



Statement before the Senate Committee on the Judiciary:
Beneficial Ownership: Fighting Illicit International Financial Networks Through Transparency

Good News, Bad News, and a Solution

The costs of anonymity in business incorporation outweigh any benefits

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Chairman Grassley, Ranking Member Feinstein, and distinguished Members of the Committee, thank you for inviting me to testify on what I believe to be one of *the* most important economic *and* security topics of our time. The good news is that we have recognized an important problem – illicit finance. The bad news is that we will never realistically rid our markets of all bad actors, and moving too fast and being too heavy-handed will damage markets and squander opportunities.

The solution resides in the great bipartisan work and genuine determination of this committee and the Congress to understand and address illicit finance.

My understanding of illicit finance encompasses the very significant Congressional work on S. 1454, S. 1241, S. 1717, S. 853, H.R. 3089, H.R. 2219, and the House CTIF draft legislation. So, this written testimony will address illicit international financial networks generally and why it is in the United States' national interest, both in terms of economic growth and national security, to take steps to disrupt them.

My remarks stem from a decade of research, writing, and teaching about how authoritarian governments survive and thrive in the post-cold war era. The one constant in my research is that 21st century authoritarians utilize international financial networks for a broad range of legal, quasi-legal, and illegal purposes: from the all-cash purchases of Manhattan real estate by Russian oligarchs all the way up to North Korea's nuclear program. The legitimacy of authoritarian sovereignty provides cover for non-transparent illicit networks that terrorists and criminals then also use to "legally" infiltrate the US economy with the profits of illegal activity.

In other words, authoritarians create illicit finance "highways" – or networks of corruption, lawyers, and loopholes – that connect into Western democratic countries with a strong rule of law, reliable property rights, and privacy rights regimes. Once the finance makes it in, the host democracy's rule of law and individual rights are then used to protect and grow authoritarian investments. Terrorists and criminals (both foreign and domestic) identify these illicit finance "highways" and then drive on them, directly in, out, and around US markets.

Criminal and terrorist illicit finance increases the likelihood of terrorist attacks, increases the supply of heroin, cocaine, and methamphetamine, and increases all the correlated economic effects and heartache caused by the related violent deaths and overdoses of American workers. It also enables consumer and tax fraud. I recently estimated an \$800 billion a year cost to the US economy stemming directly from illicit financial flows just within the US.

One of the issues that often gets confused in discussions of illicit financial flows is the question of what is considered "licit" and "illicit." A clearer way to describe that distinction is that heroin sales don't get counted in GDP as "heroin sales." The profits are recorded as something else, and that something else is constantly shifting, partially due to the role of anonymously held companies. The profits of sex

trafficking or the money spent on a terrorist attack don't get recorded as "slave profits" or "terrorist financing" – increasingly they get recorded as prepaid gift card and real estate sales – again partially due to the role of anonymously held companies.

Further complicating the understanding of "licit vs illicit" finance is the growing post-cold war international norm that the international investments of authoritarian regimes, in general, are "illicit." This norm has developed for a variety of reasons, but it is typically related to a specific threat (such as a nuclear program or being a sponsor of terrorism) or is increasingly related to a general lack of democratic standards – such as the rule of law, reliable property rights, or human rights. The entire sanctions regime of the US, the largest in the world, including the recent CAATSA (Countering America's Adversaries Through Sanctions Act), represents the idea that authoritarian finances are "illicit." This norm will, and should, continue to deepen and expand.

So, beneficial ownership legislation is a critical part of the solution. Potential pitfalls of the legislation include concerns that beneficial ownership data will be used to expose tax fraud (which is illegal) and proliferate evidence of tax avoidance (which is generally legal) to the detriment of the overall business and finance climate in the US. Other concerns include the idea that beneficial ownership data will be used to expose potentially damaging political campaign donations and contributions to a number of institutions such as universities and non-profits.

These are very appropriate concerns because we do not want to do anything that turns legitimate actors and institutions into criminals. Because of anonymous ownership, it is highly likely that most people, businesses, and institutions connected to illicit finance have no idea that they are connected to illegal activities. Therefore, we must move slow and cautiously in order to protect and preserve rights to privacy. But the severity of the costs of continuing to allow anonymity requires proactive legislation.

Furthermore, from an international perspective, we, as the leaders of the free world, need to set an example for others to follow. The EU and Britain are, in my opinion, moving too fast with this – specifically by making beneficial ownership (BO) registries public. I understand the argument that the EU makes – that added scrutiny from civil society will help law enforcement – but I think making the data public from the beginning moves a little too close to violating rights to privacy. I also think that the longer we wait to pass beneficial ownership legislation, the more likely we are to end up with a European-style system.

I also believe, from an international view, that public BO registries give away a strategic advantage of democracies to dictatorships and invites foreign and domestic witch-hunts during the process of rooting out bad actors. For example, suppose that dictator of "kleptocracy X" finds out that subordinate elites or family

members are storing (i.e. laundering) their wealth in “Western democracy Y” using anonymous shell companies. If democracy Y collects beneficial ownership data and makes it public, this gives the dictator of kelpocracy X a new and very valuable tool to identify and repress dissenters within his regime. We should be careful to not give that information away and to not restrict these capital flows.

But, I still applaud the UK and EU for accurately identifying the same problems of illicit finance – and in particular beneficial ownership – and this is a good opportunity for the Congress lead. In fact, it is my understanding that European governments are looking to us for leadership specifically in this area.

In the not-so-free world, the African Union has declared 2018 the year of anti-corruption and is pushing its member states to create beneficial ownership registries. Dictatorships like China and Saudi Arabia are pursuing beneficial ownership issues as well, but in a different way. They are cracking down on elites that are using anonymous ownership to hide their wealth from the party and the king – activities clearly documented in the recent histories of communism and older experiences with monarchy. Russia clearly is not looking at beneficial ownership because anonymous investment is one of the most important ways in which Putin holds his personal wealth outside of the reach of Russian law. This is one more reason to be discreet, strategic, and cautious in how we manage registries.

In sum, addressing key junctions in these networks of illicit highways, such as anonymous shell companies, trade-based money laundering schemes, and informal remittance providers, is a critical step to discerning between those that respect and follow US law and those that do not. In this fight, the costs of anonymity far outweigh any of the benefits that may be derived from it. In this case, the international environment and the vocal support of financial institutions and law enforcement lead me to support beneficial ownership legislation.

However, we should be careful to remember that individual rights, such as privacy, are precisely what make us prosperous. This is our comparative advantage and we do not want to squander it. The private sector is our strongest ally in this fight.

The Good, the Bad, and a Solution:

On “A New International Norm”: There is a new international norm that illicit finance distorts properly functioning free markets (such as real estate¹) *and* poses grave national security threats (such as terrorist financing and sanctions evasion). Authoritarian governments, which by definition steal from the masses in order to bribe the support of select elite groups, seek to securely store wealth *and* extract profits from it. Some distinguish among “better” and “worse” authoritarians in this realm, thus the development of and increasingly common use of the term “kleptocracy” and “kleptocrat.” In my research, I find no such distinction. Instead I find that the institutional structure of all authoritarian regimes, although diverse on the surface, *requires* “theft” and “bribery” involving private goods. Widely accepted social science theories and evidence support this claim. In the absence of a viable opposition, all dictatorship follows this pattern. Democracies, on the other hand, focus on public goods, such as the enforcement of individual rights, which in turn makes democracies economically prosperous and less corrupt.

Dictators, wanting security for their stolen wealth and a return on investments, do what everyone else does. They invest it in markets that are large, stable, and most importantly have strong property rights regimes – namely democracies – the United States and Europe.²

Academics, policymakers, financiers, businesses, and law enforcement are quickly beginning to realize that this dynamic not only has the deleterious effect of strengthening authoritarian kleptocracies that threaten U.S. national security like

¹ In 2006, [FinCEN](#) (the US Financial Crimes Enforcement Network) identified commercial real estate as the most mentioned money-laundering market activity in a random selection of suspicious activity reports (SARs). There has been considerable [press](#) on illicit finance in real estate markets and complete reports by [intergovernmental agencies](#) outlining specific real estate related techniques. In response FinCEN issues “Geographic Targeting Orders” (GTOs) that require additional reporting in high-risk areas such as Manhattan, Honolulu, Miami, Los Angeles, San Diego, San Mateo, and San Francisco – which are all currently under a [GTO](#) set to end in March of this year. Many believe that illicit finance in these markets artificially raise home values, pricing many out the market and [harming the community](#). Others have cited security concerns, naming a January 2017 GAO report that found that the GSA leases buildings with foreign owners to high-security agencies such as the FBI and Homeland Security. GAO was [unable to identify](#) the beneficial owners of a third of 1,406 high-security leases it examined.

² The DC-based advisory group, [Global Financial Integrity](#), monitors and reports on illicit financial flows around the world. One of the many methods used to calculate amounts (an estimated [\\$1 trillion a year](#) out of the developing world) is by analyzing discrepancies in publically available trade data. I have written about this issue in the [Cambodian](#) sand market. A previous witness to this committee, [John Cassara](#), is considered a leading expert on the practice of trade-based money laundering (TBML).

Russia, North Korea,³ and Iran,⁴ it creates illicit networks and money-laundering methods that are then exploited by terrorists, criminals, and drug cartels, harming U.S. interests in a host of other evil ways, such as terrorist attacks, financial fraud, and the opioid epidemic. I can point to examples of how this works, but it is difficult to provide concrete evidence specifically because of the role of anonymously held companies.

It is thought by some that the norm of illicit authoritarian finance arose out of the collapse of the USSR and the need to explain the lack of development in the absence of totalitarian communism. Many analysts, expecting the spread of “free markets” to bring development and democracy, struggled to explain why “modernization theory” was not working. Many sought to explain the lack of development through the fact that leaders in many underdeveloped countries stole the wealth generated by markets for themselves –i.e. kleptocracy.⁵

The international community still struggles with the implications of this. In particular, how do we address it without violating the principle of sovereignty? If we can find the stolen wealth, can we confiscate it? If we can confiscate it, how would we possibly return it to the people it was stolen from?⁶ The case of Equatorial Guinea and the Obiang family are frequently used as a clear case of these issues.⁷ The answer to the above questions are in no way clear or evident, but

³ The House Foreign Affairs Committee recently estimated that North Korea receives between [\\$1.2 and \\$2.3 billion](#) annually from international slave labor. My colleague, Nicholas Eberstadt, recently outlined in [“The Method to North Korea’s Madness”](#) the many ways in which North Korea uses illicit finance to further its nuclear ambitions.

⁴ The [Foundation for the Defense of Democracies](#) played a key role in the recent Reza Zarrab investigation and [conviction](#) of the Turkish banker Mehmet Hakan Atilla in a multi-billion-dollar money-laundering scheme run out of Turkey (presumably with the blessing of Erdogan) for Iran that successfully evaded US sanctions on Iran in 2013 and 2014, prior to the JCPOA. The trade-based scheme, involving over-invoicing gold, was discovered by the non-profit non-partisan policy institute by reviewing publically available Turkish trade data.

⁵ For an academic review of the development of the term and the practice of “kleptocracy” see the Journal of Democracy’s recent special issue on [“The Rise of Kleptocracy”](#) (Published for the National Endowment for Democracy by the Johns Hopkins University Press). For important policy analysis in this new area of inquiry, see a series of special reports from the Hudson Institute’s [“Kleptocracy Initiative.”](#)

⁶ For analysis of the rise of this norm, the resulting spread of anti-money laundering laws, and an assessment of their general effectiveness, see Sharman, J.C. 2017. [“The Despot’s Guide to Wealth Management.”](#) Cornell University Press.

⁷ Equatorial Guinea is famous for having the highest GDP per capita on the continent *and* the highest levels of poverty. Its wealth came from the discovery of oil, but it has been kept exclusively by the Obiang family and invested overseas. The country’s Vice President had a \$30 million [Malibu mansion](#) seized, reportedly owns Michael Jackson’s [diamond glove](#) and

the norm, or general understanding, that the wealth of dictators is not “legitimate” is continuing to gain traction and spread around the world.

The US occupies a critical role in this area as the holder of the largest and most vibrant economy in the world and the most aggressive user of economic sanctions to compel certain behaviors from sovereign states.

On “Illicit Finance as a Growth Industry”: Illicit finance into and within the U.S. is a growth industry that will only continue to grow. The goal should be to recognize the magnitude, understand it better, and take pragmatic steps to slow it. Countries all over the world are working to root out illicit finance in their own way and according to their own understanding of what illicit finance is. The EU passed the 5th Anti-money Laundering Directive (“5AMLD”)⁸ creating public registries like the one already up in Britain and facilitating better information sharing among Financial Intelligence Units (FIUs)⁹ and compliance with agreed upon Financial Action Task Force (FATF)¹⁰ recommendations. The African Union declared 2018 the year of anti-corruption, encouraging states to create beneficial ownership registries if they have not already. Wealthy dictatorships, such as China and Saudi Arabia, are publically working to purge undesirable portions of elites that attempt to move wealth out of their countries where it cannot be controlled by the government.¹¹ At the same time, they are using sovereign wealth to purchase strategic Western assets that they think will help them achieve domestic and international political goals.¹² All other dictatorships, including North Korea and Iran, are doing the same general thing but in their own ways.

These various campaigns mean that “illicit” money will continue to flow into the United States at increasing rates. Because of the differences in approaches and understandings of “licit” and “illicit”, the US and other democracies have a

moonlights as a rap music promoter in New York, and in France was recently tried and [convicted](#) in absentia of corruption and money-laundering related to real estate purchases.

⁸ [5AMLD](#) is also known the “compromise text” of revisions to 4AMLD. Groups such as the Association of Certified Anti-Money Laundering Specialists ([ACAMS](#)) regularly track and offer analysis of these developments.

⁹ The [Egmont Group](#) began in 1995 as a small group of “financial disclosure units” in a handful nations working to explore methods of [cooperation](#). The group rapidly grew to 155 member nations that now house [“financial intelligence units.”](#)

¹⁰ [The Financial Action Task Force \(FATF\)](#) is an inter-governmental policymaking body whose purpose is to establish international standards, and to develop and promote policies, both at national and international levels, to combat money laundering and the financing of terrorism. It was formed in 1989.

¹¹ I have written about the true aims of these anti-corruption campaigns [elsewhere](#). I have also written about threats posed when these campaigns [succeed](#).

¹² This issue resides at the center of current debates surrounding the role of [CFIUS](#).

strategic advantage in that we can more discreetly monitor these flows while continuing to provide the global public good of hosting the largest, most dynamic, and most prosperous rights-based marketplace in the world. Wealthy elites in dictatorships often seek to hide their wealth in democracies, away from state control. We should be careful to not block these flows, which would be considered as illicit by the authoritarian government, but in reality, is just capital seeking freedom. Exercising strategic discretion will, I believe, eventually work to help spread democracy around the world.¹³ This is the main reason I believe that making registries public, such as in the UK and plans in the EU, from the start is a mistake.

It is important to recognize that there is no silver-bullet that will end all illicit finance. Like any anti-crime measure, it requires a balance between freedom and security. I frequently give my students the following example: I can make you 100% safe, but it will require locking you in solitary confinement of a maximum-security prison. I can make you 100% free, but you will have to live in anarchy. Another way to look at it is to recognize that we will never end all violent crime. But is that a good excuse to not try? Law enforcement experts that work on violent crime don't go into it thinking they can stop all violence. They judge success by the growth or decline of the magnitude of violence. Looking at it this way, they are able to craft pragmatic policies aimed at reducing it.

Too much regulation slows economic growth much in the way solitary confinement reduces movement. But if an increasing portion of economic growth is illicit activity (and most experts believe it is, but at best we just don't know because of things like anonymity), doing nothing will put our economy and national security in increasing jeopardy. We should at least make attempts at identifying what portion of our finance is illicit. We should listen to our banks – who are our first line of defense, and we should listen to law enforcement – who are our best offense.

On “the Cost of Anonymity”: Markets that function according to supply and demand exist anywhere and everywhere there is value, however, prosperity is scarce. Prosperity is a function of the individual rights that democracy guarantees. Anonymity is not necessarily a right, but privacy is. The costs of anonymity in business incorporation far outweigh any benefits from added privacy. Anonymity has benefits in certain situations. It is a key aspect of the free press, of doing research on sensitive topics, on protecting the rights of victims of sexual abuse and other crimes, on gaining testimony from reluctant witnesses in criminal justice cases, and in other areas. What is not clear is what the immediate economic

¹³ These strategic considerations could help inform future actions of the Justice Department's Money-Laundering and Asset Recovery Section ([MLARS](#)) and the international unit's “Kleptocracy Asset Recovery Initiative.”

or security benefit of anonymity in business incorporation is to the US government, the private sector, or anybody other than bad actors. It seems there could be a case for the intelligence and defense community to leverage anonymity in business incorporation for advantageous purposes, but I see nothing in legislation that would restrict them from using anonymity if needed.

It is understandable to me that if I were to be a famous celebrity or a politically important person, I would possibly have reason to not want my business dealings to be publically accessible knowledge. But this is a question of privacy, not anonymity. The current President's tax returns remain private, but they are not anonymous. He still files with the IRS. There are a host of legitimate uses for shell companies, but to my knowledge none of them require strict anonymity.

The economist Mancur Olson made a salient point in his work on sclerotic communist markets paralyzed by the informal sector.¹⁴ He observed that markets exist everywhere, even in the midst of extreme poverty, but prosperity is scarce. While supply and demand are iron-clad market functions, prosperity only exists in markets where individual rights, such as property and privacy, are protected and enforced. Terrorist organizations and drug cartels buy and sell goods and services but they cannot grant or secure individual rights. Some dictatorships have attained a level of wealth, but not prosperity. Their wealth is ephemeral, it comes and goes according to the success or failure of elite political arrangements. Dictatorships by definition trample upon individual rights. Communism explicitly forbade them.

Only democracy can grant and secure individual rights. Anonymity has a very narrow economic utility, if any, compared to the threats it poses.

Definitions:

“Money Laundering”: According to [U.S. Code](#) (accessed through Cornell Law School website), any “monetary transaction in criminally derived property of a value greater than \$10,000 and is derived from specified unlawful activity” is punishable by law. Money laundering is a three-step process of “**placement**” (putting the proceeds of criminal activity in a legitimate financial institution), “**layering**” (obscuring the source of the money), and “**integration**” (spending the money on legitimate goods and services). Once the money is integrated it becomes extremely difficult to track. Anonymous shell companies play an integral role in all three of these steps.

¹⁴ Olson, Mancur. 2000. “Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships.” Basic Books.

“Anonymously Held Company”: This term is difficult to define precisely because of anonymity in business incorporation. The Hudson Institute’s Kelptocracy Initiative produced one of the most comprehensive [reports](#) I have seen on this topic. I have written about the subject in an article for the [National Interest](#).

“Beneficial Ownership”: Different legal systems have their own definitions of what beneficial ownership. FinCEN passed new rules on beneficial ownership, known as the “CDD” or Consumer Due Diligence rules, last year that come into effect May 11th this year and apply to US financial institutions.¹⁵ In those rules FinCEN defines beneficial ownership as “each individual, if any, who, directly or indirectly, owns 25% or more of the equity interests of a legal entity customer (i.e., the ownership prong); and a single individual with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or any other individual who regularly performs similar functions (i.e., the control prong). This list of positions is illustrative, not exclusive, as there is significant diversity in how legal entities are structured.”

Many have noted that these rules impose a significant regulatory burden on financial institutions. The rules state that covered financial institutions must “establish and maintain written procedures that are reasonably designed to identify and verify the beneficial owners of legal entity customers. These procedures must enable the institution to identify the beneficial owners of each customer at the time a new account is opened, unless the customer is otherwise excluded or the account is exempted. Also, the procedures must establish risk-based practices for verifying the identity of each beneficial owner identified to the covered financial institution, to the extent reasonable and practicable. The procedures must contain the elements required for verifying the identity of customers that are individuals under applicable customer identification program (“CIP”) requirements.”

This means that beneficial ownership information is going to be collected whether Congress acts or not. However, Congress should act because 1) the current setup forces financial institutions to pay for and set up the above complex processes that require a unified approach in order to effectively combat money-laundering and terrorist financing and 2) these financial institutions and law enforcement agencies are asking for help from Congress to create a registry or registries that can be better

¹⁵ The “Frequently Asked Questions” [FinCEN document](#) states that “For purposes of the CDD Rule, covered financial institutions are federally regulated banks and federally insured credit unions, mutual funds, brokers or dealers in securities, futures commission merchants, and introducing brokers in commodities.”

leveraged for national security, defense, sanctions enforcement, and criminal prosecutions.

The British definition of a beneficial owner is similar to the CDD FinCEN definition.¹⁶ One argument *against* the 25% threshold and very specific definitions in general is that if criminals know this they will stay just below whatever the defined threshold is, at 24%. Basically, criminals will use the specific definition to avoid detection. Arguments *for* a very specific definition are equally compelling in that businesses need to be able to easily assess who the legal beneficial owners are without worry of violating the rule. I would suggest that FinCEN and financial institutions can and should work together to manage a balance between these two concerns about definitions. Both points are important considerations.

Notes, criticisms, suggestions:

“Massive Paperwork Burden”: If a business does not know who the primary beneficiary of its enterprise is, that’s a problem. From the forms I have seen, it takes longer to fill out an application for a grocery store coupon card than to fill out beneficial ownership forms.

“The data already exist”: There are arguments that the IRS already has beneficial ownership data. These arguments are often followed up with suggestion that if the data are collected they will be misused. This brings up a question: If the data already exist, then why are they not being misused? If it needs to be collected, then the data set doesn’t exist.

“Targets small-business”: Yes. Because large companies are subject to other legislation, reporting requirements, or are publically owned. Money-laundering operations purposefully stay small in order to avoid detection. It would seem to me that a BO registry would be squarely within the interests of small businesses precisely because it will push out competition from illicit actors.

“Angel investors”: It is often argued that small start-ups will be forced to refuse investments from venture capital firms without reporting who the beneficial owners

¹⁶ In the United Kingdom, the registry is called the “Persons of Significant Control” registry. The [summary guide](#) for companies includes detailed instructions. It also states that the registry will be made public and companies have 14 days to update control data after any changes or face fines and/or jail. The list is housed and managed by a UK government entity called [“Companies House.”](#) Most US legislation under consideration keeps the registry private and only available to law enforcement, often only with a warrant, and typically there is a 60-day time period to report changes in ownership structure.

of the investment firms are. It would seem that BO legislation would actually help here. There are many Russian investment firms (small businesses) in California that are having trouble making investments because start-ups see a Russian name and assume the firm is connected to Putin. Many have stated that they wish there was a way to certify that their investments were not Putin's.

“States or the Feds”: I think that at the end of the day the list will be better leveraged for data analytics at the federal level, but I also understand that states have different needs and can also experiment with different methods in a quest to find what is best. In my view, I think it is more important to send a signal, whether in the form of a state by state or federal list, to bad actors that they can't get away with laundering money in our markets, evading sanctions, or enjoying the profits of drug smuggling and slave labor. There is a deterrent effect that shouldn't be discounted. FinCEN's GTOs (Geographic Targeting Orders) strongly reflect this deterrent power. For example, I have read that the GTOs have pushed all-cash purchases of real estate for money-laundering purposes out of the GTO jurisdictions and into small college towns around the US. Forcing criminals into different markets makes them easier to catch.