FACTCOALITION
Financial Accountability & Corporate Transparency

Briefing Memo

April 2018

Analysis of Concerns Raised by Opponents of the Draft Counter Terrorism and Illicit Finance Act

To: Interested Parties
From: The FACT Coalition
Date: April 4, 2018
RE: Beneficial Ownership Definition and Compliance with the Discussion Draft of the Counter Terrorism and Illicit Finance Act.

The purpose of this memo is to offer detailed responses to several common concerns raised by opponents of the discussion draft of the Counter Terrorism and Illicit Finance Act. Those concerns are:

1. if the intent standard would lead to civil or criminal penalties for unwittingly providing incorrect or incomplete information;
2. if the definition of a 'beneficial owner' is too complex;
3. if the information is too hard to collect; and
4. if the crimes committed were serious.

The responses below explain why none of these concerns is persuasive. In one instance, a concern is in direct conflict with opponent's own statements.

We offer this memo to inform the debate going forward.

1. Intent Standard Protects Filers from Liability for Innocent Mistakes.

Multiple versions of proposed incorporation transparency legislation before the U.S. Congress create criminal offenses for "knowingly" or "willfully" engaging in certain types of fraudulent conduct when disclosing beneficial ownership information required by the bills. Consistent with those earlier approaches, Section 9 ("Transparent Incorporation Practices") of the Counter Terrorism and Illicit Finance Act (CTIFA) discussion draft before the House Financial Services Committee[1] incorporates the same reasonable and workable standards.[2]

"Knowingly" and "willfully" are commonly and widely understood legal concepts, requiring *intentional* misconduct, not inadvertent conduct resulting from good faith mistakes, negligence or error. The standard in the legislation is consistent with existing laws and also provides equal or greater protection for filers than the standard in the American Bar Association's own Model Business Corporation Act in

---

[1] *See* House Committee on Financial Services, Joint Hearing entitled "Legislative Proposals to Counter Terrorism and Illicit Finance", Nov. 29, 2017, *available at* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402691.

[2] *See* Counter Terrorism and Illicit Finance Act Discussion Draft Dated November 14, 2017 (4:42 pm), "(c) Penalties", at 24 (line 17), *available at* https://financialservices.house.gov/uploadedfiles/bills-115hr-pih-ctifa.pdf (last accessed March 3, 2018) [hereinafter "CTIFA Discussion Draft"].

which the ABA selected the lesser of these two standards, "knowingly", as the appropriate standard for culpability in the signing and filing of false information with secretaries of state.[3]

Additionally, the ABA has developed guidance on "detecting and preventing money-laundering." In that guidance, the ABA repeatedly uses a "knowing" standard to determine when there should be legal culpability. For example, the guidance states:

> *As a matter of general principle, the legal profession does not want any exceptional or special treatment for lawyers who are knowingly involved in criminal activities – if so involved, such lawyers are also criminals and should be treated accordingly.*

The ABA wrote in its letter of opposition to the CTIFA that its guidance is "designed to help lawyers fight these problems …. ***rather than the burdensome and costly rules-based approach of the legislation***" (emphasis added). In other words, the ABA prefers its guidance over legislation, even though its guidance uses the "knowing" rather than the more stringent "willful" standard.

We have no doubt that the individuals who drafted the ABA guidance did so in good faith. However, because U.S. lawyers are either unaware or unwilling to follow the ABA's voluntary guidance, it has simply not worked. Systemic problems continue as U.S. lawyers repeatedly form companies with hidden owners on behalf of suspect or unknown parties, making necessary the enactment of legislation, with penalties for failing to ascertain and disclose the identity of the persons behind U.S.-formed entities.

Aside from the ABA, others have asserted that the bill will unjustly penalize those who simply misunderstand its disclosure requirements. That is not the intent nor the plain language of the bill authors, which is why the bill explicitly covers only *intentional*—that is, knowing or willful—violations of the filing requirements. If an individual does not know that the beneficial information they have submitted is false, they have not committed an offense under the bill.

Moreover, U.S. businesses are already well aware that submitting false information to government authorities is unacceptable and can result in penalties, and so already use due care in completing government forms. Many states, including company formation leaders like Delaware, Florida, Nevada, North Dakota, and Wyoming,[4] among others,[5] already require incorporators to sign and certify the accuracy of information included on their formation documents, some under penalty of perjury. U.S.

---

[3] American Bar Association, Model Business Corporation Act (2016 Revision), Sec. 1.29 Dec. 9, 2016, *available at* https://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/2016_mbca.authcheckdam.pdf.

[4] *See* Articles of Incorporation forms: Delaware, https://corp.delaware.gov/incstk09.pdf (last accessed March 5, 2018); Florida, http://dos.myflorida.com/sunbiz/start-business/efile/fl-profit-corporation/instructions/ (last accessed March 5, 2018), *see also* False official statements, Fla. Stat. Sec. 837.06 (2017), *available at* http://www.leg.state.fl.us/Statutes/index.cfm?App_mode=Display_Statute&URL=0800-0899/0837/Sections/0837.06.html (last accessed March 5, 2017); Nevada, http://nvsos.gov/sos/home/showdocument?id=668 (last accessed March 5, 2018) (signed under penalty of perjury); North Dakota, http://www.nd.gov/eforms/Doc/sfn16812.pdf (last accessed March 5, 2018) (signature with caution that false statements may be subject to criminal penalties); Wyoming, http://soswy.state.wy.us/Forms/Business/PROF/P-ArticlesIncorporation.pdf (last accessed March 5, 2018).

[5] For example, Colorado incorporation documents are filed under penalty of perjury. Colorado Secretary of State, Articles of Incorporation for a Profit Corporation Sample form [PDF], http://www.sos.state.co.us/pubs/business/sampleForms/ARTINC_PC.pdf (last accessed March 5, 2018).

businesses know that the very act of signing a document signifies responsibility for the information contained therein and will not be surprised that the bill incorporates that same standard of care.

It is also worth noting that businesses face similar and sometimes even more stringent standards of care for forms submitted to federal authorities. For example, the IRS penalizes knowing false statements in SS-4 forms;[6] federal law goes further and uses a strict liability standard—with no required showing of intent—to penalize false statements in a securities registration statement;[7] while the False Claims Act uses a knowing standard for reports filed under that Act.[8] The proposed bill is in full alignment with those longstanding laws.

2. Beneficial Ownership Definition Uses Common Terms and is Not Complex.

Some bill opponents have raised concerns about the use of the terms "directly" and "indirectly" when identifying the persons who control or benefit from a covered entity. But both are common legal concepts as well as common sense terms. Both are necessary to avoid loopholes that would otherwise undermine the law. For example, Fusion TV taped a segment in which a reporter created a company for her cat, Suki.[9] The transaction, which was legal, demonstrates the problem with definitions that allow nominee owners to be listed on incorporation papers without also identifying the true owners standing behind those owners of record.

The definition in the Counter Terrorism and Illicit Finance Act is the same as the definition already adopted by Congress in the National Defense Authorization Act for Fiscal Year 2018. In Section 2876 of H.R. 2810, the relevant part reads:

> *(A) IN GENERAL.—The term beneficial owner— (i) means, with respect to a covered entity, each natural person who, directly or indirectly— (I) exercises control over the covered entity through ownership interests, voting rights, agreements, or otherwise; or (II) has an interest in or receives substantial economic benefits from the assets of the covered entity.*

The proposed bill would take the same approach as this recently enacted law.

In addition, the terms "directly" and "indirectly" have long been used in federal statutes to define ownership, enabling the bill to draw upon an existing body of law. For example, the Foreign Account Tax Compliance Act, which was adopted by Congress and signed into law as a part of the HIRE Act, P.L. 111-147, in 2010, includes this ownership provision in Section 1473(2):

> *"(2) Substantial United States Owner.—*
>
> *(A) In General.—The term 'substantial United States owner' means—*
>
> *(i) with respect to any corporation, any specified United States person which owns, directly or indirectly, more than 10 percent of the stock of such corporation (by vote or value),*

---

[6] Internal Revenue Service. "Instructions for Form SS-4." Https://www.irs.gov/pub/irs-prior/iss4--2007.pdf. July 2007.
[7] Herman & MacLean & Huddleston, 459 U.S. 375, 382 (1983).
[8] The United States Department of Justice. "The False Claims Act: A Primer." https://www.justice.gov/sites/default/files/civil/legacy/2011/04/22/C-FRAUDS_FCA_Primer.pdf.
[9] Natasha Del Toro. "Watch how easy it is to start an anonymous shell company for your cat," *Fusion TV*, April 3, 2016. https://fusion.tv/story/287187/delaware-cats-shell-company/.

> *(ii) with respect to any partnership, any specified United States person which owns, directly or indirectly, more than 10 percent of the profits interests or capital interests in such partnership, and*
>
> *(iii) in the case of a trust … any specified United States person which holds, directly or indirectly, more than 10 percent of the beneficial interests of such trust.*

That same language appears in the implementing regulation, 26 CFR 1.1473-1(b)(1). The phrase "directly or indirectly" also appears repeatedly throughout 26 CFR 1.1473-1(b). In short, the concept of direct and indirect ownership has been an established element of U.S. tax law since at least 2010, and has been used in multiple U.S. agreements with foreign governments and foreign financial institutions.

Additionally, US securities laws have used "directly/indirectly" language for decades to define who must file disclosure forms related to the ownership of shares in a publicly traded corporation.

Section 13(d) of the Securities and Exchange Act of 1934 imposes the disclosure obligations on major shareholders of publicly traded corporations, defined as persons who acquire, directly or indirectly, beneficial ownership of certain shares of a publicly traded entity. The section is codified at 15 USC 78m(d)(1) which states in the pertinent part:

> *(d) REPORTS BY PERSONS ACQUIRING MORE THAN FIVE PER CENTUM OF CERTAIN CLASSES OF SECURITIES*
>
> *(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78l of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78l(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a–1 et seq.] or any equity security issued by a Native Corporation pursuant to section 1629c(d)(6) of title 43, or otherwise becomes or is deemed to become a beneficial owner of any of the foregoing upon the purchase or sale of a security-based swap that the Commission may define by rule, and is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition or within such shorter time as the Commission may establish by rule, file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations, prescribe as necessary or appropriate in the public interest or for the protection of investor[s]…*

The rule goes on to state additional information to be collected.

The implementing regulation, 17 CFR 240.13d-3(a), defines a "beneficial owner" of a security as

> *"any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and /or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security."*

Subsection (b) of the implementing regulation also uses the direct/indirect language to prohibit any scheme to evade the reporting requirement:

> *"Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security."*

The proposed bill definition reflects these longstanding federal provisions as well as the consensus language already adopted by Congress as recently as last year.

3. The Information is Not Hard to Collect.

Another concern regarding the beneficial ownership definition is that its terms may be too complex for small business owners to understand without costly legal advice, consequently putting these businesses at unfair risk of running afoul of the bill's requirements. In actuality, small businesses are best equipped to provide the information for the very reasons that some argue make small businesses less able to comply. Small businesses do not generally have complex ownership arrangements and can easily identify their beneficial owners.

The kind of complex business schemes that enable persons to have undiscoverable, or difficult to discover, ownership interests generally require the intervention of attorneys. One letter explained that small businesses "are less likely to have sophisticated in-house lawyers or the resources to engage outside attorneys,"[10] which suggests small businesses will not be using attorneys to design complex ownership structures. Legitimate businesses will be focused on their operations, not on organizing structures designed to hide or obfuscate ownership.

For those companies that do have more complex ownership arrangements and include private investors, opponents of the bill suggest that businesses do not know who their shareholders are. The business groups in our coalition assure us, however, that their members know their investors and the investors, expecting returns on their investment, are timely and forthcoming about where and to whom to send dividends or other payments.

Beyond anecdotal information, according to a GAO study (Company Formations, GAO-06-376: Published: Apr 7, 2006. Publicly Released: Apr 25, 2006), all states already require companies to know their shareholders. On page 43, they note:

> *Our review of state statutes found that all states require corporations to prepare a list of shareholders, typically before the mandatory annual shareholder meeting, and that almost all states require that this list be maintained at the corporation's principal or registered office. Industry experts told us that LLCs also usually prepare and maintain operating agreements that generally name the members and outline their financial interests.*

Existing state laws requiring shareholder lists are not substitutes for the proposed bill. The GAO report notes that the list of shareholders names the owners of record, not the beneficial owners, and may

[10] National Association of Criminal Defense Lawyers (NACDL), American Civil Liberties Union (ACLU), & FreedomWorks, Letter re Discussion draft of "Counter Terrorism and Illicit Finance Act", at 5, Nov. 28, 2017, *available at* https://www.nacdl.org/WorkArea/DownloadAsset.aspx?id=49145&libID=49117 (last accessed March 5, 2018) [hereinafter "NACDL Letter"].

include legal entities. However, these longstanding state requirements suggest that the collection of ownership information is not burdensome and, for many legitimate businesses, may already be in hand.

4. Anonymous Companies Facilitate Serious Crimes.

Some bill opponents have suggested that the offenses targeted by this bill are somehow trivial. On the contrary, *intentional* misrepresentation or falsification of beneficial ownership information—the actual conduct penalized in the bill—does more than complicate the administration of business formations. It has been documented[11] that misuse of corporate structures facilitates and promotes severe crimes – terror financing, sanctions evasion, human trafficking, drug trafficking, trading in counterfeit goods, grand corruption, tax evasion and more—by making identification of the individuals behind companies engaged in those crimes, difficult or impossible. When an individual forms a company, they create a new and distinct legal person that can engage in a wide range of activities—legal and illegal, alike—within and across borders, both domestic and international. Allowing individuals to hide their ownership of a company creates opportunities for individuals to engage in misconduct with impunity, frustrating both government administration and justice.

For more information, contact Clark Gascoigne at cgascoigne@thefactcoalition.org.

[11] *See e.g.*, Global Witness, The Great Rip Off, Sept. 25, 2014 (examining 22 case studies involving the use of anonymous companies), *available at* https://www.globalwitness.org/en/campaigns/corruption-and-money-laundering/great-rip-off/ (last accessed March 5, 2018); Fair Share, Anonymity Overdose, Aug. 1, 2016 (examining 10 case studies of the use of anonymous companies in the opioid epidemic), *available at* https://www.fairshareonline.org/content/anonymity-overdose-how-our-opioid-crisis-and-shell-companies-are-linked (last accessed March 5, 2018).