whether as the place that the proceeds originate from or as the place they eventually end up. A review of some 150 cases carried out as part of this study showed that they shared a number of common characteristics. In the vast majority of them,

- a corporate vehicle was misused to hide the money trail;
- the corporate vehicle in question was a company or corporation;
- the proceeds and instruments of corruption consisted of funds in a bank account; and
- in cases where the ownership information was available, the corporate vehicle in question was established or managed by a professional intermediary.

This report casts light on how corporate vehicles are misused to conceal the proceeds of grand corruption. It describes how providers of legal, financial and administrative (management) services—including banks, financial institutions, lawyers, accountants, and other professionals that are known as trust and company service providers (TCSPs)—can be employed to facilitate such schemes. While this report focuses on the use of front companies and the abuse of corporate opacity to conceal corruption, the weaknesses highlighted in this report are not specific to corruption. There is evidence of similar misuse of legal entities, legal arrangements as well as charities[1] in the context of other criminal and illicit behaviors, including escaping international sanctions and the funding of terrorist organizations.

Puppet Masters aims to support countries' efforts to meet international standards that were developed in recent years to help combat financial crime, including grand corruption, money laundering and terrorist financing. The two key standard-setting agreements are the United Nations Convention against Corruption (UNCAC), adopted in 2003 and ratified by 100 countries (as of October 2011), and the 2003 recommendations of the Financial Action Task Force (FATF), endorsed by more than 170 jurisdictions. As highlighted by these two documents, there is international consensus on the need to improve the transparency of legal persons and arrangements, and many jurisdictions have already taken steps in that direction.

As the study shows, however, significant hurdles to implementing these standards remain. To support countries as they work to overcome those challenges, the report offers recommendations on how to ensure adequate transparency of corporate vehicles.

There is no lack of theoretical discussion on transparency in the ownership and control of companies, legal arrangements and foundations. Taking a more practical approach, this report draws on an unprecedented depth and breadth of evidence to show:

- where the challenges of the misuse of corporate vehicles lie;
- which laws and standards are effective in practice and which are not; and

1. See also Financial Action Task Force Special Recommendation VIII.

- how the shortcomings that currently allow most corrupt officials to successfully launder illicit funds through corporate vehicles can be addressed.

Three types of evidence were collected for this research:

- a database of more than 150 actual cases of grand corruption from a wide range of jurisdictions;
- extensive interviews with practitioners (both service providers and investigators) on the difficulties they encounter when trying to determine beneficial ownership; and
- evidence from a solicitation exercise, whereby researchers posed as would-be customers soliciting shell companies and trusts to hide their financial affairs.

Through analysis of these varied sources of evidence, the report identifies a number of ways in which the misuse of corporate vehicles can be curbed. Specifically, the report—

- makes recommendations regarding the minimum information that corporate registries should collect and make publicly available about the legal and beneficial owners of legal entities seeking registration;
- explores the role that service providers should be required to play in conducting greater due diligence of the persons who exercise effective control over the corporate vehicles (that is, the beneficial owners); and
- calls for investigative capacities to be strengthened (through better training and greater resources) so that investigators will be better equipped to undertake the increasingly complex cross-border investigations required in the 21st century.

The Elusive Beneficial Owner: A Call for a Substantive Approach

Uncertainty and variation exist among jurisdictions about the meaning of beneficial ownership. This report argues that beneficial ownership should be understood as a material, substantive concept—referring to the de facto control over a corporate vehicle—and not a purely legal definition. To be effective and meaningful, beneficial ownership must not be reduced to a legally defined position, such as a director of a company or foundation or a shareholder who owns more than a certain percentage of shares or legal entitlement/benefit of a trust.

In identifying the beneficial owner, the focus should be on two factors: the control exercised and the benefit derived. Control of a corporate vehicle will always depend on context, as control can be exercised in many different ways, including through ownership, contractually or informally. A formal approach to beneficial ownership, based on percentage thresholds of ownership or designated beneficiary of a corporate vehicle under investigation, may yield useful information providing clues to the corporate vehicle's ultimate ownership or control. More generally, it may lead to the identification of people of interest who possess information regarding the beneficial owners. Service

providers, however, should be aware of the limitations of such an approach. In suspicious cases, they need to go beyond their basic obligations and find out whether others are really in control or derive benefit.

Wanted: A Government Strategy

Governments have recognized the importance of curbing the misuse of corporate vehicles to conceal beneficial ownership, and in response, they have adopted certain international standards. We have only to look at the evaluations undertaken by the Financial Action Task Force on Money Laundering (FATF) and similar international organizations, however, to see that compliance with these international standards is poor.

The evidence collected for the present study provides—for the first time—direct insight into the substantial gap between the rules on paper and the rules as applied in practice when it comes to corporate vehicles. On this basis, we argue that a more ambitious approach is needed, one that involves adopting a detailed set of policies specifically aimed at improving transparency in the ownership and control and benefit of corporate vehicles. In our view, an effective policy regime will need to address at least five key issues.

> *Issue 1. The information available at company registries should be improved and made more easily accessible.*

The first source of information mentioned by both investigators and service providers when seeking information about an incorporated entity (that is, any corporate vehicle, excluding trusts or similar arrangements) is the company registry.

The vast majority of registries contain information about legal entities that is of some use to investigators, such as the name of the entity, its address, its articles of incorporation (or charter), and details of its directors. This information should be *publicly available* in all company registries. In cases in which a director is acting as a nominee for another person, that fact should be noted in the registry, along with the name of that "shadow director."

Many registries also hold information on the owners, shareholders, and members of a legal entity. All registries should collect and maintain this information, which should cover anyone whose ownership stake is sufficiently large to be deemed a controlling interest. This information should be updated and made accessible in a timely manner to (at least) law enforcement members in the course of their investigations.

Finally, company registries in some jurisdictions—typically held by a securities supervisor, regulatory commission, or some other agency with a comparably proactive approach—are more inclined toward enforcing and supervising legal or regulatory obligations and have sufficient expertise and resources to do so. In such cases, countries

could consider requiring their corporate registry to also maintain information on beneficial ownership. Currently, however, few countries have sufficient expertise and resources to be able to do this adequately.

In addition to improving the data content in company registries, countries should strive to make it freely available. Ideally, this would mean providing free online access (without preregistration requirements or subscription fees), complete with search functions that allow for extensive cross-referencing of the data. Access to historical records on the legal entities entered in the register also should be included.

The report, however, recognizes that company registries have serious limitations—in both how they are set up and how they work in practice. Registries are almost invariably archival in nature; they rarely conduct independent verification; and in many cases, they are already stretched for resources. They clearly are not a panacea for the misuse of legal entities. For this reason, although the information supplied by a company registry may be a useful starting point, it needs to be complemented by other sources.

Issue 2. Steps should be taken to ensure that service providers collect beneficial ownership information and allow access to it.

The Advantages of Service Providers

The most important among these other sources are TCSPs and banks. These providers have unique insight into the day-to-day operations and the real "financial life" of the corporate vehicle, that is, the financial flows of funds—which are harder to manipulate and disguise. As a result, banks and service providers are an essential source of information on control and beneficial ownership of a corporate vehicle. The international standards already call on these institutions to be under an obligation to conduct customer due diligence (CDD) of the corporate vehicle to which they are providing a service. Implementation is significantly lagging however. This obligation should extend to establishing the identity of the beneficial owners, both when the business relationship is initially established and during its subsequent life cycle. Ongoing monitoring is important because the true economic reality behind a corporate vehicle becomes more difficult to hide during the course of a longer-term business relationship. In the case of corporate vehicles that are trusts or similar legal arrangements, service providers play an even more important role as source of beneficial ownership information, as few countries have the functional equivalent of a corporate register for trusts.

Why Service Providers Should Be Obligated to Conduct Due Diligence

The international standard on anti-money laundering, laid down in the FATF 40 Recommendations against Money Laundering, requires the collection of information

about beneficial ownership. The review, however, carried out as part of this study on what information TCSPs collect in practice, coupled with country evaluations carried out in more than 159 countries, shows that banks (to some extent) and TCSPs (more generally) still do not adequately identify the beneficial owner when establishing a business relationship. For example, U.S. banks are not generally obligated to collect beneficial ownership information when establishing a business relationship. At the very least, an official declaration by the customer as to beneficial ownership could be useful in improving the situation.

More generally, the imposition of due diligence obligations on service providers is important for two reasons. First, it obliges service providers to collect information and conduct due diligence on matters about which they might prefer to remain ignorant. This obligation is important because in the majority of cases in which a corporate vehicle is misused, the intermediary is negligent, willfully blind, or actively complicit. If a service provider is obligated to gather full due diligence information, it becomes impossible for the intermediary to legitimately plead ignorance regarding the background of a client or the source of his or her funds. Second, having all such information duly gathered by the service provider means that investigators have an adequate source of information at their disposal.

Enforcing Compliance

Experience over the past 10 years has shown that imposing due diligence requirements on paper is not enough. Countries need to devote adequate resources to effectively policing compliance, including supervising service providers and imposing civil or criminal penalties for noncompliance. The evidence analyzed in this study shows that TCSPs in certain financial centers more typically considered "onshore" actually exercise less strict due diligence than jurisdictions identified as offshore financial centers (OFCs).

Attorneys and Claims of Attorney-Client Privilege

Policy makers also need to address the problem of gaining access to the information held by service providers and, in particular, the issue of legal privilege. When investigators seek to access information held by attorneys regarding the establishment and operation of a corporate vehicle by one or more of their clients, the attorneys frequently seek to justify their refusal to divulge such information by invoking attorney-client privilege (or "legal professional privilege"). Investigators should guard against the unjustified use of this privilege. Although the claim of legal privilege is valid under certain circumstances, a number of jurisdictions around the world have carved out statutory exceptions to legal privilege in cases in which the attorney is acting as a financial intermediary or in some other strictly fiduciary or transactional capacity, rather than as a legal advocate.

A Two-Track Approach

Substantial debate is ongoing about which entity, person, or institution would be best suited to maintain beneficial ownership information. We believe that service providers and registries both have a vital role to play in enabling law enforcement to access beneficial ownership information, and we acknowledge that this role might differ from jurisdiction to jurisdiction. Having said that, however, we believe that the service provider generally will be the more useful source of beneficial ownership information. As noted by one investigator in a country where both the registry and the service providers maintain beneficial ownership information,

> When we receive an international request for beneficial ownership information, we always refer them to the service provider. The registry would only be able to give you a name, often (though not always) correct; but the service provider will be able to provide so much more—telephone numbers, family, real estate, and all the other bits of information one gathers over the course of a business relationship.

We realize that some countries, unfortunately, may not (yet) be able to impose such CDD regulations on the relevant service providers. The political reality is that pressure groups or other lobbies (for example, a bar association) prevent the passage of such legislation.

In countries where intermediaries are not subject to CDD requirements, other ways to ensure beneficial ownership identification, although second best, nonetheless may prove useful and effective. Under such circumstances, the obvious institution to maintain beneficial ownership information is the company registry (under the conditions described above). How policy makers choose to define beneficial ownership for the purposes of company registration will depend on the level of expertise of company registry staff. Disentangling who, in a particularly complicated structure, qualifies as the beneficial owner may require significant corporate legal expertise, which may not always be available. In such cases, a formal definition (for example, a natural person holding more than 25 percent of the shares, or a natural person holding the most shares) may be more practicable.

Issue 3. All beneficial ownership information should be available within the same jurisdiction.

Another obstacle to obtaining information about a particular corporate vehicle is that the relevant documentation may be deliberately dispersed across different jurisdictions. Collecting information on a particular legal entity that is incorporated or formed under the laws of Country A but administered from Country B often entails first submitting a request in Country A and then submitting a request in Country B. To avoid having to obtain information from different countries—with all the loss of time and resources that entails—countries should ensure that a *resident* person maintains beneficial ownership information on any entity incorporated under its laws. That

requirement could be achieved in various ways—for example, by imposing the obligation on a resident director or other corporate officer, or on a resident registered agent or a service provider. That person should receive all financial documentation relating to the legal entity. This obligation would not affect the obligation requiring the service provider (who may well be located in another jurisdiction) to also maintain this information. Certainly, if this service provider is undertaking the daily administration or management of the corporate vehicle, he or she is likely to have more current information.

Issue 4. Bearer shares should be abolished.

Companies that have issued bearer shares and bearer-share warrants continue to be problematic in terms of transparency of ownership and control of corporate vehicles. The person in legal possession of the physical shares is deemed to be their owner and thus the owner of the company. The problem is knowing who owns the shares at any given point in time. Many countries have immobilized these shares—effectively rendering them registered shares—without disrupting legitimate business. No legitimate rationale exists for perpetuating bearer shares and similar bearer instruments. We recommend that all countries immobilize or abolish them.

Issue 5. Investigative capacity should be strengthened.

Why Due Diligence Is Not Enough

The challenge thrown down by those who wish to deceive ultimately calls for a response by those seeking to unmask that deceit. Efforts to counter the misuse of corporate vehicles have, in recent years, focused on introducing new laws and regulations. Although this certainly forms an important part of an effective response to grand corruption, it is by no means enough. Similarly, prevention and information gathering by service providers or company registries, although vital, on their own are insufficient. A company registry, after all, often will not contain the most current information, and a service provider can undertake only so much due diligence. As one compliance officer noted, “Any due diligence system can be beaten.”

Enhancing the Skills and Capacity of Investigators

In any complex corruption investigation involving the use of corporate vehicles, an imaginative, tenacious, and expert investigator is indispensable. In our research, we have discerned a wide disparity among investigators in different jurisdictions around the world in terms of their knowledge and expertise, as well as the technological and

budgetary resources made available to them to conduct investigations into corporate vehicle misuse schemes. Given the transnational nature of such schemes, however, it is imperative that this gap in knowledge and resources be narrowed. Accordingly, we strongly recommend greater education, development, and training of investigators regarding (a) the nature of corporate vehicles around the world and their potential for misuse, and (b) the most effective investigative skills and techniques for "piercing the corporate veil." Moreover, as transnational schemes generally involve more than one jurisdiction, authorities need to make sufficient resources available so that investigators can respond to requests for assistance from other jurisdictions in an adequate and timely manner.

Transnational Investigations

A concerted effort is required to improve law enforcement's understanding of corporate vehicles, their function, and their rationale to enable proper investigation. Although investigators generally are familiar with some of the basic legal entities and arrangements available under their domestic laws, they are largely unfamiliar with foreign corporate bodies and the rationale for including them in any corporate structure. It is important that these investigators have some basic understanding of common corporate structures under foreign laws and the (often fiscal) rationale for their existence. In this way, they will be better able to distinguish legitimate from illegitimate uses.

Building a Transnational Case

Being able to identify a corporate vehicle misuse scheme is only the first step, however. Investigators also need sufficient resources to be able to travel to the jurisdictions involved and coordinate with local investigators in gathering all the documentary, testimonial, and other forensic evidence that is needed to be able to successfully present cases in court. Because many corporate vehicle misuse cases are transnational in nature, investigators need to work together. To facilitate this international cooperation at both formal and informal levels, legal mechanisms and more informal channels are needed. As one investigator put it, solving a transnational corporate vehicle misuse scheme is like putting together a jigsaw puzzle, with investigators in different jurisdictions each holding separate pieces of the puzzle. To complete the puzzle, an investigator needs to have access to all the pieces.

Conducting Risk Analysis and Typologies

Countries should undertake a risk analysis and conduct typology studies of the misuse of corporate vehicles in their own jurisdictions to identify what entities (of whatever extraction) and arrangements typically are abused. This analysis would give law enforcement (and service providers) useful information on the types of abuse specific to the

country. This information should include a succinct overview of legal requirements of the corporate vehicles that can be established or that operate within the jurisdiction, the rationale for these requirements, and where information may be obtained. The risk analysis should inform the efforts made by service providers when identifying beneficial ownership. Publishing the typologies information and the risk analysis and ensuring accessibility to foreign law enforcement and service providers will be important.