Due Diligence on Ownership Structure of Legal Entities and detecting shell activity

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Establishing beneficial ownership

An “Ultimate Beneficial Owner” (UBO) is normally an individual who ultimately owns or controls the third party or on whose behalf a transaction or activity is being conducted.

In order to really understand your client and gain comfort that the assets with which you are dealing with are legitimate, ultimate beneficial ownership needs to be established.

Questions to Ask
• Is the UBO’s source of wealth transparent and does it appear legitimate?
• Is the UBO a Politically Exposed Person?
• Has the UBO been subject to any negative news which give cause for suspicion of ML/TF?

Points to Note
• A legal entity is not generally a UBO
• DD and KYC procedures should seek to identify the natural person from whom funds have come
• Determining ultimate beneficial ownership will also ensure international sanctions can be complied with effectively, by screening the person(s) against lists of sanctioned individuals.
• Nominees or Corporate Directors are not UBOs.
• Identification of beneficial ownership looks for the one in ownership or/and control.

Identification of UBOs is an absolutely essential step in truly Knowing your Customer (KYC)
Due Diligence on legal entities

- Obtain full structure leading to the ultimate beneficial owners with more than 10% / 25% controlling interest
- Verify each level of the structure through corporate documents/Company Registries
- In case of Nominee Shareholders obtain trust agreement between Nominee Shareholder and actual UBOs
- All related parties should be captured (UBOs, directors, shareholders, signatories, related legal entities)
  - ✓ Screening of all related entities against PEP / Sanction Lists.
  - ✓ Search for negative media for all related entities
- Obtain Sanctions / PEP representations
- Concentrate on the UBO’s source of wealth / funds
  - ✓ Is it commensurate to the UBO’s background
  - ✓ Evidence / Justification
  - ✓ Is it transparent and legitimate?
- Consider obtaining Intelligence Reports from Investigative Firms
Increasing pressure on transparency
Beneficial Ownership Registries

EU Initiatives:
2016 - 4th AMLD
▪ Beneficial ownership: access by competent authorities / persons with legit interest.

2018 - 5th AMLD
▪ Full public access to the beneficial ownership registers
▪ Interconnection of registers and sharing of AML data between tax Member States
▪ EU list of tax jurisdictions that do not respect good tax governance standards

USA Initiatives
2020-AMLA
▪ The Anti-Money Laundering Act of 2020 (AMLA) provides for the establishment of a beneficial ownership register
▪ The register will be administered by FinCEN who can disclose information to law enforcement and regulators, and to financial institutions, for purposes of customer due diligence, if authorised by the reporting entity.
Dozens of foreign citizens linked to corruption, embezzlement of public funds, organized crime and tax crime have opened companies in Luxembourg, seemingly without any red flags, suggesting a failure in the regulation of the corporate industry.

One year after the creation of the new register of ultimate beneficial owners, barely half of Luxembourg companies have declared at least one UBO. Only 1/5 of investment funds based there have done so.

Registry limitations: (i) only searchable by company name, not by owner, (ii) administrators listed as UBOs for 1/3 of all entities in the registry (in the case of funds the numbers rise to 80%)
Major Scandals associated with shell companies

The Panama Papers: Exposing the Rogue Offshore Finance Industry

A giant leak of more than 11.5 million financial and legal records exposes a system that enables crime, corruption and wrongdoing, hidden by secretive offshore companies.

Source: ICIJ
Major Scandals associated with shell companies

Paradise Papers: Secrets of the Global Elite

A major global collaboration reveals secrets from one of the world’s most prestigious offshore law firms, a specialized trust company and 19 company registries in secrecy jurisdictions.

Source: ICIJ
Major Scandals associated with shell companies

The Russian Laundromat

- Company A based in the United Kingdom
- Company A signs a bogus contract with UK based Company B in which A agrees to lend B a large, fictitious, amount of money

Based on the court order, the Russian companies have to transfer the black money to Company A in a bank account in the European Union

Company A takes Company B to a Moldovan Court where the debt is "certified"

The debt is guaranteed by companies in the Russian Federation and by a Moldovan citizen

Source: OCCRP
FinCEN Advisory on Shell Companies

Definition:
- Non publicly traded corporations, LLCs and trusts with
  - no physical presence
  - generally little to no independent economic value

Use of Agents and Nominee Incorporation Services
- Can play a central role in the formation of such companies
- They can serve as a “resident agent”
- Use of Nominee Officers, Directors, Shareholders
- Use of Nominee Bank Signatory
FinCEN Advisory on Shell Companies

Elements cited in Suspicious Activity Reports involving shell companies

- Inability to obtain information to identify originators or beneficiaries of wire transfers
- High amount of sporadic activity, inconsistent with normal business patterns
- Payments have no stated purpose, no reference to goods or services or identify only a contract / invoice
- Goods or services do not match the company’s declared business activities
- Transacting businesses share the same address
- Unusually large number of beneficiaries
- Involvement of beneficiaries in high risk / offshore countries
- High-value payments between shell companies with no apparent reason
FinCEN Advisory on Shell Companies

Managing the Risks of Providing Services to Shell Companies

- Potential to abuse shell companies for illicit activity must be recognized
- Need to assess risks involved and take steps to manage these risks
- Policies, procedures, controls, systems, training adjusted accordingly
- File Suspicious Activity Reports in case illicit activity is identified
Latvia & Cyprus
Prohibitions on FIs relating to shell companies

**Definition:**
- No physical presence in its country of domicile
- No established economic activity
- Registered in a jurisdiction not requiring submission of financial statements
- Tax resident in a “tax haven” country (only Cyprus)

**Exceptions**
- Holding company
- Holding intangible assets / real estate/ vessels
- Convincing proof of engagement in legit business

**Cyprus**
- Latvian registered companies
Use of Shell Companies

- Geographical discrepancies between the location of the account, operations and the registration address
- Use of tax havens to register legal entities
- Unknown beneficial owners
- Lack of legitimate business / purpose
- Lack of audited financial information
- Recently incorporated
- Entity has no discernible online presence
- Entity has no employees / business activity
- Company formation services in offshore site
- Information mismatch during due diligence
Detecting shell activity red flags

- Focus on analysing the beneficial owner and his/her source of funds/wealth
- Focus on economic substance of legal entity
- Review of transaction activity and ensure it is commensurate with declared economic activities
- Compare information obtained by client with open source information
- Training of staff in detecting shell activity
- Specialised System alerts which detect shell activity
Case Study – Use of shell companies to evade sanctions on Iran

- Full 36 story building was seized by the US Government in 2017; the Court decided to distribute the proceeds ($0.5m-$1m) to families of victims of terrorism
- Alavi Foundation was accused of helping hide the fact that Assa Corporation was a front for the Iranian government
Case Study – Use of a frontman

- **Merlin Investments Ltd** applied to open a bank account
- Declared UBO is **John Smith**
- Signatory of the bank account is **Mark Veber**

### Due Diligence

<table>
<thead>
<tr>
<th>Company Website:</th>
<th>Red Flags</th>
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</thead>
<tbody>
<tr>
<td>• “Investing in the Financial &amp; Energy Sectors. Founded by John Smith and an international investor”</td>
<td></td>
</tr>
<tr>
<td>• “Governance and decision making was gradually transferred from Russia to Cyprus since 2009”</td>
<td></td>
</tr>
<tr>
<td>• Very poor website</td>
<td>• No mention who the “international investor is”</td>
</tr>
<tr>
<td>• CV of <strong>John Smith</strong> ...states that he was a Deputy CEO of RussiaNova (Russian Energy company) from 1991 to 2009.</td>
<td>• Inconsistency – company was founded in 2012!</td>
</tr>
<tr>
<td></td>
<td>• Website looks fake</td>
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**RussiaNova** and its UBO (**Viktor Venus**) were included on OFAC’s SDN list in 2018
Case Study – Use of a frontman

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<tr>
<td><strong>Unaudited Financial Statements:</strong>&lt;br&gt;Totals Assets €100m&lt;br&gt;(Investments of €95m: 3% holding in Bank of Venus and 5% holding in Energy Plus Group)</td>
<td>• Source of funds of John Smith could not be justified from his salary as Deputy CEO&lt;br&gt;• All investments are in companies controlled by Viktor Venus (SDN)&lt;br&gt;• 95% of total liabilities are to companies belonging to Viktor Venus (SDN)</td>
</tr>
<tr>
<td>Total Liabilities €80m&lt;br&gt;(Short term loan from Russianova of €16m&lt;br&gt;Long term loan from Neowood Ltd of €60m)</td>
<td>Indication that John Smith is a front man for Viktor Venus (SDN).</td>
</tr>
<tr>
<td><strong>Internet Search:</strong>&lt;br&gt;Allegations were traced in Russian sites that John Smith is described as “the person being used by the Viktor Venus for his interests in Cyprus”</td>
<td>Internet search shows that he is a close associate of Viktor Venus (SDN).</td>
</tr>
<tr>
<td><strong>Signatory:</strong>&lt;br&gt;Markus Veber</td>
<td></td>
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</table>
Thank you!
Key Information and Contact Details

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