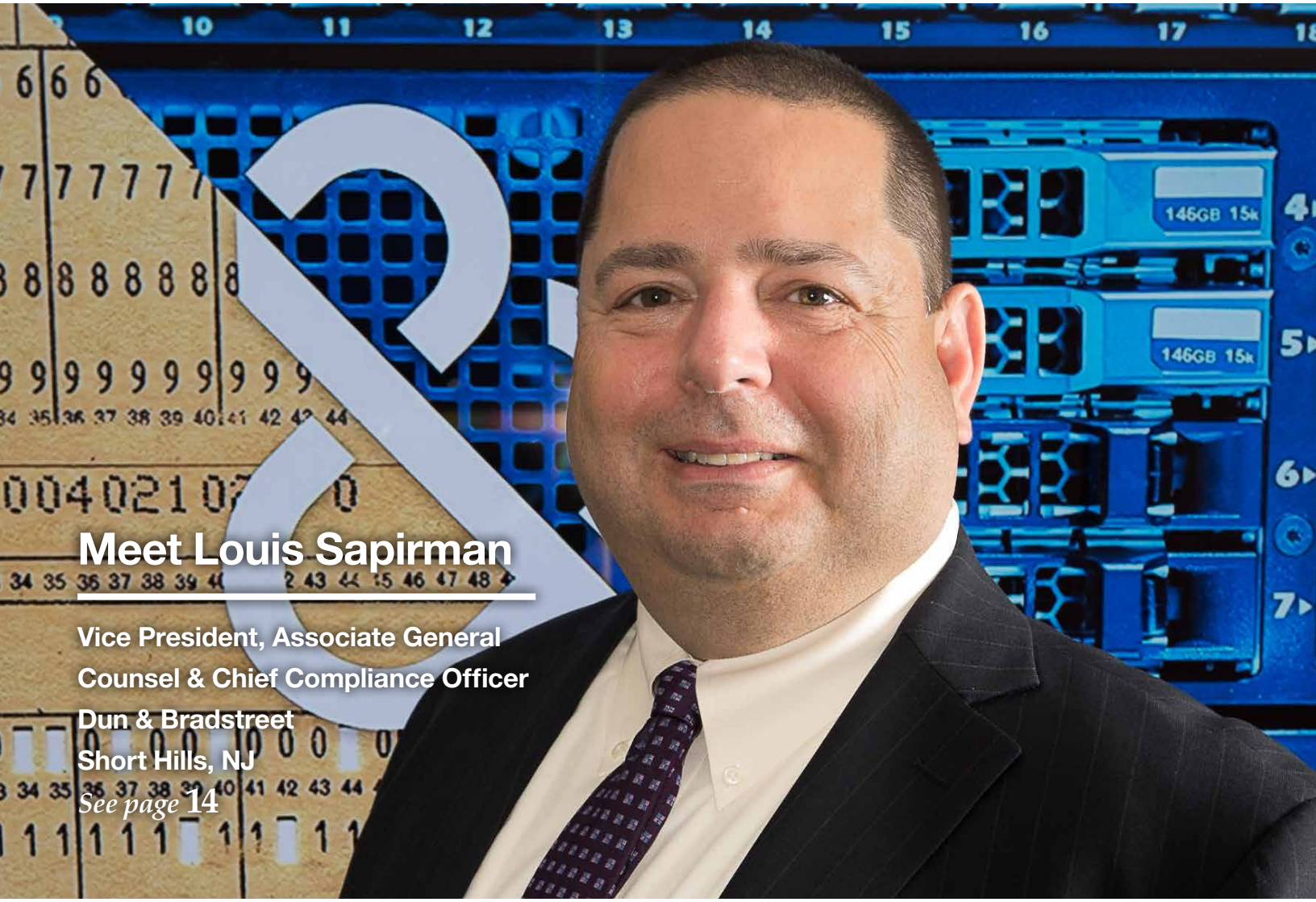
Compliance & Ethics Professional®

November 2016

A PUBLICATION OF THE SOCIETY OF CORPORATE COMPLIANCE AND ETHICS

www.corporatecompliance.org



Meet Louis Sapirman

Vice President, Associate General Counsel & Chief Compliance Officer
Dun & Bradstreet
Short Hills, NJ

See page 14

by Lori Galvin and Tracey Kungl

Shell companies: The role of beneficial ownership in third-party due diligence

» Organizations doing business with shell companies are at risk of violating anti-money laundering or anti-corruption laws.

» Shell companies offer anyone the ability to create a company with limited reporting requirements – an ideal vehicle for criminals.

» Even a gold standard compliance program can be at risk of conducting business with an "illicit" shell.

» Comprehensive compliance programs should identify beneficial ownership of third parties and screen for potential risks.

» Worldwide, regulations related to beneficial ownership are being reviewed by lawmakers and will become more stringent moving forward.

Earlier this year, the International Consortium of Investigative Journalists (ICIJ) released internal records from Panamanian law firm Mossack Fonseca, which spanned nearly 40 years on more than 214,000 companies. It was an unprecedented leak, now dubbed "The Panama Papers."[1] The murky world of offshore shell companies and tax havens—and those who utilize their services—found themselves abruptly thrown into the spotlight.

Galvin

Kungl

Mossack Fonseca is reported to be one the world's largest providers of offshore services. Specializing in trust services, wealth management, international business structures, and commercial law, the LinkedIn profile associated with Mossack Fonseca indicated they have "become a global leader in the creation of legal structures designed for asset protection, management and control."

Although some named in the Panama Papers have claimed that they used Mossack Fonseca's services for legitimate business activity, a number of high-profile individuals, criminals, and government officials have been implicated for using the law firm to create offshore shell companies for questionable activities.

Since the release, Mossack Fonseca issued a statement on their website saying that it has always complied with international law and made attempts to prevent companies it incorporates from being used for criminal purposes. However, even if the law firm had a gold standard compliance program, it is the very nature of shell companies that increases the risk that criminal activity will be conducted.

What is a shell company?

Shell companies or "shells" are companies which exist only on paper; they do not have any true operations. They have a mailing

address for registration purposes, but shells do not have an actual physical presence, nor do they have employees, produce goods, or have economic activity. When used "legally," shells can be used for activities such as those related to intellectual property rights, reverse mergers, or joint venture operations.

For those who use shell companies in criminal activity, shells strategically hide the identity of the true beneficial owner, while at the same time providing the ability to conduct financial transactions, such as opening bank accounts and transferring money. Often created in jurisdictions such as Panama, which have strict secrecy laws, lax regulatory and supervisory regimes, and corporate registries that safeguard anonymity, it can be impossible to determine the actual ownership behind a company. The three most popular tax havens in the Panama Papers, as noted by the ICIJ website, are the British Virgin Islands, Panama, and the Bahamas, but tax havens are by no means limited to tropical locales. Delaware, Nevada, and Wyoming have long been considered to be some of the most accommodating jurisdictions for shell companies, due to their lax reporting requirements.

Shell companies are often created by intermediaries such as Mossack Fonseca. In this arrangement, the intermediary is known as a *nominee incorporation service.* It can provide an additional level of secrecy through the use of bearer shares, nominee shareholders, and nominee or corporate directors—all of which hide the true individuals behind a company. In essence, shell companies offer anyone the ability to create a company with limited reporting requirements, unknown ownership, and the ability move funds—an ideal vehicle for criminals.

What are the risks?

Well before the Panama Papers were released, shell companies were commonly utilized in a variety of criminal activities, such as funneling money for bribes. A 2000 report from the United Kingdom Performance and Innovation Unit of the Cabinet Office noted that, "Almost all the most complex [money] laundering operations involve UK shell companies."[2] On November 9, 2006, the U.S. Department of the Treasury Financial Crimes Enforcement Network (FinCEN) issued a statement regarding the "potential money laundering risks to shell companies," citing the lack of transparency in the formation and operation of shell companies as a "vulnerability that allows these companies to disguise their ownership and purpose" as well as "an opportunity for foreign or domestic entities to move money by means of wire transfers or other methods."[3]

Under the Currency and Foreign Transactions Reporting Act of 1970 (Bank Secrecy Act), the U.S. Department of Finance laid out formal rules for financial institutions to actively detect and prevent money laundering. Although currently no law or formal guidance exists specifically for private companies to be held to the same level of due diligence, those who do business with shell companies, knowingly or not, inherently assume a higher level of risk of violating laws regarding anti-money laundering or anti-corruption, such as the U.S. Foreign Corrupt Practices Act (FCPA), U.S. Bank Secrecy Act, U.S. Patriot Act, and United Kingdom Bribery Act of 2010 (UKBA).

In fact, the U.S. Department of Justice and Enforcement Division of the U.S. Securities and Exchange Commission (SEC) noted that a common "red flag" associated with potential FCPA violations of third parties includes that "the third party is merely a shell company incorporated in an offshore jurisdiction."[4]

The Office of Foreign Assets Control (OFAC) considers companies subject to US sanctions if 50% or more of the beneficial ownership is held by a designated entity or individual. More importantly, US companies

that conduct business with entities at least 50% (directly or indirectly) owned by a designated entity or individual are considered in violation of OFAC sanctions. On February 8, 2016, OFAC announced its first penalty under this so called "50% rule" when Barclays Bank Plc agreed to pay $2,485,890 for violation of the Zimbabwe Sanctions Regulations.[5]

The use of shells has also been found to be a key tool used by government officials to misappropriate public funds, particularly in developing countries. Shells can be used by officials to accept bribes, deposit checks issued to "ghost vendors," or hide the government official's interest in companies that receive government contracts. They may also be used to transfer the funds used to give or receive bribes as seen in several legal cases of large, international companies in which the parent company may have had no knowledge of the activities of subsidiary companies.

Shells can be used by officials to accept bribes, deposit checks issued to "ghost vendors," or hide the government official's interest in companies that receive government contracts.

Hewlett-Packard, for example, agreed in 2014 to pay more than $108 million to settle allegations by the SEC that subsidiaries in Russia, Poland, and Mexico utilized shell companies to pay government officials to retain or win government contracts.[6]

Signs you may be conducting business with a shell company

Unfortunately, a high-level due diligence review will not necessarily result in red flags when shell companies are involved. Those attempting to hide funds are engaged in a high rewards game, and the means to deceive can often be elaborate. On the surface, shell companies can have an air of legitimacy as they are incorporated, have an address (albeit it is usually the registration address of the nominee agent), and may even have a website and issue press releases—similar to traditional, operating companies.

However, if your transaction or engagement has any of the following characteristics, you should consider conducting additional due diligence to more thoroughly review the situation:

- A third party (or its subcontractor) requests an unusual payment structure, such as asking for payments to be made to a previously unknown company with no history in the business for which the contract work is being conducted or which is located in an offshore jurisdiction;
- A third party (or its subcontractor) has an unclear or inexplicably complex ownership structure or one which ends with entities registered in offshore jurisdictions; or
- The shareholders of a third party (or its subcontractor) are law firms, incorporation agents, or another company, rather than individuals.

What steps should be taken to mitigate risk?

In 2012, Eli Lilly and Company agreed to pay more than $29 million to settle SEC charges of FCPA violations. The company's Russian subsidiary allegedly paid millions of dollars to the offshore accounts of third parties who were found to rarely provide any services and,

in some cases, were used to obtain business for Eli Lilly's subsidiary by making payments to government officials. The subsidiary reportedly knew little about the third parties and the transactions did not "receive specialized or closer review for possible FCPA violations."[7]

Conducting business with a shell company or a company owned by a shell company does increase risk, but it does not automatically mean that the business engagement should not be considered.

A comprehensive due diligence program can be structured to include the following requirements.

1. Require beneficial owners to be identified
Require the third party to identify their beneficial (ultimate) owner and include them in your due diligence screening. As noted above, shell companies and offshore structures are used for many legitimate business purposes. Although an excessively complex ownership structure can be an indication of risk, not all complex corporate structures carry risk. A legitimate company should agree to provide their ownership structure (and an explanation of the rationale behind it), regardless of whether the beneficial owner is once removed or exists through several additional layers.

If beneficial ownership is not provided for a shell company at the beginning of a due diligence investigation, it is difficult, due to the lack of transparency, to link shell companies to their actual owners. When beneficial ownership is provided, the investigation should include all individuals and entities involved in the reported ownership structure to attempt to reveal risk factors or potential red flags, such as government affiliations or sanctions. The level of screening recommended would be dependent on several factors, such as the engagement's overall risk rating as well as how the individuals/entities fit into the overall ownership structure (e.g., direct vs. indirect ownership, percent ownership, level of control, etc.).

Require the third party to identify their beneficial (ultimate) owner and include them in your due diligence screening.

2. Verify the information on your due diligence questionnaire
Require third parties to complete a comprehensive questionnaire—then verify all of the information. The completion of an in-depth questionnaire is a valuable tool for evaluating third-party engagements, but it is particularly important when limited information is available from official sources, such as the case with entities registered in offshore jurisdictions. However, the true value of this information is only realized if all of the data provided is analyzed. Potential red flags can often be found by researching the provided responses. Below are just a few examples of what can be identified by carefully reviewing the questionnaire and conducting cursory research:

- The third-party's address is a mailbox drop, virtual office, or nominee incorporation service.
- The third-party's address is also being reported by numerous other entities in online profiles.
- The provided website address was recently created (incongruent with the incorporation or founding date of the third party).
- The website is inactive, has numerous typos, or is otherwise inconsistent with

what would be expected based on the reported size and nature of the third-party's business activity.

- The online profile of the third-party's business activities are inconsistent with the responses in the questionnaire.

3. Expand the scope of research

The level of due diligence conducted will be driven by the overall risk rating of the engagement. However, if the ownership structure reveals shell companies, an expanded scope of research is recommended. In addition to a "boots on the ground" investigation, it may be prudent to conduct the following enhanced due diligence to specifically address the risks exposed by shell companies:

- **Site visit** to answer questions such as: Is the company actually operating at this location? Are there employees? Are there concerns with the location, such as it being in a residence or in a crime-ridden area? Is the facility or office setting consistent with what was expected based on the entity's reported capabilities and background?
- **On-site interview with principal/owner** that includes questions designed to address client's concerns;
- **Business reference checks**; and
- **Reputational inquiries** conducted in the business community to confirm true industry presence with competitors, reported clients, and industry insiders.

Conclusion

Lawmakers are still in the process of reviewing the data from the Panama Papers, as well as the legislation currently in force; however, regulations related to shell companies and beneficial ownership will only become more stringent.

By the end of the year, all members of the EU must implement the European Commission's 4th Anti-Money Laundering Directive, which is intended to prevent money laundering and terrorist financing. Member states will be required to retain a central registry of the beneficial owners of all registered companies.

In May of this year, noting the ability of criminals to hide "ill-gotten" proceeds anonymously, FinCEN published a Customer Due Diligence Final Rule under the Bank Secrecy Act to add the requirement for financial institutions in the U.S. to know the identity of beneficial owners with whom they are doing business.[8] Also during this time, the U.S. Department of the Treasury announced it had sent beneficial ownership legislation to Congress which would require that companies formed in the U.S. provide the Treasury Department with the names of their beneficial ownership.

Ultimately, the risk of conducting business with shell companies lies in the inability to identify beneficial ownership. However, for the organizations that conduct business with them, it is not enough to merely obtain the names of the beneficial owners. A comprehensive compliance program must also include additional due diligence measures when high-risk shells are found to be involved. ✳

1. International Consortium of Investigative Journalists: "The Panama Papers: Politicians, Criminals and the Rogue Industry That Hides Their Cash" Available at https://panamapapers.icij.org
2. United Kingdom Performance and Innovation Unit, Cabinet Office: "Recovering the Proceeds of Crime" June 2000, p. 85. Available at http://bit.ly/uk-archive + http://bit.ly/cabinet-office
3. U.S. Department of the Treasury, Financial Crimes Enforcement Network: "Potential Money Laundering Risks Related to Shell Companies" November 9, 2006. Available at http://bit.ly/fincen-on-shells
4. Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission: "FCPA, A Resource Guide to the U.S. Foreign Corrupt Practices Act" November 2012. Available at http://bit.ly/justice-resource
5. Richard L. Cassin: "OFAC fines Barclays $2.5 million for 159 Zimbabwe sanctions violations" *The FCPA Blog*, February 12, 2106. Available at http://bit.ly/ofac-fines
6. U.S. Department of Justice, press release: "Hewlett-Packard Russia Pleads Guilty to and Sentenced for Bribery of Russian Government Officials" September 11, 2014. Available at http://bit.ly/hp-russia
7. Richard L. Cassin: "Eli Lilly pays $29 million in SEC settlement" *The FCPA Blog*, December 20, 2012. Available at http://bit.ly/eli-lilly-settles
8. U.S. Department of the Treasury, Financial Crimes Enforcement Network, "Customer Due Diligence Requirements for Financial Institutions," *Federal Register 81*, no. 91 (May 11, 2016). Available at http://bit.ly/us-dept-tfcen

Lori Galvin *(lgalvin@kreller.com) is Vice President, Global Investigations and* ***Tracey Kungl*** *(tkungl@kreller.com) is Lead Investigator, Global Investigations at Kreller Group in Cincinnati, OH.*