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BEFORE THE
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

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Chairman Coleman, Senator Levin, and distinguished Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the Financial Crimes Enforcement Network's (FinCEN) ongoing efforts to address money laundering and terrorist financing concerns associated with the lack of transparency in the ownership of certain legal entities. I appreciate the Subcommittee's interest in this important issue, and your continued support of our efforts to help prevent illicit financial activity.

I am also pleased to be testifying with my colleagues from the Department of Justice and Internal Revenue Service. Each of these agencies/offices plays an important role in the global fight against money laundering and terrorist financing, and our collaboration on these issues has greatly improved the effectiveness of our efforts.

FinCEN's mission is to safeguard the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity. FinCEN works to achieve its mission through a broad range of interrelated activities, including:

- Administering the Bank Secrecy Act (BSA);
- Supporting law enforcement, intelligence, and regulatory agencies through the sharing and analysis of financial intelligence; and
- Building global cooperation and technical expertise among financial intelligence units throughout the world.

FinCEN's main goal in administering the BSA is to increase the transparency of the U.S. financial system so that money laundering, terrorist financing and other economic crime can be detected, investigated, prosecuted and, ultimately, prevented. Our ability to work closely with our regulatory, law enforcement and international partners assists us to achieve consistency across our regulatory regime and, consequently, to better protect the U.S. financial system.

Shell Companies

Business entities, such as corporations, limited liability companies (LLCs), and trusts can be organized and established in all states with minimal public disclosure of information regarding controlling interests and ownership. We use the term "shell company" to refer to corporations, LLCs, and other business entities that typically have no physical presence (other than a mailing address) and generate little to no independent economic value.[1] Most legal entities are formed by individuals and businesses for legitimate purposes, such as to hold stock or intangible assets of another business entity[2] or to facilitate domestic and cross-border currency and asset transfers and corporate mergers. However, as noted in the 2005 U.S. Money Laundering Threat Assessment, shell companies have become common tools for money laundering and other financial crime, primarily because they are easy and inexpensive to form and operate, and because ownership and transactional information on these entities can be concealed from regulatory and law enforcement authorities.

According to a survey conducted by the U.S. Government Accountability Office, there were approximately 8.9 million corporations and 3.8 million LLCs registered nationwide in 2004. Although the corporation historically has been the dominant business structure, the LLC has become increasingly popular. More LLCs were formed nationwide in 2004 (1,068,989) than were corporations (869,693).[3]

Agents and Nominee Incorporation Services

Agents, also known as intermediaries, or nominee incorporation services (NIS) can play a central role in the creation and ongoing maintenance and support of shell companies. NIS firms are often used because they can legally and efficiently organize business entities in any state.

Agents and NIS firms advertise a wide range of services for shell companies, such as serving as in-state resident agents and providing mail forwarding services. Organizers of legal entities also may purchase corporate "service packages" to give the appearance of having an established physical local presence. These service packages can include a state business license, a local street address, an office that is staffed during business hours, a local telephone listing with a receptionist, and 24-hour personalized voicemail.

International NIS firms have entered into marketing and customer referral arrangements with U.S. banks to offer financial services such as Internet banking and funds transfer capabilities to shell companies and foreign citizens. U.S. banks that participate in these arrangements may be assuming increased levels of money laundering risk.

Some agents and NIS firms also provide individuals and businesses in the United States and abroad with a variety of nominee services that can be used to preserve a client's anonymity

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[1] U.S. Money Laundering Threat Assessment Working Group, *U.S. Money Laundering Threat Assessment* (December 2005), p. 47.

[2] Companies that hold significant assets (for example, subsidiary company shares) but that are not engaged in active business operations would not be considered shell companies as described herein (although they may in practice be referred to as "shell holding companies").

[3] U.S. Government Accountability Office, *Company Formations – Minimal Ownership Information is Collected and Available*, GAO-06-376 (April 7, 2006).

in connection with the formation and operation of legal entities. These services, although legal, may be attractive to those seeking to launder funds or finance terrorism, and can include:

- Nominee Officers and Directors: Incorporators provide the legal entity with nominees for all offices that appear in public records.

- Nominee Stockholders: A beneficial owner may use nominee stockholders to further ensure privacy and anonymity while maintaining control through an irrevocable proxy agreement with the nominee.

- Nominee Bank Signatory: A nominee appointed as the company fiduciary (such as a lawyer or accountant) can open bank accounts in the name of the legal entity. The nominee accepts instructions from the beneficial owners and forwards these instructions to the bank without needing to disclose the names of the beneficial owners.

Banks that serve as company formation agents remain subject to all BSA recordkeeping and reporting requirements, including customer identification program requirements and suspicious activity reporting.

FinCEN Study

As stated earlier in my testimony, FinCEN's main goal in administering the BSA is to increase transparency in the U.S. financial system. The lack of transparency in the legal entity formation process, the absence of ownership disclosure requirements and the ease of formation of legal entities make these corporate vehicles attractive to financial criminals to launder money or conduct illicit financial activity. This, in turn, poses vulnerabilities to the financial system, both domestically and internationally. That is why finding a way to address the misuse of legal entities in the context of the BSA has been and continues to be a priority for the U.S. Department of the Treasury and for FinCEN.

In response to concerns raised by law enforcement, regulators, and financial institutions regarding the lack of transparency associated with these business entities, FinCEN prepared an internal report in 2005 on the role of domestic shell companies (and particularly LLCs) in financial crime and money laundering. An updated version of this report was publicly released last week, along with an advisory to financial institutions reminding them of the importance of identifying, assessing and managing the potential risks associated with providing financial services to shell companies.

The report highlights several key findings that demonstrate the vulnerability of shell companies to abuse. They include the following:

- Domestic shell companies have legitimate and legal uses, but the ability to abuse such vehicles for illicit purposes must be continually monitored.

- Domestic shell companies can be and have been used as vehicles for common financial crime schemes such as credit card bust outs, purchasing fraud, and other fraudulent loans.

- The use of domestic shell companies as parties in international wire transfers allows for the movement of billions of dollars internationally by unknown beneficial owners. This could facilitate money laundering or terrorist financing.

- Agents and NIS firms play a central role in the creation and ongoing maintenance and support of domestic shell companies, some of which appear to be used for illicit purposes domestically and abroad.

- Based on our research, states do not appear to impose effective accountability safeguards on agents and NIS firms to ensure that the business entities they create, buy, sell, and support are used only for lawful and allowable purposes.[4]

- There is currently neither a requirement that the agents and NIS firms report suspicious activity involving the shell companies they create, buy, sell, or support, nor requirements or procedures to identify beneficial owners in certain jurisdictions if illicit activity is suspected.

- Certain domestic jurisdictions, especially when served by corrupt or unwitting agents or NIS firms, are particularly appealing for the creation of shell companies to be used for illicit purposes.

- LLCs, particularly when organized in states which do not require reporting of information on ownership,[5] provide an attractive vehicle for shell companies because they can be owned or managed anonymously, and are inherently vulnerable to abuse.

State Requirements

The report also examines the level of transparency among states with respect to the reporting of information on ownership of LLCs. All limited liability companies have "members." A "member" of an LLC is equivalent to a shareholder of a corporation. LLCs may also have "managers." A "manager" of an LLC is equivalent to an executive officer or a member of the board of directors. An LLC may lack managers – in which case the members themselves would manage the LLC. The members in this case would resemble partners in a general partnership.

Fourteen states[6] impose no requirement to identify – in documents filed with the states – either members or managers of limited liability companies.

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[4] A few states – most notably Delaware – impose "standards of conduct" on persons serving as "registered agents." For example, the Court of Chancery in Delaware can enjoin a person from serving as a "registered agent" if the person has engaged in criminal conduct or in conduct that is likely to deceive or defraud the public. Service as a "registered agent" forms only part of the services that company formation agents and similar service providers often offer their clients. Moreover, a business entity need not organize or conduct activities in Delaware or any other state that imposes "standards of conduct."

[5] Although some states require the reporting of ownership information, no state requires the reporting of information regarding *beneficial* ownership. An individual may own an LLC indirectly, through nominees and other business entities. The U.S. Securities and Exchange Commission (SEC) addresses this potentiality through the concept of beneficial ownership, which the SEC defines as holding the rights of ownership "directly or indirectly, through any contact, arrangement, understanding, relationship, or otherwise." The concept of beneficial ownership would require an LLC – when reporting information – to "look through" nominees and business entities.

Eight states and the District of Columbia[7] require limited liability companies to include information that identifies managers. If an LLC has one or more managers, the LLC may report the identities of managers only. In the absence of managers, the LLC must report the identities of members.

Twenty-four states[8] require the inclusion of information that identifies members or managers. If an LLC has one or more managers, the LLC may report the identities of managers only. In the absence of managers, the LLC must report the identities of members.

Only four states[9] require the inclusion of information that identifies members, even when an LLC has one or more managers.

The discussion of state law requirements in the report is based on FinCEN's preliminary understanding of each state's reporting requirements.

The report discusses other ways, consistent with the laws of the states, in which those involved in the operation of limited liability companies may obscure ownership. For example, the laws of many states permit corporations, general partnerships, trusts, and other business entities to own and manage LLCs. Layers of ownership can be devised which make it highly unlikely that relationships among various individuals and companies can be discerned, even if one or more of the owners is actually known, discovered, or reported.

This patchwork of state laws allows LLCs to tailor their structures and activities to avoid reporting ownership information.

Statistics

When comparing the number of new LLCs created from 2001-2005 in conjunction with the various levels of transparency among the states, our analysis revealed the following:

- The average increase in new LLCs from 2001-2005 for the states with the least transparency was 120.09%.

- The states that provide the next level of transparency averaged a 112% increase from 2001-2005.

- The states that require information on members only when an LLC lacks managers had an average increase of 146.68% (three of five states reporting).

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[6] Arkansas, Colorado, Delaware, Indiana, Iowa, Maryland, Michigan, Mississippi, Missouri, New York, Ohio, Oklahoma, Pennsylvania, and Virginia.
[7] Massachusetts, North Carolina, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Wisconsin, and the District of Columbia.
[8] California, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Kentucky, Louisiana, Maine, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Oregon, Texas, Utah, Washington, West Virginia, and Wyoming.
[9] Alabama, Alaska, Arizona, and Kansas.

- The four states that provide the greatest level of transparency averaged an increase of 138.75%.

- The average increase in number of LLCs (2001-2005) for all states reporting to the International Association of Commercial Administrators (IACA)[10] was 133.37%.

In terms of percentage increases in new LLC filings, there appears to be no definitive correlation between level of transparency and preference of a state for LLC formation. Indeed, states with more transparency have exhibited slightly higher growth on average than states with less transparency, but there is much variation within each category. Other factors appear to account for the relative popularity of certain states over others.

Of the four states often recognized as being particularly appealing for the formation of shell companies (Oregon, Wyoming, Nevada, and Delaware),[11] only Delaware falls in the group offering the least transparency. The other three states fall in the group offering a moderate level of transparency.

A preliminary conclusion based on the above information suggests that mandating that all states require LLCs to report the identities of members and managers would not significantly affect the number of LLCs formed or the relative balance among states. Therefore, it appears that the vulnerabilities of the states that allow less transparency could be reduced through requiring greater transparency without a major effect on revenue generated for those states. In contrast, the ensuing benefits to law enforcement and regulatory entities of greater transparency could prove significant.

Again, other factors may be at work in determining the preference of organizers for one state over another when setting up a shell company. These might include considerations of convenience as well as availability. The services and advice of particular agents and NIS firms may be another key factor when legal entities are being formed for illicit purposes.

Examples of Abuse

FinCEN identified 1,002 Suspicious Activity Reports (SARs) filed from 1996 through the beginning of 2005 that reference activity that appears to be related to shell companies. These SARs reveal a wide variety of domestic and offshore financial center activity. Suspected shell company locations range from the United States to the Cook Islands, Vanuatu, Bahamas, the United Kingdom, Panama, the Cayman Islands, Nigeria, and Antigua. Nine-hundred thirty-two SARs identify activity involving suspected U.S.-based shell companies. Sixty-seven SARs identify activity primarily involving shell companies in typical offshore financial centers with some connection to a U.S. entity or financial institution (38 of these SARs identify suspected shell banks in foreign locations such as Uruguay, the Cook Islands, St. Lucia, and St. Vincent/Grenadines.) The activities or location of the suspected shell companies referenced in the SARs have some nexus with the United States. Because SAR filers frequently do not or

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[10] The IACA is an organization that solicits annual reporting information from the states.

[11] *See, e.g.,* U.S. Money Laundering Threat Assessment Working Group, *"U.S. Money Laundering Threat Assessment*," (Dec. 2005) at pp.47-50; U.S. Government Accountability Office Report No. GAO-06-376 to the Permanent Subcommittee on Investigations, U.S. Senate, *"Company Formations –: Minimal Ownership Information is Collected and Available*, GAO-06-376*"* (April 2006).

cannot provide information regarding the location of suspected shell companies (business location, mailing address, address of registered agent), the actual number of U.S.-based shell companies cannot be accurately determined. Many of the SARs identify multiple companies as possible shell companies.

Of the SARs describing recent domestic shell company activity in the United States, there are examples of a suspected Ponzi scheme, pump-and-dump stock fraud, telephone "cramming" by organized crime, possible money laundering by politically exposed persons, and other suspected frauds and suspicious movements of money, particularly through wire transfers.

Many of the U.S.-based suspected shell companies were observed to maintain banking relationships with Eastern European financial institutions, particularly in Russia and Latvia. Of the 1,002 SARs identified, 768 involved suspicious international wire transfer activity involving domestic shell companies following recurring patterns and sharing common characteristics. These SARs identify what appear to be 1,361 different suspects, both individuals and business entities, including 329 U.S.-based LLCs.[12] In addition, 504 of the SARs identify Russia and 449 identify Latvia as locations of activity in the narrative. The aggregate suspected violation amount reported by these SARs is nearly $18 billion.[13]

Case data suggest that the misuse of U.S. legal entities is of concern throughout the international community. For instance, during the first half of 2005, 15% of research requests made to FinCEN from the Latvian Financial Intelligence Unit (FIU), 21% of research requests from the Bulgarian FIU, 25% of research requests from the Slovakian FIU, 33% of the research requests from the Russian FIU, and 55% of the research requests from the Ukrainian FIU identified a U.S. LLC as the primary subject of the request. Concerns about the misuse of U.S. legal entities have been specifically referred to by the Financial Stability Forum, the European Commission, the International Organization of Securities Commissions (IOSCO), and the Organization for Economic Cooperation and Development (OECD).[14] Moreover, the Financial Action Task Force (FATF) also acknowledges the potential for abuse within its Forty Recommendations on Money Laundering (in particular, Recommendations 33 and 34 relating to transparency of legal persons and arrangements).[15]

Steps Forward

FinCEN is undertaking three key initiatives to deal with and mitigate the risks associated with misuse of legal entities.

1. Concurrent with this report, FinCEN issued an advisory to financial institutions highlighting indicators of money laundering and other financial crime involving shell companies, and emphasizing the importance of identifying, assessing, and managing the potential risks associated with providing financial services to such entities. The advisory also describes identified abuses by criminals of domestic shell companies overseas. The

[12] The number of truly unique subjects is probably slightly less due to alternate spellings, misspellings, incomplete identification, etc.
[13] As with the other SARs in this sampling, the actual total is somewhat less.
[14] *See, e.g.,* Financial Action Task Force (FATF) Report, *"The Misuse of Corporate Vehicles, Including Trust and Company Service Providers"* (Oct. 2006) at pp1.
[15] http://www.fatf-gafi.org/document/28/0,2340,en_32250379_32236930_33658140_1_1_1_1,00.html#40recs

advisory is consistent with existing guidance and does not represent a change in regulatory approach. [16] The advisory does not encourage financial institutions to discontinue or to refuse particular accounts on behalf of these business entities.

2. FinCEN is continuing its outreach efforts and communication with state governments and trade groups for corporate service providers to discuss identified vulnerabilities, and to explore solutions that would address vulnerabilities in the state incorporation process, particularly the lack of public disclosure and transparency regarding beneficial ownership of shell companies and similar entities.

3. Lastly, FinCEN is continuing to collect information and studying how best to address the role of certain businesses specializing in the formation of business entities in its effort to reduce money laundering and related vulnerabilities in the financial system through the promotion of greater transparency.

Given their role in forming and supporting business entities, these service providers – which could include attorneys, trustees, and other intermediaries engaged in the business of providing services relating to the formation and support of business entities – are in a unique position to know and obtain information about beneficial owners, to determine whether these entities are to be used illicitly, and to recognize suspicious activity. They have information critical to law enforcement, regulatory authorities, and other financial institutions in combating the use of shell companies to promote illicit finance. Moreover, they are in the best position – in the first instance – to discourage abuses by reducing the ability of the beneficial owners of these entities to operate anonymously and, consequently, with relative impunity.

Conclusion

In conclusion, Mr. Chairman, we are grateful for your leadership and that of the other Members of this Subcommittee on this issue, and we stand ready to assist in your continuing efforts to ensure the safety and soundness of our financial system. Thank you for the opportunity to appear before you today. I look forward to any questions you have regarding my testimony.

[16] *See,* "Business Entities (Domestic and Foreign"), FFIEC BSA/AML Examination Manual (July 28, 2006).