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BEFORE THE UNITED STATES SENATE COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

EXAMINING STATE BUSINESS INCORPORATION PRACTICES:
A DISCUSSION OF THE INCORPORATION TRANSPARENCY
AND LAW ENFORCEMENT ASSISTANCE ACT

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I would like to thank Chairman Lieberman, Senator Collins, and the Committee and Staff for the opportunity to present testimony at this hearing on state incorporation processes and the need for systemic reform. Senators Levin, Grassley and McCaskill have introduced an excellent piece of legislation that merits the support of the law enforcement community, and we thought it important to participate in today's debate and discussion.

Not only does the bill merit the support of the law enforcement community – it fully has its support. To quote a colleague who works on financial criminal investigations for a federal agency, "It's a no-brainer." This bill, from our perspective, is exactly what is needed to address the problems associated with shell companies created to hide criminal activity.

In so many areas of financial crime we see transparency as a simple solution to a host of problems. Systems promoting opacity and secrecy are the best friend of the money launderer, the child pornographer, the tax cheat, the fraudster, the corrupt politician, and indeed, the financier of networks of terror. The beauty of the bill we are discussing today is the simple solution it brings to a host of problems: Transparency. If there is one lesson we have learned in investigating financial crimes, it is that the best and easiest solution for many areas of criminal conduct is to encourage and require transparency in financial arrangements. Lack of transparency played a role in almost all of the major financial cases prosecuted by my office. Going back to the early 1990's and our investigation of the Bank of Credit and Commerce International (BCCI), our prosecutions of boiler rooms and pump-and-dump stock schemes since the 1990's, and our recently announced investigations into the movement of funds by Iranian banks and the Iranian

military; the criminal actors in all of these cases benefited from systems lacking transparency.

My goal in presenting this testimony is to provide the law enforcement perspective on the issue of beneficial ownership registration; to wit, that anonymous shell companies present current and ongoing problems to the law enforcement community, and why Senate Bill 569 (S. 569) is the best solution. My remarks are organized as follows: First, I discuss the current lack of standards among the 50 states. Second, I analyze the alternative measures and discuss why, from the viewpoint of the law enforcement community, they fall well short of the mark. Third, I discuss the standing of the United States in the global financial and anti-money laundering community, and why our current standards lag behind those of many foreign nations, even some generally viewed as problematic by the United States. In this regard, I note the impression of hypocrisy this double standard leaves with the international law enforcement community. Finally, to illustrate the importance of transparency, and to demonstrate the use of the corporate structure for criminal purpose, I will discuss briefly a few cases prosecuted by my staff over the past decade where criminal organizations used corporate structures to engage in criminal conduct. Make no mistake – S. 569 is not a panacea. Criminals will still find ways to hide their identities and use corporate entities for their criminal purposes. But by providing more transparency, and by creating accountability and the possibility of criminal prosecution for incorporating agents, this bill will help us stop corporate criminals.

I was appalled to learn of the current state of the law for incorporation standards. According to a summary prepared by the General Accounting Office in 2006, only two states require any statement of beneficial ownership in their incorporation processes. I believe only seven have such a requirement for LLC's. The reasons behind this, while cynical, make sense. For many states, incorporation fees are a tremendous source of revenue. Any state that raised its standards unilaterally would put itself at a competitive disadvantage as opposed to other states with lower standards. It would be foolish to expect any state to act against its financial self-interest, especially in this economic climate.

I have reviewed some of the alternative proposals under debate today. The proposal from the National Association of Secretaries of State (NASS) would require "owner-of-record" information. This is of little value from a law enforcement perspective. The owner-of-record can be another shell company, another straw owner, an incorporation service – anything. Beneficial ownership – who really owns the corporation - is the important information, and S. 569 quite rightly focuses on this concept.

Moreover, the proposal from the National Conference of Commissioners on Uniform State Laws (NCCUSL) suffers from deficiencies similar to those of the NASS proposal. First, it will not be binding unless adopted by the States. Again, no state will be the first to enact such requirements, and the states that, from the law enforcement perspective, most need reform are least likely to enact. That gives little cause for optimism. The "race to the bottom" will be on, and the worst states will seek a competitive advantage

over those that seek reform. Even with a federal mandate requiring adoption of the NCCUSL proposal, it would still impose an entirely new regime. S. 569 would be much simpler and more direct: simply collect a statement of beneficial ownership and keep it in the same type of file currently maintained by the states.

In addition, the complicated structure of "Record Contact" and "Responsible Individual" in the NCCUSL proposal will actually make matters worse from a law enforcement perspective, not better, for a number of reasons. First, either system will destroy the ability of law enforcement to gather corporate information without alerting the targets of the investigation. In any long term investigation, we must find ways to gather evidence while maintaining confidentiality. If our suspects learn of the investigation, they may flee, records may be destroyed, criminal techniques may be altered. Thus, we constantly seek ways to gather evidence without alerting the suspects. This is particularly true of the type of sophisticated criminal who takes the time to set up shell companies to hide his or her involvement. Under the Senate bill, information of beneficial ownership would be provided to the State, and law enforcement seeking such information would use a subpoena to obtain it from the State. It is simple, direct, and would take only days. And, most importantly, it would not alert the suspect.

Compare that to the NCCUSL proposal. A request would have to be made to the Record Contact (who could be anywhere in the United States and would have to be located). The Record Contact is someone designated by the corporation to act on its behalf. Contacting this person is akin to picking up the telephone, calling the suspect, and saying, "You're under investigation." I can already hear the shredders starting to whir. The concept of the Responsible Individual suffers from the same shortcoming. An inquiry to the Responsible Individual is akin to a direct notification to the company that it is under investigation. Moreover, from a law enforcement perspective, the Responsible Individual is something of a mystery. The Responsible Individual is defined as someone "who, directly or indirectly, participates in the control or management of an entity." There is no requirement that this person be in the United States. The interpretation of someone who "directly or indirectly controls a corporation" is vague enough to mean anything. Could a nominee, officer or director who is an employee of an incorporation service in Panama be someone "who indirectly controls" a shell company? Of course he could. This is a huge loophole that would defeat the purpose of this legislative reform.

Finally, I note that this bill would render impotent one tool commonly employed by law enforcement. Federal law and the laws of many states allow us to obtain non-disclosure orders for our subpoenas. For example, when we obtain phone records, bank accounts, credit card information or other investigative data, such an order prevents banks and other subpoenaed entities from notifying the account holders. The very structure created by the NCCUSL proposal nullifies such orders, as the system the proposal would create requires the Record Contact to notify the corporation upon receipt of the subpoena. For those seeking to abuse the system and hide their involvement, the twin concepts of the Record Contact and the Responsible Individual will be a bonanza, in that they will create a system that will frustrate law enforcement investigations by its very structure. We would be better off, from a law enforcement perspective, with no legislation at all.

There is an aspect of this issue not readily apparent to those who do not investigate and prosecute crime for a living. Critics have charged that the law will not work because criminals will continue to use false names to hide their identities. This criticism misses the point. By requiring the inclusion of beneficial ownership information, all people seeking the benefits of corporate status from the states will be expected and required to provide accurate and truthful information. When a criminal uses a false name, or a straw man, or incorporates in the name of a family member – there are two significant results from the law enforcement perspective.

- First, it provides evidence of what the criminal law refers to as "consciousness of guilt." To put it another way – why would someone use false information? Would an innocent person do that? The answer is usually "no," and this type of evidence is tremendously important in establishing a suspect's criminal intent. Simply by requiring information regarding beneficial ownership, criminals would be forced to lie. And a lie goes a long way to establishing criminal intent.

- Second, and equally importantly, it will give law enforcement a criminal charge to bring against criminals who use false information to incorporate, and also against the agents who intentionally assist such criminals. If an incorporation agent sets up 100 shell companies for an identity theft ring that plans to steal and launder money, the incorporation agent may or may not be guilty as an accomplice to identity theft, larceny, and money laundering. But, the agent is certainly guilty of filing false incorporation documents with the state. The ability to punish the enablers and middle men will go far in cleaning up corruption. For example, according to information gathered by the Financial Crimes Enforcement Network, there is one U.S.-based incorporation service that, for the period from April 2005 to March 2006, was named in 86 separate Suspicious Activity Reports for its association with corporations involved in over $100 million in suspicious conduct. During the period from April 2006 to March 2007, this same service provider was named in an additional 218 Suspicious Activity Reports, five of which alone totaled over $100 million in suspicious transactions.

I think it is important to note that we do not support imposing a verification requirement on the States. Often legitimate businesses need to set up corporations quickly, and a verification requirement for all incorporation processes would hamper the normal practices of business and would impose a financial burden on the States. The states are not expected to verify the data or take any extra steps – they simply would have to make sure that the information identifying beneficial ownership is obtained from the party seeking incorporation. The solution seems to be as simple as an extra data field in an online form, and a simple and easily understood requirement for incorporation agents. There would be no extra costs for the states, and because the bill would set a uniform minimal standard for all states, there would be no concern that any state could have a competitive advantage. There could be no "race to the bottom."

Equally important, we do not necessarily support making information of beneficial ownership publicly available. Under the Senate bill, it would be available only by means of a subpoena from law enforcement and, while not within my area of concern, presumably available pursuant to a civil subpoena issued by a court in civil litigation. Individuals can have legitimate interests in maintaining the privacy of their business affairs, but that interest must be balanced against the need of law enforcement agencies to investigate criminal conduct and the state's interest in protecting the incorporation process from abuse. This bill will strike a reasonable balance at no cost to businesses or the states.

Finally, there are moral reasons – and reasons of national pride -- to support this bill. My Office is well known for its work chasing offshore tax cheats, corrupt politicians, dirty banks, and other international cases. We regularly speak to law enforcement agents and prosecutors around the world. It is difficult to speak with moral authority in criticizing offshore bank secrecy jurisdictions when they can point an accusing finger back at us. The British Virgin Islands is a well-known (in law enforcement circles) bastion for dirty shell companies, but even the British Virgin Islands can level criticism at the lack of transparency in the incorporation processes in our states. That we were deemed "non-compliant" by the Financial Action Task Force is an embarrassment. That we have made no progress in the three years since then is absurd. Our statement of national transparency standards should be something more than: "U.S. financial transparency: Better than Lichtenstein and trying to catch up to Panama." Simply put, we lag behind many other countries in the world in this regard, and it makes our statements concerning transparency and tax evasion ring hollow and hypocritical.

Foreign law enforcement authorities even refer to certain states as "offshore U.S. jurisdictions." And when asked, I am hard-pressed to define why these well-known states are any different from Cayman or the British Virgin Islands. The Committee should also know the imprimatur of respectability that a certificate of incorporation from a U.S. state carries with it, and the access it gives a foreign citizen to open bank accounts and engage in all manner of business, both legitimate and otherwise. And, for many foreign persons wishing to hide their income in an "offshore jurisdiction," there is no need to turn to a Caribbean hide-away. In one case where we rendered assistance to foreign prosecutors, we were able to connect the head of a foreign central bank to an "offshore" Delaware corporation. He used the corporate entity to open a bank account in Florida. He used black market money systems (prosecuted in New York) to move funds to this secret account he held in Florida. By obtaining a corporate entity, this corrupt official could rest assured that his funds would be safe in the United States, and his name would not easily be linked to the corporation. I am hard-pressed to find a difference between his use of a Delaware corporation to open a Florida bank account and the use by a U.S. taxpayer of a Lichtenstein corporation to open a Swiss bank account. At the end of the day, both systems provide a security blanket of anonymity for those who seek it.

Having discussed the issues in the abstract, allow me to present a few cases where we have seen criminals employ shell companies. The historic record is replete with more examples, including the federal investigation and prosecutions of Hezbollah members for

smuggling cigarettes and the ongoing federal prosecution of associates of the accused Iraqi terrorist Shawqi Omar. Both of these criminal organizations used domestic shell companies to launder criminal proceeds, ultimately to the benefit of terrorist organizations. Here then, are a few more examples of cases in which criminals created anonymous domestic shell companies to further their criminal schemes.

Money Laundering by Iran

The Manhattan District Attorney's Office recently announced a number of cases involving the movement of funds through banks in New York by entities controlled by the Iranian military. In at least two related matters, domestic shell companies in two different states were opened to hide secret Iranian interests. In one of these cases, individuals working on behalf of the government of Iran created a New York shell company to own assets in the United States, and to move funds to secret accounts held in offshore jurisdictions. Our investigation led us to a corporate parent in this offshore "bank secrecy" jurisdiction. Ironically, the foreign government wherein the corporate parent was created was able to give us more information about the ownership of the New York corporation than was the State of New York. A required declaration of beneficial ownership might not have stopped the Iranians, but even a false statement would have been an extra tool for law enforcement to shut down this misconduct and prosecute the perpetrators.

Tax Evasion: Consulting Fees to Shell Companies

A frequently observed fact pattern involves tax evasion through the use of payments of so-called "consulting fees" to shell companies. In these schemes, the owner of a business sets up domestic shell companies and causes the business to send payments to them. These payments are recorded in the books of the business as consulting fees or vendor fees. The shell company maintains a bank account or accounts (because multiple accounts make it more complicated to trace the funds), and the payments sent from the business to the shell company are deposited and then used to pay personal expenses of the business owner. As a tax scam, it is a double hit – the business gets a false deduction (for the bogus consulting fees) and the owner receives income he does not declare. This is the tax scam that led to convictions of the principal owners of the infamous Manhattan strip club called Scores. We have prosecuted this fact pattern dozens, if not hundreds, of times in the past decade.

Mortgage Fraud

My office has a number of ongoing investigations into mortgage fraud. In these cases, which involve upward of $100 million in larcenous conduct, we see the same use of domestic shell companies as described above for tax evasion. The criminals use wildly inflated appraisals and false paperwork to obtain mortgages on properties. They deposit checks from the closings into accounts set up in the names of the shell companies. They can then withdraw the ill-gotten funds as they see fit, or use them to pay personal expenses. The lender issuing the mortgage is out of luck.

Creation of Multiple Entities for Tax Evasion and Larceny

Another common fact pattern occurs when an individual creates a shell company with a name similar to some other corporation. For example, in a case indicted early last year, eight people were charged in a fraud scheme involving stolen checks. The ring leader hired an accomplice who worked in the mail room of a major corporation. The mail room clerk stole numerous checks issued by the corporation to various vendors. The checks ranged in value from about $10,000 to $75,000. Once he had the checks, the ring leader would create domestic shell companies or obtain business certificates in a name close to the payee on the check. For example, a check made out to "Con Edison" would prompt the ring leader to obtain corporate papers in a name like "Consulated Edison." The ringleader would then hire straw men to open business bank accounts in their own names, "doing business as" the bogus corporation. The ringleader and accomplices would deposit the stolen checks and withdraw or transfer the funds. The indictment covered about $350,000 in fraud of this nature, but the ringleader was involved in an array of frauds. This is a common scheme employed by organized identity theft rings.

Sales Tax Evasion and Use of the Corporate Entity to Hide Control

Another current investigation from my office involves a business that provides security protection services for residential facilities (such as senior citizen centers and health care clinics), in the form of armed and unarmed guards. Under current New York law, the NYS Department of State is the agency licensing such a company, and it is also the agency that oversees and maintains records of incorporation of corporate entities.

The business has had at least three New York corporate identities in the past few years. It seems that the business regularly and repeatedly fails to file payroll taxes, its owners seem regularly to under-estimate their income tax liability, and the companies have other irregularities that, in our estimation, raise questions about whether it should be hiring and deploying armed guards. However, every time the tax department files a tax lien against this company, the business owners simply dissolve that corporate iteration and re-form under a different corporate name. No agency within the State of New York requires a statement of ownership for the corporate entity, although the ownership appears to be consistent and the repeated re-incorporation seems to be a simple dodge to avoid tax liability.

Bribery / Political Corruption

In a case prosecuted by the Department of Justice that resulted in a guilty plea last month, two Florida residents admitted using a Florida shell company to pay bribes to corrupt government officials in Haiti. The defendants, Juan Diaz and Antonio Perez, admitted that they created a shell company in Florida and used it to open a corporate bank account. They then laundered over one million dollars through the shell company account to pay off the Haitian officials to obtain telecommunications contracts. These payments were recorded on the books of the Florida telecomm companies where the defendants worked as "consulting services."

We also receive regular requests from foreign law enforcement seeking to trace money moved through accounts held by U.S. corporate entities. A case indicted in Brazil involved criminal proceeds sent to an account at a U.S. bank. Again, a U.S. shell corporation was created and used to open the account. In this case, the defendants discussed using a British Virgin Island company as the nominee director of the corporation. Consider the following communication from the U.S. incorporating agent to the Brazilian defendant:

> *The recommendation is to open a US Limited Liability Company (LLC). This entity combine the advantages of a limited with the ones of a partnership, especially about the taxes (we will open "a pass-through entity)."*
>
> *The instruction is to not mention in the public files the owners' names.*
>
> *It is possible to point a Registered Agent to receive the official letters.*
>
> *The LLC might be managed directly by its owners, but it must be done preferentially by operating managers (equivalent to directors) and that will have duties and responsibilities similar to the corporation's directors.*
>
> *The Managers don´t need to be American citizens or to live in United States and their data may, but not necessarily, be disclosure to the public records.*
>
> *The total cost for the opening procedures is US$ 6,000 including a Nominee Member. Per year the managing will cost US$ 1,600.*

This communication, and the examples set forth above, demonstrate how the systems of anonymity in this country's incorporation processes are being exploited by criminals. They also demonstrate why we need to be able to retrieve beneficial ownership information from the states directly, and not from the sham nominee of a domestic shell company.

Ultimately the Levin-Grassley-McCaskill bill strikes a reasonable balance between the call for transparency and accountability from the law enforcement community and the need to encourage responsible business growth and development. The investigations referenced in this testimony, as well as the practices outlined in the GAO Report and in Senator Levin's investigation, paint a clear picture as to why change is necessary. The cases mentioned in this testimony barely scratch the surface of the problem. S. 569 provides a minimalist and direct answer to a difficult problem. It places almost no burdens on the states or on business, while simultaneously addressing our security needs. I urge the Committee to adopt it and recommend its passage.