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DEALING WITH THE OFFSHORE ECONOMY

**THE THREAT OF OFFSHORE FINANCE TO
THE WEST AND HOW TO DEAL WITH IT**

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INTRODUCTION

When money is sent to foreign banks, corporations, or investments with the intent of reducing a tax burden or disguising its origins, it's referred to as being sent to an "offshore" location. But the Western offshore economy described in this paper does not just refer to tax havens such as the Cayman Islands, or indeed the corporate anonymity afforded by US states such as Delaware. It also refers to the business and financial practices that permit huge flows of money to pass from developing countries, former Soviet states, and China into the offshore nexus of tax havens;¹ property markets in New York, Florida, and London; and other Western blue chip assets, from stocks and bonds to art and sports teams.²

The argument of this paper is that the existence of this Western-organized and governed offshore economy has pernicious effects on Western democracies.³ Most of the public critique of the Western offshore economy so far has focused on the large loss of tax revenue to Organization for Economic Co-operation and Development (OECD) states through the use of havens by major corporations and individuals. This paper argues, however, that the greatest danger posed by the offshore economy is not a financial threat but a security one. The flows of tainted capital from across the developing world, ex-Soviet states, and China—which are the products of bribery, state extortion, procurement padding, and tax theft—have significant destabilizing effects on countries in the developing world and on Western democracies.

This report argues that the West's safe haven status, its professional business service firms, its banks, and its rule of law are being deployed to loot developing countries, keep corrupt elites in power, and ultimately allow those elites to turn their own peoples against the West and Western values. On top of those negatives, the capital inflows into the West are so large that they threaten to undermine the West's own democratic institutions, through financial professions and institutions, and therefore their economic and political life.

This threat can be effectively tackled, however, and corrupt elites' Western holdings can be turned against them. The foundation of any effective approach is high level cooperation between the European Union (EU) and the United States. With this, it could be possible to seal off the West and deprive looting elites of a home for their ill-gotten gains.

Any policy aiming to undermine these dark capital flows must have three prongs. First, the capacity of the West—and particularly of the EU—must be improved in order to apply effective money laundering regulations. Second, whistleblowers in banks and professional service firms must be incentivized to speak out, without fear of personal repercussions, about illegal money flows. Third, anonymous property holdings, bank accounts, and companies must be effectively challenged; assets held anonymously in shell companies should be frozen and assessed as to whether they represent the fruits of unlawful transactions.

If the putative owners of those assets are not able to justify their actual ownership or do not come forward, the assets would be seized. Seized assets could be then held in a fund for legitimate claims against the local elites of the states who stole the money. For instance, in the case of Russia, victims of the downed flight MH-17 or Ukrainians affected by the illegal invasion of their country could be compensated by seized Russian assets. Remaining funds could be held against future damages caused by the Russian state, made available for scholarships for young Russians in the West, or used to help rebuild Russia once President Vladimir Putin is out of the picture.

This paper is divided into several sections. The first records the history and the modern operation of the offshore economy. It also considers the two main drivers of the modern offshore sector: the use of tax-efficient mechanisms by major Western corporations, and the tainted capital flows that come from developing countries. It then discusses the harm that the

1 The major physical offshore havens are taken to be Cyprus, Malta, Dubai, Singapore, Hong Kong, British Virgin Islands, and the Cayman Islands. The US has a number of states which act as havens, such as Delaware, Wyoming, Nevada, and South Dakota. In addition, significant amounts of foreign capital end up based in the US and UK even if they are nominally held in a haven.

2 Included in this definition of the offshore economy are the law firms, accountants, and financial institutions that provide the professional services to ensure that this shadow economy is fully functional.

3 For a recent analysis of the operation of this offshore system, see Oliver Bullough, *Moneyland: Why Thieves and Crooks Now Rule the World and How to Take it Back* (London: Profile, 2018).

extensive offshore system does to developing countries and the West, and the growing danger to the integrity of Western institutions. The second sets out a number of solutions to undermine the illegal flows of money, including enhanced EU-US cooperation, an

increased focus on anonymous entities, empowering whistleblowers, and the creation of a holding fund for ill-gotten gains together with a compensation scheme. The final section offers a conclusion.



Château de la Muette, the Headquarters of the Organization for Economic Co-operation and Development (above) located in Paris, France. *Photo credit: Wikimedia Commons*

THE OFFSHORE ECONOMY: HISTORY, DEVELOPMENT, AND THE DAMAGE IT CAUSES

Given that offshore tax havens are largely located in small, independent states or self-governing territories, it could be assumed that they have little connection to OECD states and major financial centers such as London and New York. This is not the case. The so-called tax havens are in fact part of a much larger network of financial and corporate services that depends on lawyers, accountants, and bankers located in major Western cities. Only one part of the havens' business actually involves providing lower tax rates to individual foreign account holders.

“Tax havens are in fact part of a much larger network of financial and corporate services that depends on lawyers, accountants, and bankers located in major Western cities.”

These financial safe havens—which are in OECD countries like Luxembourg and Switzerland, US states such as Delaware, and literal offshore areas such as the Cayman Islands—provide a much broader range of services. These include banking and capital-raising facilities, capital holding, and establishing and maintaining anonymously held companies. The havens cannot provide these services without being part of the Western financial system: most major Western banks have branches on their territories; assets nominally held in these tax havens are often physically held in liquid or illiquid forms, such as real estate, in major Western cities; and Western banks raise capital in these havens for projects in the West. The nominal headquarters of a significant portion of the Western financial services industry may be based

in these financial havens; for instance, half the hedge fund industry is nominally headquartered in the Cayman Islands, but the companies' assets and operations are actually based in London and New York.⁴

This should not be surprising. These tax havens only really developed after World War I as a result of rising tax rates in Western countries and the economic and political uncertainty of the 1920s and 1930s. The original havens were found in Europe, in Luxembourg and Switzerland, and in the Americas, in Bermuda and the Bahamas. They operated on a small scale for wealthy refugees from Europe, as well as for Americans who faced higher taxes under the New Deal. It was only after 1945 that the number of tax havens accelerated alongside the nature and type of services provided. The two major factors in the accelerating development of the havens were the growth of the welfare state in Europe and the US, with its consequent higher tax rates, and decolonization. The latter saw some of the newly independent states seeking to provide similar services in competition with existing tax havens.⁵

Notably, the United Kingdom encouraged some of its former colonies, both those that were newly independent as well as the remaining dependent territories, to develop their nascent financial services industries as a means of achieving economic viability. The development of the London-based Eurodollar and later Eurobond market in the 1960s and 1970s resulted in further development of the sophistication and operations of these regions. The tax havens would be an important linchpin in the capital-raising operation for Eurobonds organized from London, and for US and European companies that were still subject to tight regulatory and fiscal regimes.⁶

There are two factors that have accelerated the further development of these offshore regions. The first and most well-known is their use by Western firms to reduce corporate taxes in home or operating

4 Vanessa Ogle, “Archipelago Capitalism: Tax Havens, Offshore Money and the State, 1950s-1970s,” *American Historical Review* (2017), 1431.

5 *Ibid.*, 1436-1439.

6 *Ibid.*, 1445-1446.



Financial safe havens, such as Delaware, provide a much broader range of services. These include banking and capital-raising facilities, capital holding, and establishing and maintaining anonymously held companies. *Photo Credit: Wikimedia Commons*

jurisdictions. The second is the flow of tainted capital into these areas from developing countries.

Western corporations have sought to lower their corporate tax rates by shifting profits to havens where taxes are lower. It is estimated that the US loses \$70 billion annually in corporate tax revenues from these practices.⁷ This can be achieved by transferring the intellectual property rights of goods or services that a company provides to a subsidiary company located in a tax haven, for example. The haven subsidiary charges other subsidiaries operating in France or the United Kingdom (UK), for instance, a fee for using the intellectual property rights, reducing taxable income in the operating country and therefore the amount of tax that is paid. Meanwhile, the subsidiary in the haven earns significant profits in a jurisdiction where corporate taxes are very low. Google, for example, has a subsidiary in Bermuda that generated \$15 billion in annual earnings from such practices.⁸ These “profit shifting” techniques have generated tremendous concern in OECD states. While such techniques are legal, they are unfair: they illegitimately extract profits from countries in which those profits are generated, subsequently eroding the local tax base. Western states, particularly those in the EU, are examining ways to tackle this tax base erosion.⁹

The havens and their supporting army of Western bankers and business professionals still provide traditional services to protect personal incomes and assets from Western tax authorities. These services have become increasingly sophisticated and have been developed around anonymous companies and trust vehicles, operating if necessary in multiple layers of legal entities and jurisdictions to provide an impenetrable barrier to any investigator or regulator. Those companies or trusts then hold bank accounts in the havens as well as in the West. They can use common law ownership rules, particularly in the US and the UK, to hold real estate without having to disclose the ultimate beneficial ownership. James Henry of Columbia University conservatively estimated that \$12 trillion in assets from OECD countries was held offshore in 2016. This included both lawful corporate assets using techniques such as allocated intellectual property rights and a wide range of grey area operations, as well as outright evasion of national tax and regulatory requirements.¹⁰

These techniques originally developed to assist American executives and Belgian dentists, and later multinational corporations, to limit their exposure—sometimes lawfully, sometimes unlawfully—to their

7 Gabriel Zucman, “How Corporations and the Wealthy Avoid Taxes (and How to Stop Them),” *New York Times*, November 10, 2017.

8 *Ibid.*

9 The commission’s most notable weaponry, which is unique, is the EU’s state aid rules. This has forced Apple, for example, to make additional tax payments of \$13 billion. As the Irish state has provided specific permission for the tax deal that permitted larger tax charges than would otherwise be paid, this permission was deemed to be a form of unlawful aid. There is a similar investigation ongoing regarding the French energy firm Engie and a special tax deal with Luxembourg. Clearly, where special deals have been entered into or special regimes have been created, the EU can effectively combat tax erosion.

10 James S. Henry, “Global Haven Industry-Progress Report-Quantifying Kleptocracy,” *Tax Justice Network*, 2016.

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respective tax authorities. Today, they're increasingly deployed to flows of tainted capital from developing countries, helping those funds transit from their home jurisdictions and ultimately to the West.

In this case, tainted capital means revenue flows generated by local elites in developing countries, ex-Union of Soviet Socialist Republics (USSR) states, and China, which are substantially the profits of various forms of corruption and ill-gotten gains: bribery, extortion, sales tax fraud, padding of procurement contracts, and even outright looting of the state treasury. It is this "tainted capital" that has been an additional driver of business for the safe havens and the broader offshore industry.

Not all of these developing country capital flows are tainted. However, given the scale of the flow of money from developing countries, which Henry estimates at approximately \$12 trillion,¹¹ and the extent to which the elites from a number of developing countries can engage in domestic bribery, extortion, and corruption, it is not unreasonable to assume that a significant proportion of the capital flows is likely to be tainted.

Another way to analyze these figures is to consider the extent of bribery and corruption in the Russian Federation. In her book *Putin's Kleptocracy*, Karen Dawisha estimates that such bribery and corruption annually amounts to approximately \$300 billion. To give some sense of the impact of bribery on the Russian economy, \$300 billion is roughly one-third of Russia's 2016 state budget.¹² It is extremely unlikely that a majority of those corrupt profits would stay in Russia. More likely, much of that money is transferred out of Russia to the financial safe havens, or to the West through those offshore tax havens. Given the scale of bribery and corruption in Russia over more than fifteen years, one can see why the National Bureau of Economic Research estimates the cumulative capital

flows out of Russia at over \$800 billion.¹³ Dawisha's work is also supportive of the proposition that much of the capital that has been transferred is tainted.

This view is reinforced by the recent public exposure of transfers from Russian clients that passed through the Estonian branch of Danske Bank. The small Estonian branch saw more than €200 billion pass through the branch over almost a decade, despite concerns from the external Estonian regulator regarding the source of these funds, warnings from internal whistleblowers, and the resignation of correspondent banks dealing in dollar clearances who were worried about the bank's non-compliance with anti-money laundering standards.¹⁴ Clearly this was an open entryway into the Western financial system, easier than going through a tax haven, but it does also illustrate the scale of likely capital flows to the West from Russia.¹⁵

There are more capital flows into the offshore world from OECD states than from developing countries. The argument of this paper, however, is that while OECD-origin capital flows erode the tax base and some of the flows amount to illegal tax evasion, the overall effect of the money coming from developing countries, especially the tainted flows, is more damaging from both an economic and a security perspective.

In the first place, the effect of looting what often amounts to the budget revenues and other state and private assets of developing countries stunts their development. Undoubtedly, OECD states are damaged by the erosion of their tax base, which reduces the level of available public services or results in higher tax rates for those who do pay taxes. However, the damage to developing countries, which start at a lower level of economic development, is much greater; it can result in greatly decreased access to health care, much more limited levels of schooling, or reduced infrastructure

11 Ibid. It is worth pointing out that the numbers here are difficult to estimate and different researchers give differing figures. Sunstein provides a good overview of the problems and differing approaches in his essay review "Parking the Big Money," NYRB January 14, 2016, as does the reply by Christensen and Henry, "The Offshore Trillions," NYRB, March 10, 2016. Sunstein focuses on Zucman's research, which uses different calculations and produces smaller numbers of around \$7 trillion. The response to Sunstein explains why the transfers to havens may well be significantly larger than \$7 trillion, with Christensen and Henry estimating that the transfer may be \$21-\$32 trillion. They point out that Zucman relies principally on one survey of IMF data of fifty states and does not include whole classes of assets. The answer is that given the opacity of the systems that aim to hide assets, carrying out an assessment with great accuracy is extremely difficult. Zucman has focused as far as possible on peer reviewed research, which by its nature is limited. Henry's more investigative approach provides insight but cannot provide a grounded account of the numbers, though it does provide some sense of likely scale. Hence this paper has relied more heavily on Henry's work than Zucman's.

12 Karen Dawisha, *Putin's Kleptocracy: Who Owns Russia* (New York: Simon & Shuster, 2014), 1, and "Russian Government submits federal draft budget for 2017-2019 to State Duma," Sputnik, October 28, 2016.

13 Filip Novokmet, Thomas Piketty, and Gabriel Zucman, "From Soviets to Oligarchs: Inequality and Property in Russia, 1905-2016," NBER Working Paper no. 23712, National Bureau of Economic Research, 2017.

14 Richard Milne and Daniel Winter, "Danske: Anatomy of a Money Laundering Scandal," *Financial Times*, October 4, 2018.

15 For further discussion on Russian offshore capital flows and the Kleptocratic state, see Anders Åslund, *How the US Can Combat Russian Kleptocracy*, Atlantic Council, 2018. <https://www.atlanticcouncil.org/publications/issue-briefs/how-the-united-states-can-combat-russia-s-kleptocracy>

funding, substantially undermining the future of those states. One can argue that stopping tainted capital flows should be a primary step when aiming to improve the economic prospects and life opportunities in developing countries.

“The West and its Western offshore economy, in other words, assists in making the rest of the world unsafe for democracy and simultaneously creates more enemies for the West.”

Second, for elites to loot at the scale that they do, they need somewhere safe to hold their ill-gotten gains. The West itself, including its offshore havens, provides that place and allows elites from non-Western countries to continue their plunder, safe in the knowledge that their assets are secure outside the country. Unlike elites in the US and Europe in the 18th, 19th, and early 20th centuries who ultimately promised their own populations that they would stop the looting, pay taxes, and adhere to more or less to the same rules, elites in developing countries today are under no such obligation.¹⁶ If they lost power at any point, these powerful players could simply get onto their Gulfstream jets and head West to collect their assets.

This leads to a third issue. Not only does this mean that developing countries remain badly run, and offer far fewer opportunities to their people, but they are also much less likely to become democracies, as the

long-term plundering of their economy by ruling elites made possible by Western safe havens creates incentives to keep those states in indefinite “plunder mode.” In other words, the West, with its rule of law and creation of the Western-governed offshore economy, has given corrupt elites in developing countries the tools and capacity to avoid ever establishing the rule of law in their own countries. They are the beneficiaries of the West’s firmly-established rule of law and can leverage that advantage against their own people to ensure that they never benefit from the rule of law themselves. This is the rule of law paradox.

Worse still, in order to justify or deflect from their plundering, these elites, despite having their assets in the West, often seek to turn the West into an enemy. This strategy of inciting nationalism and anti-Western feeling deflects from their plundering of the economy. The West and its Western offshore economy, in other words, assists in making the rest of the world unsafe for democracy and simultaneously creates more enemies for the West.

Fourth, because of the lack of financial depth of the financial safe havens for billions of tainted assets, much of the developed world’s tainted assets do not remain there. Instead, often under the guise of anonymous companies, those assets make their way to the West, principally the US and the UK, where authorities estimate that between \$125 and \$300 billion is laundered annually.¹⁷ The incentives for the financial system and business professionals to overlook these flows’ origins are not insignificant. Furthermore, once these assets are hidden in the West, they may well be used to buy influence and develop anti-Western propaganda. In other words, the West is importing and enabling the means for hostile enemy powers to further undermine its democracies.¹⁸

16 This is also a point for the West. One key reason for tackling the offshore economy in its broadest sense is that the more our own elites can offshore their wealth, the more they can plunder and disrupt our own societies.

17 This will also include money laundered from OECD countries, including from purely criminal, as opposed to political-criminal, sources of developed countries. See respectively US Dept. of Treasury, “National Money Laundering Risk Assessment,” 2015 and Margaret Hodge, “This is how to Curb Putin: Stop Welcoming Russian Kleptocrats,” *Guardian*, March 16, 2018.

18 Åslund, *How the US Can Combat Russian Kleptocracy*, 11.

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At first, it can seem as if the flood of tainted capital into the offshore economy, in particular the tax havens and other secrecy jurisdictions, is extremely difficult to stop. It is true that the hidden nature of companies' ownership and assets held in tax havens makes it challenging to gain information. These assets are protected by immensely capable professionals who have been dubbed the "wealth defense industry."¹⁹ This army of secret-keepers will create long chains of shell companies that bar access to information, shift assets to other jurisdictions, and raise endless procedural issues to frustrate the work of law enforcement agencies aiming to unravel the tainted capital flows.

There are, however, a number of measures that could simplify authorities' ability to identify, freeze, and ultimately seize such tainted assets. The starting point is deep US and EU cooperation. If the two most significant Western jurisdictions are able to engage in deep cooperation to root out tainted money, then much can be achieved. Cooperative measures can be agreed upon, allies brought in, and physical offshore tax havens encouraged to buy into a more transparent and accountable capital flows regime.

A major problem with such US-EU cooperation is that at the EU level, institutions themselves have only limited powers. OLAF, the EU's anti-fraud agency, depends on the support of member states' law enforcement agencies. Its powers are also limited to fraud connected to the use or misuse of EU funds. This is significant: first, the tainted money flows of interest are not usually connected to EU funds. Second, this capital can easily pass through several EU states, and wholly relying on support from member states to investigate and prosecute means that any EU enforcement system is only as good as the weakest link in the chain. Any weaknesses in enforcement among member states is likely to be ruthlessly exploited by those organizing such capital flows.

Therefore, the foundational move for any effective US-EU cooperation is for EU institutions, and in particular the European Commission, to obtain the surveillance, investigative, and enforcement powers necessary. Ideally, the European Parliament and the European Council would grant legislative authority to the commission in a manner not dissimilar to powers



OLAF, the EU's anti-fraud agency, depends on the support of member states' law enforcement agencies. *Photo Credit:* Wikimedia Commons

granted to the commission in the field of competition law. One of the commission's directorate-generals would, ideally, be in charge.

There are, however, political and constitutional reasons why granting the European Commission direct criminal law powers is likely to be problematic. From the very conception of the European Union, member states have been unwilling to give the commission such powers. 20 EU institutions have limited power to adopt EU laws that carry criminal penalties; such legislation is

19 Ilya Zaslavskiy, *How Non-State Actors Export Kleptocratic Norms to the West*, Hudson Institute, September 2017.

20 For example, the valuable but member state-dependent 4th Money Laundering Directive, EU/2015/849, OJ L141/73, June 5, 2015.

implemented and operated by member states. Even OLAF wholly relies on EU member states to prosecute cases of fraud against the EU budget.

However, on closer examination, this limitation on the commission's civil law powers does not have to undermine its effectiveness in the battle against tainted capital flows. Civil powers can give the commission significant means to tackle such flows and engage in deep cooperation with the US and other allies. Such civil powers would include the ability to impose personal and corporate fines, freeze and seize assets, and disqualify and prohibit non-EU nationals from EU territory. The files could then be handed over to member state authorities to run criminal law prosecutions where appropriate. The initial scope of the EU jurisdiction would include money flows into the EU from third states and between EU states, as well as fraud on the EU budget.

Of particular importance would be the commission's ability to apply EU money laundering laws to member states. Here the "weakest link in the chain" argument is particularly applicable.²¹ As the former governor of the Central Bank of Cyprus has said,

"The political pressure on supervisors in small EU states with large offshore sectors, such as Cyprus, Estonia, Latvia, and Malta is so great that it is very hard for them to do the right thing."²²

Aside from political pressure, there is the asymmetry of resources between member state regulatory agencies in being able to effectively enforce the EU's anti-money laundering regime.²³ Sophisticated organized crime groups as well as looters of authoritarian states understand this asymmetry and seek to exploit it. The commission would not seek to run every money laundering case. It would aim to deal with major cases; maintain a supervisory jurisdiction that would permit it to intervene; receive complaints that could trigger

intervention; and permit member states to refer cases to the commission. All of the commission's measures would be civil in nature: account freezing, civil seizures, civil fines, and director disqualification. After such civil actions at the EU level, the processing of criminal cases would be handed over to member states to run.²⁴

A major barrier to detecting and suppressing tainted capital flows is the network of professionals within the banking, legal, and accounting communities who create the structures through which such capital can flow. One significant way to undermine the capacity of elites from developing countries to deploy such professionals to transfer and hide their ill-gotten gains is to utilize effective whistleblowing statutes. The most effective whistleblowing statute is the US Civil False Claims Act (CFCA), originally enacted by President Abraham Lincoln in order to protect the US defense budget during the civil war and then revived by President Ronald Reagan during the Cold War defense buildup.²⁵

Under the CFCA regime, any perpetrator of fraud on the US Treasury (which in essence covers any US funding) could be subject to a fine of three times the loss to the Treasury. A whistleblower who discovers fraud and reports it to the US Department of Justice could ultimately be rewarded with one-third of the recovery. Since its revival in 1986, the CFCA has proved to be the most effective anti-fraud statute in history, with over \$30 billion in recoveries; it is considered to have deterred hundreds of billions of dollars of fraud.²⁶

Under the financial reforms introduced by the US in the Dodd-Frank Act after the financial crisis, the CFCA was extended beyond simply fraud of public funds. Today, a person who discovers a wide range of securities frauds—including accounting fraud, bribery, market manipulation, skimming or other improper diversion of funds, and Ponzi schemes—and reports them to the US Securities and Exchange Commission (SEC) may

21 Joshua Kirschenbaum and Nicolas Veron, *A Better European Architecture to Fight European Money Laundering*, Peterson Institute for International Economics, December 2018, 4.

22 *Cyprus, Russia's EU Weak Link?* EU Observer, September 25, 2018.

23 Kirschenbaum and Vernon, *A Better European Architecture to Fight European Money Laundering*, 4.

24 Kirschenbaum and Vernon, *A Better European Architecture to Fight European Money Laundering*, 4. The authors argue for the creation of a European Money Laundering Authority. As argued in this paper, the economic and security problems surrounding dark money flooding into the West and particularly the EU are not limited to money laundering, nor is the solution here simply the EU's application of a money laundering law. A broader range of tools is required, including an EU equivalent of the Civil False Claims Act and controls over shell companies' assets. The accumulation of these powers looks far more like a department of justice than an independent EU agency. Furthermore, all EU agencies are subject to significant implementation delay as member states seek to negotiate where the agency may be ultimately located. Placing these responsibilities with the commission would short-circuit the location argument and permit these operations to be up and running much faster.

25 For a historical, policy, and legal discussion of the role of whistleblowing statutes in common law jurisdictions from Edward I to President Reagan, see Alan Riley, *The Civil False Claims Act: Using Lincoln's Law to Protect the Community Budget*, Centre for European Policy Studies, 2003.

26 "The National Whistleblower Center (NWC) - Protecting Whistleblowers," National Whistleblower Center (NWC). <https://www.whistleblowers.org/>.



Today, a person who discovers a wide range of securities frauds—including accounting fraud, bribery, market manipulation, skimming or other improper diversion of funds, and Ponzi schemes—and reports them to the US Securities and Exchange Commission (SEC) may obtain between 10 and 30 percent of the monetary sanctions recovered by the SEC. *Photo Credit:* Wikimedia Commons

obtain between 10 and 30 percent of the monetary sanctions recovered by the SEC.²⁷

The CFA legislation was activated by lawyers working for Bradley Birkenfeld, the private banker who revealed the extent of Swiss bank participation in hiding \$20 billion of US taxpayers' offshore wealth. UBS, his

former employer, was fined \$780 million; reports of the whistleblowing prompted 33,000 Americans to report offshore accounts to the US tax authorities, generating an additional \$5 billion for the US government. In addition, on the basis of evidence provided by Birkenfeld, US authorities opened an investigation into eleven other banks. Birkenfeld himself was paid \$104 million

²⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Sec. 922, Pub. L. 111-203, 124 Stat. 1376 (2010).

in reward money.²⁸ More recently, it is reported that the whistleblower Howard Wilkinson in the €200 billion Dansk Bank money laundering scandal is making a Dodd-Frank whistleblowing claim to US authorities.²⁹

Cooperation between the SEC and the European Commission, with both being able to deploy CFCA-style whistleblowing incentives, would allow them to much more easily disrupt the flow of tainted capital due to the significant reach of those powers. With the European Commission applying such powers, whistleblowers from across the European continent and EU states' overseas territories would be able to safely disclose the movement of tainted capital within most of the Western economies and the physical offshore sector.

“Since its revival in 1986, the CFCA has proved to be the most effective anti-fraud statute in history.”

A second major method that the EU and US can deploy to disrupt such illegal capital flows is to freeze all assets held by anonymous shell companies or trusts, whether they are held in bank accounts, securities, or real estate. Such assets would then be subject to an assessment process illuminating their ultimate beneficial owners, and then another assessment uncovering the source of the funds that permitted the original acquisition of the asset, stock, other financial security, or the holding of liquid funds.

While this would clearly be an effective means to disrupt tainted capital flows, freezing the assets of anonymous companies may initially appear to be a radical step. However, one has to ask: why would such companies be used, if not for illicit gain? True, closed family companies may prefer to hold arrangements in such a

manner; equally, there may be some commercial logic in keeping the name of a potential major acquirer out of the public domain in order to forestall higher asking prices from the seller; or there may be personal security reasons. However, such cases are a thin justification for permitting anonymous companies. In cases where justified personal security concerns are an issue, saving provisions could protect them from further disclosure. Similar legislation already exists in the EU's Fourth Money Laundering Directive.³⁰

This also leads to a point of principle that corporate limited liability is a privilege that permits individuals to operate their businesses while limiting their personal risks. The quid pro quo is disclosure. This has been traditionally limited to the annual accounts of the company. It is not unreasonable, however, to argue that in order to properly understand whom one is dealing with, access to annual accounts is insufficient, and the identity of the beneficial owners should also be held on the company register.³¹ There is also a question of how modern anti-laundering and know-your-customer principles are compatible with anonymous companies where financial institutions may not be able to ascertain who is the ultimate beneficial owner.

Much of the debate on anonymous ownership of real estate, bank accounts, and securities has focused on introducing ownership registers in OECD countries. The difficulty with this solution is that the current restrictions on the use of anonymous companies are limited. For example, one can own real estate in Mayfair or Florida through a British Virgin Islands entity that does not disclose the beneficial owner.³² The anonymous ownership legislation, by contrast, would tackle all anonymous companies.

It would seek to undertake two tasks. First, it would utilize the “freeze, assess, release, or seize” policy. Second, it would follow the example of the Latvian legislation and seek to prohibit any transaction by any

28 Stephen Kohn, “Whistleblower Brad Birkenfeld Rewarded Record \$104m for Exposing how UBS Helped Rich Evade Taxes,” *Democracy Now*, September 12, 2012.

29 Mr. Wilkinson has the same lawyers as Mr. Birkenfeld: Kohn, Kohn & Colapinto LLP. For a detailed account of the Dansk Bank scandal, see Bradley Hope, Drew Hinshaw, and Patricia Kowsmann, “How One Stubborn Banker Exposed a \$200 Billion Russian Money Laundering Scandal,” *Wall Street Journal*, October 23, 2018.

30 This principle of justified reasons for maintaining anonymity is already established in the 4th Money Laundering Directive and could be applied to the post-freezing assessment process described above.

31 As Global Witness also points out, not knowing whom one is dealing with on the other side of a commercial transaction can be extremely damaging. GW gives numerous accounts of the damage to businesses that do not know whom they are really contracting with. “Chancing It: How Secret Company Ownership is a Risk to Investors,” *Global Witness*, 2017.

32 The problem with the 4th Money Laundering Directive, which requires disclosure of beneficial ownership of companies, is that it only applies to entities incorporated in a member state. Article 30 (1) reads, “Member states shall ensure that corporate and other legal entities incorporated within their territory are required to obtain and hold adequate, accurate, and current information on their beneficial ownership, including the details of the beneficial interests held.”

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financial institution, corporation, or public authority with an anonymous company.³³

A freezing, assessment, release, or seizure policy will also address a particularly American aspect of the problem. US states like Delaware are taking on an increasingly significant role as US onshore tax havens by providing “anonymity services.” Delaware is probably the world champion registrar of anonymous shell companies; in 2017, 200,000 were created, and approximately half of these were shell limited liability companies (LLCs). This registration system generates approximately one-quarter of the state’s revenues.³⁴ Clearly, there are significant constitutional difficulties as well as political difficulties for Washington to rein in the states.³⁵ Freezing all of the assets of anonymous companies and trusts is a means of cutting the Gordian Knot binding this dilemma.

“One can own real estate in Mayfair or Florida through a British Virgin Islands entity that does not disclose the beneficial owner.”

With a freeze, assess, release, or seize policy, the suspect assets are immediately in the hands of the US, EU, and other Western authorities, and the onus is on the alleged owners to prove title and the source of funds. This policy would dramatically increase the ability of law enforcement to identify tainted assets and deter such capital flows in the future. The alleged owners would be given a significant period of time—perhaps three years—to demonstrate title and the original source of funds. If the assets were not claimed, or title and source not proved within those three years, the assets would be transferred to a public fund (discussed further below).

As the Atlantic Council’s Anders Åslund points out, that deep dark money is protected below what could be twenty or thirty layers of anonymous shell companies. The approach here should therefore be to freeze all of the assets in a chain of companies if even a single

anonymous company is found there. Banks that have a single anonymous company in a chain of transactions and banks that pass money through or provide financing would also face fines.

One danger is that given the vast control held by elites from developing countries over the states they are looting, they may well be able to manufacture documentation to prove title, for example. To combat this, agencies would be established in the US, EU, and other states to oversee the ownership title and source of funds assessment. A small fee would be placed on the frozen funds to pay for both agencies to perform an assessment and ensure that the funds are not released to thieving elites who are merely creating documents after the fact.

What would likely happen is that as soon as anonymous shell companies are impossible to use to launder tainted capital, non-anonymous companies would be used instead. In response, the SEC and the European Commission would undertake a follow-up process of investigating suspect companies for hiding their true ownership and source of funds, with the freezing, assessment, and ultimate seizure of assets. It is likely that the US and EU whistleblowing statutes would play a major role in this process of uncovering what might one call “covered” anonymous companies.³⁶

The practical argument against freezing the assets of anonymous companies and trusts is if only the US and the EU do this, it will have not much effect. The counter-argument is in part that given their size, the US and the EU are the central pillars of any effective policy to tackle tainted capital flows. Thereafter the US and the EU would seek initially all OECD nations and other states to join in undertaking a freezing, assessment, and then release or seize policy. States and financial entities who refused to participate would find their access to the Western financial systems limited. In essence, maintaining a registration of anonymous companies would cut a state off from the Western financial system and the use of the dollar or the euro, and would greatly limit local elites’ ability to hold assets in the West.

This then brings in the second part of the counterargument. When dealing with such huge flows of tainted

33 Ivana Kristo and Elodie Thirion, *An Overview of Shell Companies in the EU*, European Parliament Research Service, October 2018, 33. In the US, given the constitutional issues, Congress could probably only forbid federally regulated institutions and federal institutions from cooperating with anonymous companies.

34 Åslund, *How the US Can Combat Russian Kleptocracy*, 11.

35 Nevada, South Dakota, and Wyoming are also significant players in the anonymous shell company business.

36 There would be a clear fraud issue here, as the assertion of ultimate beneficial ownership would be false.



Victims of the downed flight MH-17 or Ukrainians affected by the illegal invasion of their country could be compensated by seized Russian assets. *Photo Credit: Wikimedia Commons*

capital, the elite looters of developing countries do not want to hold those assets anywhere but in the West. Even when assets are nominally held in offshore tax havens, the actual physical assets are often held in London or New York. This is because, given the large amounts of capital involved, their owners do not want them to be at risk in jurisdictions that do not have robust rule of law, an independent judiciary, or the political resilience of major Western states.³⁷ The other point is that given the sheer size of the US and EU economies, the range of real estate there, and the diversity and depth of the Western financial system, it is possible to hide trillions of dollars relatively unnoticed. It is much more difficult to do so in the rest of the world.

It should therefore be possible to severely disrupt tainted capital flows by freezing the assets of anonymous companies already held outside developing countries and denying new capital flows the means to transfer assets

out of their home jurisdictions through anonymous corporate shells or trusts. In addition, the cooperation of the financial havens will make it much more difficult for elites from developing countries to make and hide transfers in the West or its offshore sector.

Such a freeze, assess, release, or seize policy then leaves the US, EU, and other participating authorities with a conundrum. It is likely that this policy will leave Western authorities with significant assets in their hands running into the hundreds of billions of dollars. It is not possible to send the tainted assets immediately back to their home countries because the assets would in all probability be reacquired and re-exported by the same corrupt elites.

One solution, then, is to create a series of national funds that can be used to pay down legitimate claims against the state that was the original source of the funds. In addition, the assets could be used to provide scholarships

³⁷ James S. Henry, "Taxing Tax Havens," *Foreign Affairs*, April 12, 2016.

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at Western universities for students from the looted countries and provide humanitarian support to residents of those countries. The balance of the funds would remain available at the disposal of a legitimately elected democratic government, which could effectively make use of those funds in the public interest.

To give a practical example, assets that had been frozen and ultimately seized because they had been earned through Russian elites' activities in illegal rent extraction, bribery, and corruption would soon accumulate into a fund of significant size. Under this policy, the fund's trustees would protect the assets, while a compensation commission³⁸ would assess legitimate

claims against the fund. For example, the families of the victims of downed flight MH-17 or Ukrainians who were forced to flee their homes in Crimea or the Donbas would be able to make claims against the fund. International courts and international arbitration claims against the Russian Federation could also make claims before the compensation committee. The remaining balance of the fund could provide Russian students with scholarships in the West, support for balanced Russian language media, and humanitarian assistance. The fund could also undertake research on how to improve Russian civil and economic life post-Putin, with the aim of being ready to assist a democratic reformist post-Putin government once it assumed power.

³⁸ A model for the compensation process could be the UN Compensation Commission for Kuwait for claims arising from the invasion of that country by Iraq. See Caron and Morris, *The UN Compensations Commission: Practical Justice Not Retribution* (2002) *European Journal of International Law*, 183.

CONCLUSION

There are a number of other valuable steps that could be taken to reduce the options for those aiming to hide and launder ill-gotten money. However, enhancing US and EU cooperation provides an effective platform for reducing the options for tainted capital flows. Furthermore, freezing the assets of anonymous companies would immediately reduce the capacity of malicious actors to deploy their influence and propaganda operations against democracies. Enhanced whistleblowing powers on both sides of the Atlantic would mean that the authorities would be much more likely to gain further evidence of tainted capital flows and deter new sources.

The establishment of national funds from looted assets would also provide a means of turning the tables on extractocrats or kleptocrats. Rather than destabilizing their own countries and seeking to destabilize the West, such funds would begin to destabilize them. The public establishment of such funds would provide an initial indication of the scale of thievery that these elites had engaged in against their own people, and the sources and size of the money in the funds would be public knowledge. The fund administrators would also clarify that when the country became a functioning democracy, the funds would be available to its new leaders.

The UK and its overseas territories remain one of the major points of access to the Western financial system for tainted capital flows. The UK has shown some

determination recently by establishing domestic beneficial ownership registers and creating “unexplained wealth orders.”³⁹ However, even after Brexit has been finalized, it will be necessary to integrate the UK closely into the cooperation mechanisms developed by the EU and the US in order to ensure there is no remaining access point or safe harbor for tainted capital.

“The establishment of national funds from looted assets would also provide a means of turning the tables on extractocrats or kleptocrats.”

Over the last two decades, the West has permitted its financial systems and the financial safe havens it established to be purloined by malevolent actors who have undermined their own countries’ futures. Intentionally or not, with their actions, these kleptocrats also seek to undermine the integrity of our financial and democratic institutions. As a result, it is critical that the US and the EU now focus on effective measures to suppress and deter these flows—for their own sake, and for the sake of developing countries that remain the kleptocrats’ greatest victims.

³⁹ For a discussion of how Unexplained Wealth Orders (UWO) work, see “First Ever Unexplained Wealth Order Issued,” Organized Crime and Corruption Reporting Project, March 2, 2018.

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