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Tackling shell companies: Limiting the opportunities to hide proceeds of corruption

Shell companies that cannot be traced back to their owners are one of the most important mechanisms by which corrupt officials transfer illicit wealth from developing countries. This process damages these countries' development prospects. Clear international standards mandate that the real owners of all companies should be traceable, but this is often not enforced. Development agencies and developing country governments should work to prioritise more effective regulation of shell companies.

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Large-scale corruption by senior political officials is a serious obstacle to development. Much of the money stolen is transferred overseas. Recent research strongly indicates that untraceable shell companies are the most common means of facilitating grand corruption, also known as kleptocracy. Thus it is important to be able to link shell companies with their real owners, because companies that cannot be traced back to their real owners act as a "corporate veil" that conceals the process and proceeds of corruption. Although no single reform by itself can stop major corruption, ensuring corporate transparency would greatly aid the fight against the looting of developing countries.

This brief has four aims: first, to explain what shell companies are and how they are used to transfer wealth from developing countries; second, to summarise the state of play in the global regulation of shell companies; third, to do the same for key jurisdictions; and lastly, to set forth recommendations on how development agencies and their partners can help prioritise this policy issue.

What are shell companies?

All companies have a legal personality, meaning that like actual individual persons, they can own property, hold bank accounts, engage in transactions, sue and be sued. Most of the companies we interact with on a day-to-day basis engage in the production of goods or the provision of services; they have employees, equipment, and a physical location. Shell companies, however, are just legal personalities; they do not produce any goods or services. They are identities that can be created or annulled by legal fiat within days, at a cost of between a few hundred and a few thousand dollars.

The majority of shell companies are used for legitimate purposes. For example, imagine that a Chinese business wants to raise capital by being listed on a US or British stock exchange. Firms from China and most other developing countries, however, are barred from listing on the New York and London exchanges. The business may form a foreign shell company that is allowed to list, and then pass the capital raised from the foreign shell company through to the operating business in China (Sharman 2012). In this way, investment flows from the developed to the developing world. More generally, allowing the formation of companies efficiently and cheaply helps individuals access the formal economy, while the limited liability that companies provide can protect small entrepreneurs from personal bankruptcy should their business fail.

Yet the combination of legal personality, intangibility, and disposability means that the shell company becomes a very useful mechanism for those seeking to conceal criminal funds, including the proceeds of corruption. In particular, where transactions are booked or assets held in the name of a shell company, rather than in the criminal's own name, this obscures the trail from a given crime to the funds that result. Such a situation presents regulators and law enforcement agencies with the challenge of "looking through" the shell company to find the real person in control. For example, if suspicious funds were passed through a corporate bank account opened in the name of a shell company, investigators need to find out the real individual or individuals who control the company, referred to as the "beneficial owners." If the shell company cannot be linked back to its beneficial owners, the investigation often fails.

Although there are other means by which to launder corruption funds, shell companies are the most frequently used. The nongovernmental organisation Global Witness points out, "'Shell' companies . . . are key to the outflow of corrupt money that keeps poor countries poor. Those who loot state funds through corruption or deprive their state of revenues through tax evasion need more than a bank:

they need to hide their identity behind a corporate front" (2012, 4). Research conducted under the Stolen Asset Recovery (StAR) Initiative, a joint effort of the World Bank and the United Nations Office on Drugs and Crime, confirms this conclusion. It notes that of the 150 cases of grand corruption analysed, the vast majority involved the use of a shell company to hide the illicit wealth (Does de Willebois et al. 2011, 2). Shell companies featured much more often in this role than any other sort of legal entity or arrangement, such as trusts, partnerships, or foundations (for this reason, this brief focuses only on companies and not on these other forms).

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The shell companies in question were rarely set up by the corrupt officials themselves. Rather, they were purchased through professional intermediaries and businesses that specialise in setting up and then selling shell companies, collectively referred to as corporate service providers (CSPs). A CSP can provide shell companies registered in many different jurisdictions, not just the one in which the CSP happens to be located.

How shell companies are used to transfer wealth from the developing world

Along with international interbank wire transfers, shell companies are the most common means by which looted wealth and corruption proceeds are transferred from the developing to the developed world. The example of Equatorial Guinea is particularly egregious, but it is indicative of mechanisms used in many other cases as well.

Equatorial Guinea, a small, oil-rich nation in West Africa, is perhaps the most blatant single example of the development consequences of grand corruption. Per capita, Equatorial Guinea is one of the richest countries in the world, considerably richer than the United States (de la Baume 2012). Yet according to the most recent figures available, 76.8 per cent of the population lives under the United Nations poverty line (Holmes 2009), and a majority lack access to clean water. The country ranks 136 of 186 on the UN Human Development Index, and it has the largest gap of any country in the world between its score on that index and its per capita gross domestic product. In terms of human rights, Freedom House regularly places Equatorial Guinea in the "worst of the worst" category.

Teodorin Obiang is a government minister and vice president of Equatorial Guinea. He is also the son and heir apparent of Teodoro Obiang, the country's president. Obiang Junior's official annual salary is $60,000 (US Senate 2010, 21), but between 2004 and 2008 he used shell companies formed by American lawyers to transfer more than $100 million from Equatorial Guinea to the United States. These funds were spent on assets including a $30 million mansion in Malibu, California, a $38 million private jet, and $1.1 million of Michael Jackson memorabilia. He also purchased an $80 million mansion in Paris with furnishings valued at $50 million (Silverstein 2011, 1; US Senate 2010, 7; de la Baume 2012). In addition to misappropriated oil wealth, most of this money came from bribes extracted from foreign timber firms by Obiang in his capacity as minister of forestry. A US Department of Justice memo noted, "The prosecutors suspect that most, if not all, of (. . .) Obiang's assets are derived from extortion, bribery or the misappropriation of public funds" (cited in Global Witness 2009, 13).

To avoid US prohibitions on the receipt of corruption proceeds, Obiang did not hold these assets in his own name. Instead he used shell companies: Sweetwater Malibu LLC (registered in California) to hold the mansion, and Ebony Shine International Ltd. (British Virgin Islands) for the private jet. After US banks closed Obiang's accounts on suspicion that his funds were the proceeds of corruption, Obiang and his lawyer relied more heavily on a set of other shell companies to try to hide the true origins of the money (Global Witness 2009; US Senate 2010). Money was remitted to the United States from Obiang's companies in Equatorial Guinea via France, further obscuring the trail.

This case illustrates both the severe development consequences of grand corruption and the key role that shell companies play. It also fits the general pattern in which shell companies are used as channels to receive bribes from foreign firms (in this case, oil and logging interests), as well as to directly embezzle state funds, and then to move the proceeds out of the developing country in question to developed countries. Although Obiang is currently facing actions by the US and French governments to seize the proceeds of his corruption, it is far from certain that these efforts will be successful.

Shell company regulation in multilateral venues

The most important international standard setter for the regulation of shell companies is the Financial Action Task Force (FATF) on money laundering. In the last few years the FATF has been explicitly directed by the G20 to prioritise the interlinked issues of the beneficial ownership of shell companies and the laundering of corruption proceeds.

The international standards that govern shell companies in relation to the question of beneficial ownership are clear. FATF Recommendation 24 states: "Countries should take measures to prevent the misuse of legal persons [i.e., companies] for money laundering or terrorist financing. 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" (FATF 2012). This standard has been endorsed by a wide variety of international organisations, including the United Nations, and by over 180 countries.

In principle, there are two ways to obtain access to information on beneficial ownership. The first is to require the government offices that receive and issue formal company documents, called company registries, to collect and hold on file proof of identity for the relevant beneficial owners (e.g., certified or notarised copies of passports).

At present, however, only one registry (Jersey, a British Crown dependency) is known to perform this function, and thus there are doubts as to how well this would work in practice. Especially in developing countries, registries struggle to fulfil their existing duties and are ill equipped to undertake the demanding task of checking and recording beneficial ownership.

This leaves the second option: regulating the corporate service providers. Some countries require CSPs to collect proof of identity from customers (again, notarised or certified copies of government-issued photo identity documents), hold this information for five years, and provide it to regulators and law enforcement officials on request. The advantage of this system is that it has been shown to work in practice. When faced with this requirement, CSPs really do collect the information, which is then available to the authorities (Does de Willebois et al. 2011; Findley, Nielson, and Sharman 2012). Furthermore, the cost of regulation in this case tends to be passed on to the customers buying shell companies, rather than to taxpayers at large.

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Unfortunately, however, it seems that few countries effectively comply with the rule on beneficial ownership, and so shell companies that cannot be traced back to the beneficial owners are in practice readily available to corrupt officials (Does de Willebois et al. 2011). This reflects the facts that, as noted, registries do not hold beneficial ownership information, and CSPs are completely unregulated in many countries, leaving them free to provide shell companies with no questions asked. A study in which the authors impersonated fictitious consultants and then approached more than 4,000 CSPs found that over a quarter of them were willing to provide shell companies without the proper identification documents, or in many cases without any documents at all. Significantly, providers in developed countries were less likely to meet international standards than those in tax havens or developing countries (Findley, Nielson, and Sharman 2012).

Shell company regulation in key jurisdictions

The United States has great influence on the content and enforcement of international standards on corporate transparency. Approximately 2 million companies are formed in the United States every year, although only a minority of these are shell companies. Importantly, company registration takes place at the state rather than federal level, and few if any states require the collection of beneficial ownership information. Senator Carl Levin of Michigan noted, "The problem with incorporating nearly two million new U.S. companies each year without knowing anything about who is behind them is that it becomes an open invitation for criminal abuse" (2006).

In 2009 Senator Levin introduced the Incorporation Transparency and Law Enforcement Assistance Act. Had it passed, this legislation would have required state company registries to obtain a declaration for each company specifying the name and address of the beneficial owner or owners, updated annually. Submitting a false declaration would be a criminal offence. Foreign citizens would have to have a US-based registered agent endorse the beneficial ownership statement, with the agent liable to prosecution if the declaration were false. The bill was defeated in 2009 due to lobbying by the states, which feared losing the revenue stream from company incorporation and the cost of the new regulation. The powerful American Bar Association also opposed the bill, although law enforcement agencies strongly endorsed it. Senator Levin reintroduced the bill in September 2012.

Within Europe, one of the most important developments is the EU Third Anti-Money Laundering Directive, which came into force in 2006. This contains provisions for the licensing of CSPs and for identifying the beneficial owners of companies and related legal entities (Deloitte 2009). Whether or not the system works in practice, however, is open to question.

In Britain, for example, although financial firms are required to establish beneficial ownership, there is an exemption for those engaging in a one-off transaction. The largest CSPs in Britain apparently argue that because they sell shell companies as a product rather than as an ongoing service, they are covered by this exemption and thus have no duty to establish customers' true identities by collecting and verifying identification documents. In any case, the UK Treasury has never conducted a single audit or inspection to see whether the rule on verification of beneficial ownership is being followed (Global Witness 2012). Global Witness recounts how UK shell companies were used to move hundreds of millions of pounds of suspicious funds from Central Asia to Britain; in one case the ostensible owner of the company had died several years before the company was formed (Global Witness 2012).

Conclusions and recommendations

Given the importance of untraceable shell companies for facilitating grand corruption and thereby retarding development, what can be done? This concluding section presents some brief suggestions for bilateral development agencies and the governments of developing countries.

The first is simply to ensure that the issue of untraceable shell companies is given due weight in development policy deliberations and forums. For more than a decade it has been a commonplace that controlling corruption is vitally important in promoting development, yet many of the implications of this conventional wisdom are still not appreciated. The regulation of shell companies is not some dry detail of corporate regulatory arcana, but a key front in the struggle against the illicit financial flows that impoverish dozens of countries (Reed and Fontana 2011; Reuter 2012). A world without anonymous shell companies

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would obviously not be a world without corruption, as there are other means of transferring loot from the developing to the developed world. Yet better enforcement of international standards mandating access to beneficial ownership information is likely to make a significant difference in the incidence of major corruption, and thus to development outcomes.

Development agencies should ensure that their counterparts in other parts of government, and the international organisations and NGOs they interact with, are aware of the true significance of this issue. Here the UK Department for International Development has been exceptionally effective in its positive contribution (Fontana 2011). The point about the importance of giving this topic adequate priority applies even more strongly to developing country governments. These governments were instrumental in ensuring that the United Nations Convention Against Corruption gave prominent place to the issue of stolen asset recovery. Properly regulating shell companies is a key part of meeting this aim.

Further progress in making shell companies more transparent is almost entirely a matter of better implementation. The existing FATF standard is clear and straightforward. The practical means of ensuring proper implementation is also relatively straightforward: CSPs must be licensed; they must be subject to a legal duty to collect, hold, and share customer identification data; they must be audited by the authorities to ensure they are doing so; and, finally, there must be strong penalties for failure to carry out this duty. At present, however, a large number of countries have simply chosen not to implement the rules necessary to ensure access to beneficial ownership information. It is developed countries which are most at fault in this respect.

Both development agencies and developing country governments can create momentum to make good on these commitments by highlighting the current gap between words and action. It is only by forcefully demonstrating the connection between untraceable shell companies and the looting of already impoverished countries that we can expect progress in promoting transparency, accountability, and the associated development benefits.

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