Working Paper

Beneficial ownership in the investment industry

A strategy to roll back anonymous capital

Andres Knobel*

7 October 2019

NOTE: This is a working paper to start the discussion on how to increase transparency in the investment industry and the trading of securities. If you have any feedback or suggestions please contact Andres Knobel, Researcher at the Tax Justice Network, at andres@taxjustice.net.

With the support from

***** This paper received invaluable contributions from Delphine Nougayrede, Mark Morris, Joshua Kirschenbaum, Kevin Comeau, Lakshmi Kumar, Moran Harari and Markus Meinzer. However, the views expressed in this paper are solely those of the author and do not necessarily represent those of the contributors.

Executive Summary

The investment or asset management industry refers to people's and institutions' money that is invested through different types of investment funds to hold real assets (eg land, gold, commodities, infrastructure projects) and financial assets (eg shares of companies listed on a stock exchange, shares of unlisted companies, debt issued by corporations or countries, indexes, complex financial instruments such as options, swaps and futures, etc.).

Some investment funds are classified as retail and hence are available to any person. Mutual funds, referred to as "undertakings for collective investment in transferable securities" or UCITS in the EU, are an example of such investment funds. Other investment funds, referred to as alternative investment funds or private investment funds, are only available to high net worth individuals or professional investors. Examples of alternative investment funds include hedge funds and private equity funds. Globally, assets invested in mutual funds and institutional funds exceeded USD $46.7 trillion in 2018. More than USD $8.8 trillion was invested in alternative investment funds in 2017.

Investment funds do not always hold onto assets for a long period of time. Usually they engage in securities trading or other financial transactions, where financial assets may be held for just a few seconds. In relation to these financial transactions, in 2018 the total value of securities (ie financial instruments) processed in the US was USD $1.85 *quadrillion* (USD $1,850 trillion). To put these astronomical numbers into perspective, the US had a gross domestic product (GDP) of 'merely' USD $19.4 trillion in 2017.

Current regulation of the investment industry and securities trading primarily focuses on protecting investors and maintaining the soundness of the investment and securities market. While financial institutions and other intermediaries are usually also bound to perform customer due diligence and anti-money laundering procedures to prevent illicit financial flows, the secrecy underpinning the investment industry and securities trading significantly undermines measures to address tax evasion, corruption and money laundering.

Not surprisingly, investment entities have been involved in several corruption and money laundering scandals, including Malaysia's 1MDB (misappropriation of billions from Malaysia's state investment fund) or the theft of Venezuela's oil revenues. The US has repeatedly been unable to effectively enforce its own sanctions against other countries because of the secrecy in the investment industry and securities trading. For example, Iran was able to invest in US securities worth billions of dollars by hiding behind financial intermediaries. Even after the US found out that Iran was the ultimate owner of those investments, Iran managed to keep the investments by hiding behind a different intermediary.

The more recent Cum-Ex and Cum-cum scandals revealed how investment funds and banks defrauded EU countries of billions of dollars by misleading tax authorities about who owned shares of companies, taking advantage of tax exemptions when

these should not have been applicable and claiming tax refunds when no tax had been paid at all.

The main secrecy problem in the investment industry and securities trading is that no single party has access to a full picture of individual chains of ownership, meaning nobody fully knows who owns what. At best, some parties have access to partial information. Out of the many intermediaries involved in the investment industry and securities trading (eg brokers, custodian banks, central securities depositaries, etc), the only ones most likely to be able to identify an end-investor and check the origins of their money are those that are closest to the end-investor. However, these intermediaries may not necessarily be able to identify which underlying securities (eg shares of Apple or Google, South American junk bonds or interest rate swaps) the end-investor indirectly own through intermediary investment vehicles.

To put this into perspective, it would be as if a passenger flying from India to San Francisco via Dubai and New York was only subject to a passport and luggage check at the New Delhi airport. Airport officers at New Delhi doing the checks would not be able to know where the passenger’s trip ends. They would only be able to see Dubai or at best New York as the final destination. The other countries and airports would not have access to the passenger’s passport details and would not be able to look inside the passenger’s luggage. They would have to trust that the New Delhi airport checks would have detected and stopped any suspicious activity. At best, other airports could examine New Delhi’s airport’s security procedures.

Since custodian banks are usually the intermediary closest to the end-investor, they are the parties that are likely to run the checks on the end-investor’s identity and the origin of their money (eg the investor’s name is John Smith, and his income is related to his work as an accountant). However, banks have proven to be unable to consistently detect and prevent money laundering. This may be related to the lack of sources to verify end-investors’ details or to the fragmentation of information. Another factor may be incentives against diligence, considering that banks and other intermediaries’ business models depend on getting more clients and more trades. On top of this, banks have at times been found to be actively facilitating financial crimes, especially when supervision and sanctions are negligible. Older and more recent cases of banks failing to prevent or actively helping money laundering or tax evasion include Riggs Bank, Deutsche Bank, Danske Bank, UBS and Credit Suisse, to name a few.

While one could argue that anti-money laundering regulations have become stricter in the past years, the truth is that the first scandals are more than 20 years old but new scandals kept emerging as recently as 2018, brining new records on the value of money being laundered or taxes being abused. Besides, criminals may directly open or purchase their own banks for illegal purposes, like Odebrecht’s global corruption scheme. Therefore, trusting that banks and other intermediaries, will police a trillion dollar industry with uneven government oversight or no public scrutiny represents a huge risk.

Given the presence of many intermediaries, a possible solution would be to require all intermediaries to conduct checks, similar to how passengers are scrutinised at multiple checkpoints in every airport they travel through. However, intermediaries block information from each other by using omnibus accounts, that is, accounts where intermediaries pool together money or securities from many investors, without disclosing investors' identities. Intermediaries favour omnibus accounts because they make trades easier, they bring liquidity to the financial system and because they also prevent other intermediaries from identifying their clients (and so prevent competitors from stealing them). However, this secrecy also prevents other intermediaries from running their own anti-money laundering checks on the money being invested.

One could argue that the responsibility for identifying the end-investor and the origin of the money should be higher for a first-level intermediary (a custodian bank or investment fund) directly engaging with the end-investor (John). However, intermediaries who only engage in securities trading as requested by other intermediaries (without direct contact to the end-investor) should still be required to check the identity of the end-investor (John) on whose behalf a transaction is carried out. After all, in an international bank transfer, correspondent banks are now also required to know the identity of the account holder on whose behalf the bank transfer takes place. It is not enough for the correspondent bank to trust that everything is fine solely because another bank is asking for the transfer (on behalf of a customer).

Two recent transparency advancements improved the investment industry's situation, but only marginally. Many countries, especially in the EU, have started to establish beneficial ownership registries, where companies, trusts, partnerships and other legal vehicles have to disclose their "beneficial owners", the individuals who ultimately own, control or benefit from a legal vehicle. However, investment entities (as well as companies listed on a stock exchange, whose shares may be held by investment entities as underlying financial assets) are in many cases being excluded from the scope of these new beneficial ownership registries, either by law or in practice.

In other words, beneficial ownership registries do not solve problems stemming from the secrecy underpinning the investment industry and securities trading because they do not allow the public to see which end-investors own what securities. The only actors in the investment industry who directly benefit from beneficial ownership registries are the first-level intermediaries, usually custodian banks, who have the ability (and obligation) to identify the end-investor and its beneficial owners (eg John, and if John uses a company to invest his money, both the company and John should be identified). These intermediaries can use beneficial ownership registries to cross-check the information declared by their customer (the end-investor).

In contrast, beneficial ownership registries do not currently make the investment industry more transparent from the perspective of the public because even if the public has access to beneficial ownership information on a company, there is no indication that this company is in fact an end-investor in an investment fund. To the public, it would look like any regular company.

The other transparency breakthrough is the OECD's Common Reporting Standard (CRS) for automatic exchange of information. However, many loopholes and exemptions prevent the new standard from being truly effective at solving the secrecy problem of the investment industry and securities trading. For instance, the US is not implementing the standard. Secondly, the inability of lower income countries to join the CRS means no information will be collected in financial centres on wealthy investors who reside in these lower income countries. Thirdly, given that the CRS is meant for international exchange of information, banks or investment entities need not report on end-investors who are resident in their same country (ie a custodian bank in Germany would not need to report an end-investor who is also resident in Germany). Notwithstanding the many loopholes and exemptions, when the CRS does apply to the investment industry, it only covers information about the value and income from investment entities. It does not collect information on the underlying securities (eg shares in Apple or Google) held by investors through investment entities. This makes it impossible for authorities to detect misreporting or underreporting. Lastly, the CRS in principle permits authorities to use information received from automatic exchanges to tackle only tax evasion, not corruption or money laundering.

To address these secrecy problems, the most comprehensive solution to the secrecy underpinning the investment industry and securities trading could be to disclose every individual that directly or indirectly holds: (i) any interest in an investment fund, (ii) any interest in an underlying financial asset (eg a share in a company listed on a stock exchange), and (iii) how the individual holds these underlying securities, including all intermediaries involved.

Given the current trend of super-fast trading where securities may be held for just a few seconds, ownership could be reported regarding the situation at the end of the business day (identifying only the last end-investors who held each interest in the investment fund and in the underlying security at the end of each business day).

In addition, this comprehensive identification of the end-investor and its beneficial owner (the individual end-investor) should involve replacing omnibus accounts (that pool together money from many different investors) and employ segregated accounts at the end-investor beneficial ownership level. (An alternative could be to keep using omnibus accounts but to have a parallel reporting mechanism to identify the beneficial owner holding any interest).

As for implementation, one option could be to require beneficial ownership registries or central securities depositories to register this information. To be comprehensive in its scope, beneficial ownership thresholds for legal persons (currently at "more than 25%" of ownership) should be lowered so as to require any individual holding any interest in an investment fund or in a financial asset (eg holding one share in Apple) to be registered as a beneficial owner. This proposal assumes that "beneficial ownership" is not *just* about control, but also about any ownership, however small. An individual holding 0.1% in a listed company (let alone only one share) would have no decision making at all over the entity, but should still be registered as a beneficial owner. This no-de-minimis threshold approach already applies to trusts: all settlors, trustees, protectors and beneficiaries are considered beneficial owners, even if they have no control or interest in the trust.

By identifying every individual holding at least one share or unit of interest it would be possible to account for every underlying financial asset, and every interest in an investment fund in the world (or at least in a given market).

This granular ownership detail about every existing investment fund and every underlying financial asset would ensure that there is no case of underreporting or double reporting of financial assets (to prevent evading income tax, capital gains tax, or trying to obtain illegal tax refunds).

This very low thresholds (far lower than the current "more than 25%") make sense especially in the investment industry that has trillions of dollars under management. Even a 0.1% could be relevant to measure inequality or to investigate whether a person is engaging in money laundering. For example, as of September 2019, merely 0.1% of Apple shares are worth USD 220 million.

With regard to access to this granular information on the beneficial owners of investment funds and underlying financial assets, in the ideal scenario it should be publicly available (as it already applies in the EU for beneficial ownership of companies). This would reduce costs of data security, handling access to the data, and would allow an extra pair of eyes to verify information.

The second best option could be for this granular information to be available only to authorities.

A third best scenario would be to ensure access of this granular transparency to only intermediaries within the investment industry and securities trading. In this case, any intermediary would be able to identify the end-investor and beneficial owner, and so would be able to apply anti-money laundering checks on the origin of the money.

A fourth, much less transparent option would be to have information on end-investors and beneficial owners for just underlying financial assets, even if there is no disclosure on how these interests are held (intermediaries, including investment entities would not be disclosed). In this case, each intermediary could disclose to a neutral party, such as a securities regulator or the central securities depository, the daily percentage of shareholdings ultimately owned by each individual end-investor. For example, if at the end of the business day, John owned 0.01% of company A through investment entity 1, custodian bank X and broker Y and 0.05% of the same company A through investment entity 2, custodian bank Z and broker Q, then the neutral party could report at the end of business day that John owned 0.06% of company A, without disclosing through which intermediaries. A similar reporting scheme called "securities holdings statistics" (SHS) is applied by the European System of Central Banks.

This fourth scenario would not allow other intermediaries to run checks on John and the origin of his money, but would at least reveal the entire list of financial assets held in the world (or in the applicable market). This would also prevent underreporting. For example, if only 99% of the world's securities are accounted for, authorities would know to investigate for the missing 1%. At the same time, this would reveal cases of misreporting or double-reporting, for example if two persons pretend to be the owners of a share when only one of them holds it (as it happened in the Cum-Ex tax fraud). It would also reveal ownership over securities directly held by end-investors (not through investment entities).

A fifth, and even less transparent option, would work oppositely to the fourth option. This would involve disclosing the end-investors and beneficial owners of investment entities, instead of the end-investors of the underlying securities. This alternative is less relevant because investment entities ultimately hold securities or other assets, over which there would be no comprehensive transparency. Information on ownership over investment entities would add transparency and help for instance on tax issues, to make sure investment income is being taxed. However, it would not make it possible to detect cases of underreporting, misreporting or double reporting over securities by investment entities (eg Cum-Ex tax fraud) nor would it reveal cases where securities are held directly by end-investors (not through investment entities).

In opposition to these comprehensive proposals, one could argue that investment funds are very different from each other, and that alternative investment funds pose more risks than a mutual fund or a pension fund for employees. However, if transparency measures covered only alternative investment funds, criminals and anyone trying to remain hidden would like try to abuse any type of fund falling outside the scope of the new transparency measures. This would require more supervision in all countries to prevent this type of abuse. Moreover, in this scenario, it would not be possible to account for every financial asset and how they are held. Underreporting, misreporting or double-reporting would continue to be a risk.

In conclusion, these proposals attempt to answer the question about who owns what (beneficial ownership transparency of financial assets, at least of shares of listed companies) and how they own them (all the involved intermediaries, including the beneficial owners of investment funds).

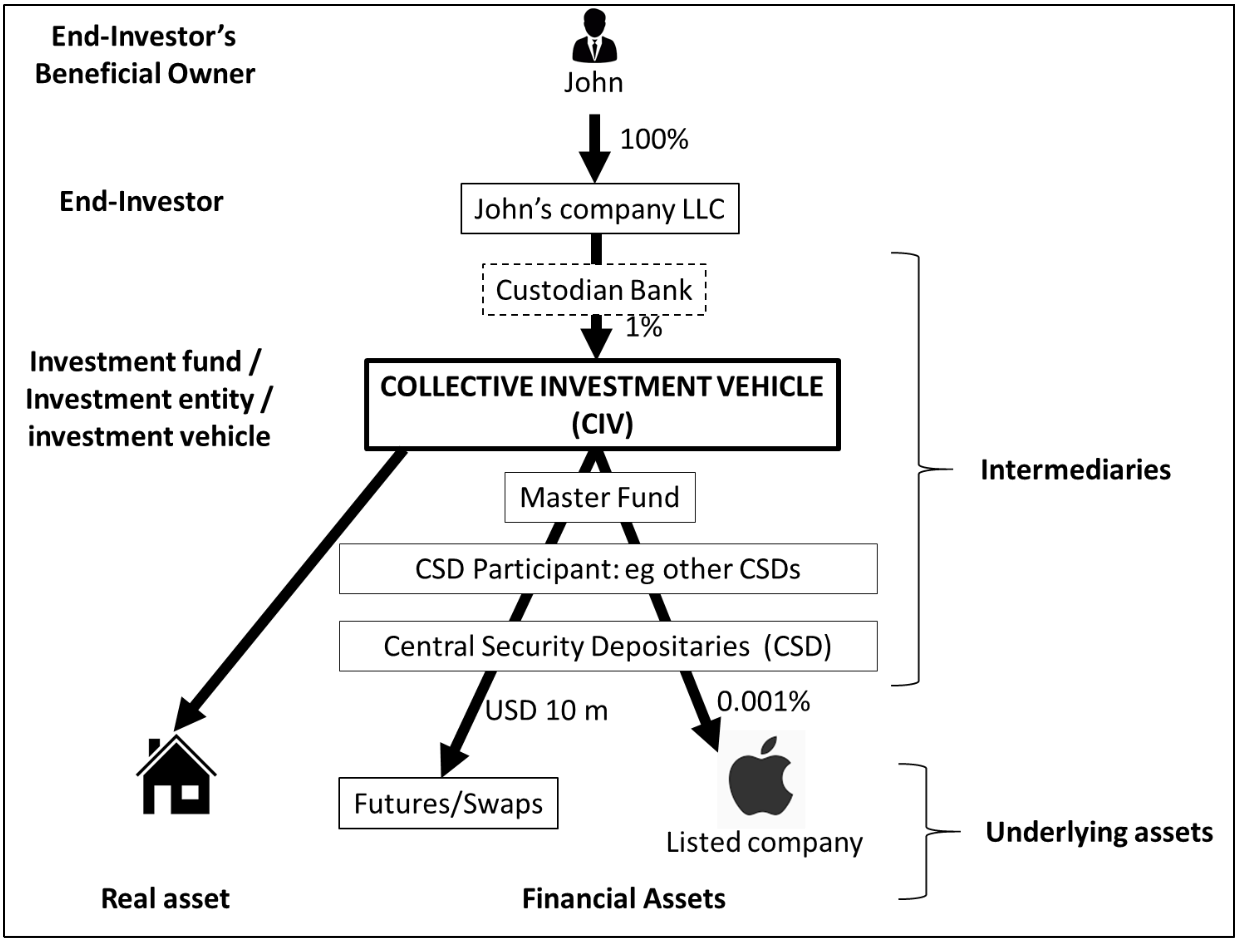
Contents

Foreword and definitions

This working paper attempts to start the discussion about the need for more transparency on the investment industry and the trading of securities. This paper does not focus on the different types of investment funds or intermediaries, but on the need for more transparency, the current obstacles that create secrecy and proposals on what that transparency could look like.

This paper uses terms with the following meanings, as described in figure A.

Figure A. Actors involved in the investment industry



The term "end-investor" always refers to the ultimate interest holder, meaning the individual or household who has an interest in the investment fund. This end-investor is the ultimate interest holder of the underlying assets (eg shares of Apple) indirectly held through the investment fund or through other intermediaries. This paper never considers an "investment fund" or another intermediary as an end-investor, even if the underlying assets (eg shares of Apple) are held in the investment fund's name.

Given that the end-investor may use a company or another legal vehicle to hold their investments in the investment fund, this paper assumes that the end-investor is an entity (eg "John's company LLC"). The end-investor's beneficial owner (John) is the natural person who ultimately owns and controls the limited liability company (LLC) acting as an end-investor ("John's company LLC").

If John directly held an interest in the investment fund under his own name (not using a company), then he would be considered the end-investor. However, this paper considers that an entity is used as an end-investor, so John is defined as the end-investor's beneficial owner.

Investment fund, investment vehicle, collective investment vehicle (CIV) or investment entity are used interchangeably. They refer to either retail funds (eg mutual funds), or alternative investment funds (eg hedge funds) or any type of collective scheme that pools together money from different investors to invest in different types of assets, as described in the prospectus or other fund documents. These funds usually have a fund manager who takes investment decisions. While mutual funds available to any person may be very different in terms of risks and regulation from alternative investment funds available only to high net worth individuals or professional investors, this paper treats all investment funds equally because transparency is needed for all types of investment funds.

Many different types of intermediaries may be involved in the investment industry and securities trading: different types of brokers who engage in financial trades, custodian banks where the investor holds the account to invest in investment funds, the investment funds, central securities depositories where a register of securities is held, and so on. The different types of intermediaries and their roles is beyond the scope of this paper. Their reference is only to explain that many players are involved in the holding of financial assets, and that these players hold partial information, making it very difficult for each of them to know the identity of the end-investor's beneficial owners, the financial assets ultimately held and all the intermediaries involved in such holding.

Real assets (eg real estate, gold) held by investment funds are outside the scope of this paper. The focus is on financial assets (mainly shares of companies listed on a stock exchange) as underlying assets held by investment funds.

Investment funds do not hold assets for ever. They may also engage in trading of financial assets or securities, either to follow an investment strategy (eg acquire assets with lower risk) or as part of financial transactions to obtain income (short selling, etc). The paper refers to this as securities trading, with the purpose of highlighting that financial assets are not statically held, but may be constantly changing, requiring each involved intermediary to do the proper checks.

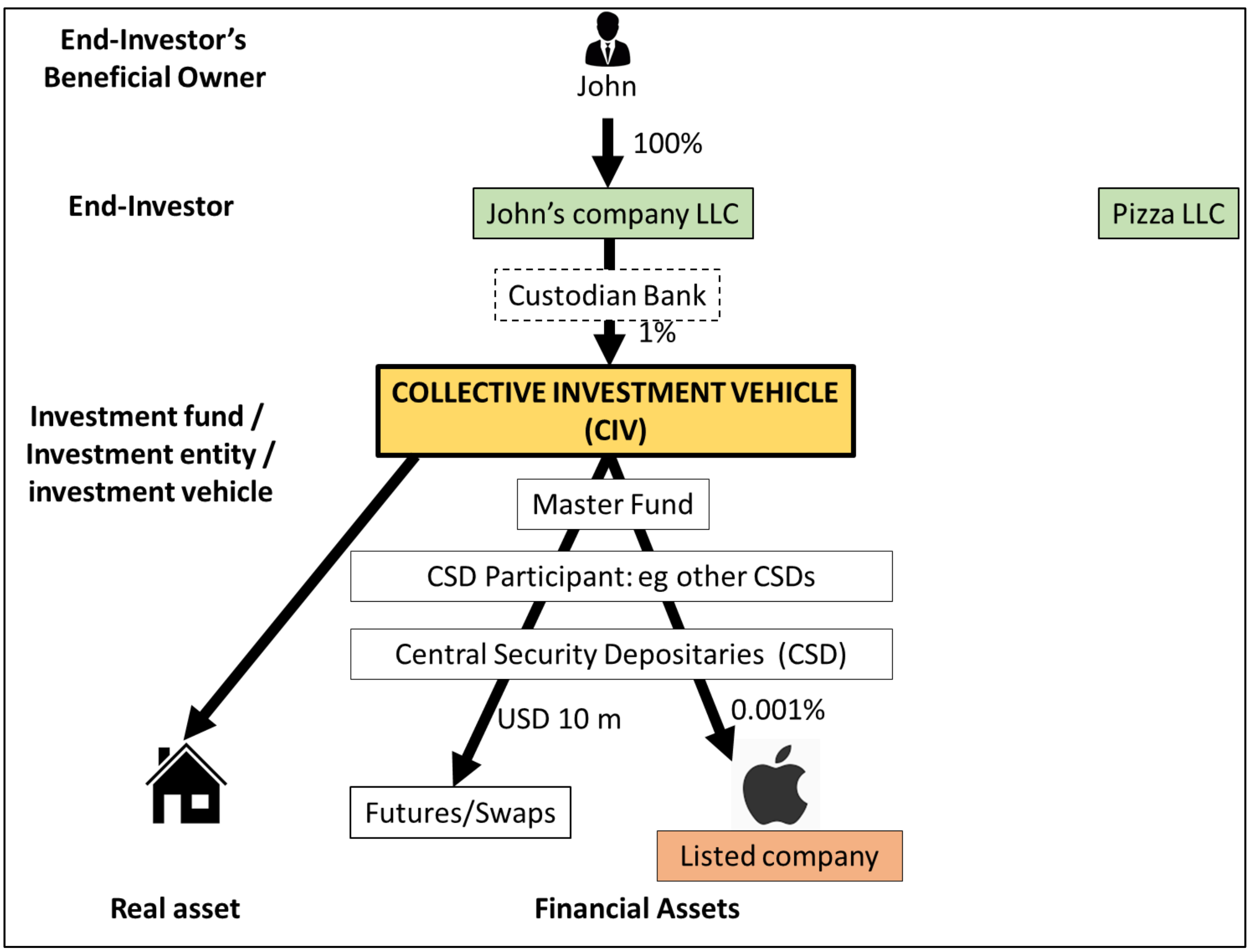
Beneficial ownership

As for beneficial ownership, this paper considers the concept to refer to the natural person who ultimately owns, controls or benefits from a legal vehicle or asset. In other words, beneficial ownership here has a focus on ownership, regardless of control. This means that a person holding any interest in a legal vehicle, in an investment fund or in an underlying asset (eg in a company listed on the stock exchange) should be considered a beneficial owner, even if they had such a small ownership that they would never be able to exercise any control over the investment fund or over the listed company. The rationale behind this is that complete transparency requires accounting for every interest in an investment fund or financial asset. Even a 0.1% ownership in an investment fund or listed company may represent millions of dollars. It would be necessary to know if that 0.1% is related to tax evasion, money laundering, etc.

Legal vehicles subject to transparency

This paper considers the presence of legal vehicles that could hinder beneficial ownership transparency in three different instances: the end-investor, the investment fund and the underlying financial asset (eg a company listed on the stock exchange).

Figure B. Three instances where legal vehicles should be subject to transparency



The first case (in green) refers to the ultimate interest holder, where the end-investor John uses a legal vehicle (in this case a limited liability company or LLC) to hold his investments. John could have also held his investments directly under his own name, but if he uses a legal vehicle (in this case "John's company LLC"), he is adding another layer of secrecy.

In many countries with beneficial ownership registries, eg the EU, John's entity ("John's company LLC") would have to register and disclose John as its beneficial owner. The same would happen to a regular company engaging in any business, say "Pizza LLC" that sells pizza. However, beneficial ownership registries only disclose beneficial owners. They do not indicate whether the entity is also an end-investor with interests in an investment fund, or merely a regular company engaging in business, eg selling pizza. From the perspective of the public accessing the beneficial ownership register, both companies would look the same.

The second case (in yellow) refers to the investment fund as a legal vehicle. While an investment fund may be organised in different ways, they are usually organised as limited partnerships, trusts or companies.

The third case (in red) refers to the underlying financial asset, supposing that it includes the shares of a company listed on the stock exchange. Opposite to this, if an investment fund directly held interests in real assets only, for example gold, this third case would not exist.

This paper focuses on the three instances where legal vehicles related to the investment industry and securities trading create obstacles to transparency.

1. Introduction

The investment or asset management industry refers to people's and institutions' money that is invested through different types of investment funds to hold real assets (eg land, gold, commodities, infrastructure projects) and financial assets (eg shares of companies listed on a stock exchange, shares of unlisted companies, debt issued by corporations or countries, indexes, complex financial instruments such as options, swaps and futures, etc.).

There are many different classifications for investment funds, for example depending on whether they are closed-end (fixed number of shares or capital) or open-end (unlimited shares or capital). Investment funds may also be classified as retail and hence available to any person, like mutual funds (referred to as "undertakings for collective investment in transferable securities" or UCITS in the EU), or alternative investment funds (also called private investment funds) which are available only to high net-worth individuals, and other sophisticated or professional investors.

In 2019, the Investment Company Institute reported that the total assets invested in regulated open-end funds (eg mutual funds, exchange-traded funds or ETFs, and institutional funds) was more than USD 46.7 trillion.[1] Preqin reported that assets

[1] https://www.ici.org/pdf/2019_factbook.pdf; 8.1.2019.

invested in “alternative investment funds” such as hedge funds, real estate funds and private equity funds was USD 8.8 trillion in 2017.[2]

Investment funds do not always hold these assets long-term. Usually they engage in securities trading or other financial transactions, where financial assets may be held for just a few seconds.

Most of the trading of these financial assets are handled through intermediaries such as central securities depositaries (CSDs). The US central securities depositary is called the Depositary Trust Company (DTC). In 2018, the total value of securities (financial instruments) processed by the Depositary Trust Company was USD 1.85 *quadrillion* (USD 1850 trillion).[3] To put these astronomical numbers in perspective, in 2017 the US gross domestic product (GDP) was ‘merely’ USD 19.4 trillion.

Countries and the private sector promote the investment industry because it brings liquidity to the economy by putting people’s savings into the market, allowing companies and governments to obtain financing for their endeavours. This is the theory. Unfortunately, “financialisation” has become an end in itself, where investors and companies engage in speculation (investing in financial instruments as if gambling in a casino) more than channelling the necessary funding for productive endeavours or to hedge (protect) themselves against negative scenarios in the real economy (eg an airline that wants to secure the price of oil for its planes). For example, just 3.5% of all business lending by UK banks went to Britain’s manufacturing sector in 2017, while 60% went to financial intermediaries, like commercial banks and private equity funds.[4] But the legitimacy and appropriate uses of the financial industry for financial speculation is beyond the scope of this paper.

While the investment industry tends to be highly regulated, provisions refer mostly to “investor protection”, that is, making sure that investors are aware of the risks of their investments and to prevent fraud. For example, the EU has a directive for regulated collective investment schemes called the directive on undertakings for collective investment in transferable securities (UCITS)[5]. This directive includes rules on information for investors to make it easier to understand the product they are investing in. The EU also has a directive for managers of alternative investments[6] such as hedge funds, private equity and real estate funds which are funds that are only available to sophisticated or professional investors (usually high net worth individuals or institutional investors who invest at least USD 1 million).

While financial institutions and other intermediaries are usually also bound to perform customer due diligence and anti-money laundering procedures to prevent

---

[2] https://docs.preqin.com/reports/Preqin-Future-of-Alternatives-Report-October-2018.pdf; 1.8.2019.
[3] http://www.dtcc.com/annuals/2018/#/financial-performance; 1.10.2019.
[4] Shaxson, Nicholas, *The Finance Curse: How Global Finance Is Making Us All Poorer*, 2018.
[5] https://eur-lex.europa.eu/legal-content/EN/LSU/?uri=CELEX:32009L0065; 2.8.2019.
[6] https://eur-lex.europa.eu/legal-content/EN/LSU/?uri=CELEX:32011L0061; 2.8.2019.

illicit financial flows (except for fund managers of private investment funds in the US[7]), the secrecy underpinning the investment industry and securities trading significantly undermines measures to address tax evasion, corruption and money laundering.

1.2 Illicit financial flows risks in the investment industry

Several factors contribute to the investment industry's secrecy, as described in section 3. Investment funds usually take the form of trusts or limited partnerships, which tend to have less registration requirements than companies (although investment funds are sometimes organised as companies). In addition, individuals may invest in investment funds through companies or other entities (instead of directly under their own name). Moreover, there usually are many intermediaries (brokers, custodian banks, central securities depositories, etc.) between the investor and the investment fund as well as between the investment fund and the underlying financial assets.

The investment industry's secrecy prevents all stakeholders (including authorities) from obtaining all the pieces of information necessary to creating a complete picture: the identity of the end-investors (eg John Smith), the origin of their funds used to acquire interests in investment funds, and the underlying financial assets (eg shares in Apple) these end-investors ultimately own through the investment funds. Some financial intermediaries may know nothing of the above.

This secrecy attracts illegal activities. The Financial Action Task Force's (FATF's) 'Guidance for a risk based approach for the securities sector' published in 2018 describes the money laundering risks associated with the investment industry where "securities markets are often characterised by complexity, internationality, a high level of interaction, high volumes, speed and anonymity."[8] The specific list of vulnerabilities includes:

> "global reach of the securities sector and speed of transactions across a multitude of onshore/offshore jurisdictions and financial markets; ability to transact in securities products via an intermediary which may provide a relative degree of anonymity; high liquidity of some securities products, which often enables their easy conversion to cash; complex products that may be offered before they are regulated (or not regulated at all) or rated for ML/TF [money laundering/terrorism financing] risks (e.g. the crypto-assets mentioned above); common involvement of a multitude of securities providers and intermediaries on behalf of both buying and selling principals

[7] Kirschenbaum mentions three gaps: fund managers are not required to: report or maintain records of the identities of the beneficial owners of the funds they manage; disclose their investments in the United States; maintain an AML compliance program or file suspicious activity reports (https://securingdemocracy.gmfus.org/russian-investments-in-the-united-states-hardening-the-target/; 27.9.2019).

[8] FATF, *Guidance for a Risk Based Approach for the Securities Sector*, 2018 <https://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/RBA-Securities-Sector.pdf> [accessed 2 August 2019].

or agents, potentially limiting the ability of any one participant to have complete oversight of the transaction; an often highly competitive and incentive-driven environment, which may lead to a higher appetite for risk, or failure to adhere to internal controls; pricing volatility of some products, particularly low-priced securities; transactions executed both on registered securities exchanges and elsewhere, such as over-the-counter (where parties trade bilaterally); challenges in pricing some securities products due to their bespoke nature or complexity."[9]

Joshua Kirschenbaum[10] describes recent corruption and money laundering scandals involving investment funds. In the infamous 1MDB corruption scandal related to Malaysia's state-owned development company, hundreds of millions of dollars were layered using investment funds: the money that originated from a 1MDB bond offering was "invested" in Curacao-based private investment funds. The money was then immediately transferred to shell companies controlled by the alleged perpetrator of the scheme[11]. Another complaint filed by the US Justice Department refers to the theft of hundreds of millions of dollars from Venezuela's state oil company, with the proceeds layered through a Malta-based investment fund.[12]

The secrecy underpinning the investment industry has also enabled banks, and other intermediaries to engage in tax fraud worth billions of dollars. In 2017, the Cum-Ex scandal revealed that banks, stock traders and lawyers had defrauded European countries of more than USD $60 billion in relation to a dividend tax and credit by simulating ownership over traded stock. Banks exploited the fact that no one has access to the big picture on who owns which shares, to pretend that two different parties separately owned the same share.

[9] FATF, *Guidance for a Risk Based Approach for the Securities Sector*.
[10] https://securingdemocracy.gmfus.org/russian-investments-in-the-united-states-hardening-the-target/; 1.8.2019.
[11] https://www.justice.gov/archives/opa/page/file/877166/download; 1.8.2019.
[12] https://www.courtlistener.com/recap/gov.uscourts.flsd.531919/gov.uscourts.flsd.531919.3.0.pdf; 1.8.2019.

Box 1. The Cum-ex and Cum-cum scandals

These scandals relate to illegal reimbursements of dividend tax. While dividend tax has to be paid when a company distributes dividends, some investors (but not all) are allowed to obtain a reimbursement for the paid dividend tax.

In the Cum-cum scandal, the fraud involved misleading authorities into believing that an investor entitled to obtain dividend tax reimbursements owned shares that were actually owned by an investor who was not entitled to reimbursements. The real owner of the shares, who could not legally obtain a reimbursement of dividend tax because for example they were resident in a different country, would temporarily transfer their shares to an investor who was able to receive a reimbursement for dividend tax. After the dividend tax was reimbursed, the shares were returned to the real owner. Both investors shared the money from the dividend tax reimbursement that should not have taken place.

In the Cum-ex scandal, authorities were misled into reimbursing the dividend tax to two different investors even though only one of them held the shares and paid the dividend tax. The "trick" involves the second investor engaging in a financial transaction ("short selling") to buy the shares from a third person and thus appearing to be a shareholder as well. However, this third person does not own the shares yet, and will actually get them from the first investor (so it is always the same shares that appear to be owned by different investors). The three parties are in this together and share the money from the extra dividend tax reimbursement (that was illegally received).

More information is available at the EU Parliament: http://www.europarl.europa.eu/cmsdata/158435/2018-11-26%20-%20Information%20paper%20on%20Cum-ex%20-%20Cum-cum.pdf; 5.8.2019.

Countries may also be interested in restricting access to strategic technologies and assets, and to prevent business with people and countries under sanction lists. However, if the identity of the end-investors remains unknown (except to some rogue intermediaries who are either negligent or complicit with the investor's criminal activities), it may be impossible for countries to enforce their own regulations.

Paradoxically, the US was unable to enforce its own sanctions against the Islamic Republic of Iran. In January 2014, Clearstream Banking (an intermediary based in Luxembourg) paid $151.9 million dollars to settle allegations that it had held US securities worth $2.81 billion on behalf of the Central Bank of Iran. Iran held the American securities through two intermediaries. The ownership chain began with an account that Iran directly held at Clearstream. This intermediary in turn held an omnibus account (on behalf of Iran and other clients) at a New York financial institution. The New York financial institution held the US securities. After the Iranian holdings were disclosed, instead of closing the account that Iran directly held at Clearstream, as would be necessary to abide by the sanctions, Clearstream decided to "bury it one layer deeper in the custodian chain". The account Iran directly held at Clearstream was transferred to another Clearstream account. This new account was under the name of a European commercial bank, disguising Iran's involvement. In other words, Iran remained the owner of USD 2.8 billion of US securities not through its direct Clearstream account, but through a European bank's Clearstream account.[13]

In relation to this, Joshua Kirschenbaum describes recent cases related to US investments by Russians. For example, the US-sanctioned Russian businessman Viktor Vekselberg invested in the US through Columbus Nova, a private investment firm.[14] Altpoint Capital, the private equity firm of Russian billionaire Vladimir Potanin, in 2015 bought a company that has a contract to store Maryland's state-wide list of eligible voters on its servers. The same company has also won data centre work for the Department of Defense and the Department of Labor.[15]

Secrecy may also thwart anti-trust regulations. When large investors own holdings in several competing companies, market competition among the underlying companies may be reduced, affecting consumers and the economy. If the ultimate owners of these competing companies cannot be known, then it may appear that these competing companies have different owners while in reality they are the same individuals. The anti-competition consequences are related to the goal of the individuals who ultimately own or control these companies. As described by Walker there is a theory that "because these common owners might prefer to maximize the values of their portfolios of companies, rather than the value of individual companies in isolation, this new reality has led to a concern that companies in concentrated industries with high degrees of common ownership might compete less vigorously with each other than they otherwise would."[16] Similar research by Fichtner et al has been done in relation to corporate holdings owned by the 'Big Three' passive investment funds: BlackRock, Vanguard, and State Street:

> "the ownership of the Big Three in the United States … together they constitute the largest shareholder in 88 percent of the S&P 500 firms…Through an analysis of proxy vote records we find that the Big Three do utilize coordinated voting strategies and hence follow a centralized corporate governance strategy… Moreover, the Big Three may exert 'hidden power' through two channels: First, via private engagements with management of invested companies; and second, because company executives could be prone to internalizing the objectives of the Big Three."[17]

[13] https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20140123_clearstream_settle.pdf; 6.8.2019.

[14] https://home.treasury.gov/news/press-releases/sm0338; 1.8.2019.

[15] https://securingdemocracy.gmfus.org/russian-investments-in-the-united-states-hardening-the-target/; 1.8.2019.

[16] David I. Walker, *Common Ownership and Executive Incentives: The Implausibility of Compensation As an Anticompetitive Mechanism* (Rochester, NY, 1 March 2019) <https://papers.ssrn.com/abstract=3345120> [accessed 5 August 2019].

[17] Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo, 'Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk', *Business and Politics*, 19/02 (2017), 298–326.

Moreover, secrecy over the ultimate owners of financial debt has prevented scrutiny of recent abusive actions by private funds against highly indebted countries. Vulture funds (considered alternative investments, and available only to high net worth individuals or institutional investors) have been found to exert enormous pressure against highly-indebted countries, in transactions considered predatory and abusive. Recent examples include Greece[18], Argentina[19] and Puerto Rico[20]. While it may be easy for vulture funds to show no mercy and exploit the law to achieve unfair but profitable results (after all, they would claim that they have fiduciary duties to obtaining the maximum profit), investors who ultimately benefit from these unfair transactions do have their reputation at stake. If there was transparency on the end-investors ultimately benefitting from these vulture funds, the situation may have been different. If the end-investors included public figures, university endowments or other respectable institutions, it would have been easier to put pressure on these investors to achieve fairer deals for the highly-indebted countries.

Financial assets and securities represent the dominant form of wealth for the wealthiest individuals, as described by Credit Suisse's Global Wealth Report 2018.[21] The same has been reported for France[22] and the UK[23]. Therefore, the investment industry's secrecy hinders measuring and tackling global inequality, which is already at alarming levels[24].

Lastly, secrecy makes it impossible to enforce current regulations on controlling interests of companies listed on a stock exchange. Many securities regulators require investors to disclose their identity when they surpass a threshold, usually 5% of ownership over a listed company[25]. However, if John owns 6% in listed company 1 through three funds: 2% through fund A, 2% through fund B and 2% through fund C, no one other than John will know that he owns more than 5% in company 1, making it impossible to enforce this disclosure requirement. In addition, listed companies may have such a high market capitalisation that ownership of less than 5% may still represent millions of dollars that could be related to illicit financial flows. For example, as of September 2019, 0.1% of Apple shares are worth USD 220 million.

---

[18] http://www.cadtm.org/Vulture-Funds-Lessons-from-Greece; 5.8.2019.

[19] https://unctad.org/es/paginas/newsdetails.aspx?OriginalVersionID=783&Sitemap_x0020_Taxonomy=UNCTAD%20Home; 5.8.2019.

[20] https://prospect.org/article/hedge-funds-win-puerto-ricans-lose-first-debt-restructuring-deal; 5.8.2019.

[21] https://www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/global-wealth-report-2018-en.pdf; 29.8.2019.

[22] https://wir2018.wid.world/part-4.html; 29.8.2019.

[23] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/774644/Wealth_National_Statistics_Commentary_2014-16.pdf; 29.8.2019.

[24] https://www.oxfam.org/en/even-it/5-shocking-facts-about-extreme-global-inequality-and-how-even-it-davos; 29.8.2019.

[25] https://www.sec.gov/fast-answers/answerssched13htm.html; 28.8.2019.

The investment industry's current transparency measures

While most countries have laws preventing tax evasion, corruption and money laundering, the secrecy underpinning the investment industry significantly undermines the ability to enforce these laws, as shown in the examples above.

The main secrecy problem in the investment industry and securities trading is that no single party has access to a full picture of individual chains of ownership (eg that John owns 0.001% of shares in Apple through 0.1% in investment fund A, which also involves custodian bank X, broker Y, central securities depository Z, etc). At best, some parties have access to partial information. For example, a custodian bank may know the identity of the end-investor (John) and the value of their holdings, but not the actual underlying financial assets held through the investment fund (such as shares of Apple). In other cases, a central securities depositary may know the exact number of shares held by an investment fund and their value, but not the identity of the end-investor who ultimately owns and benefits from those holdings. Authorities may request some information, but this will mostly be based on self-declarations by the taxpayer or disclosures by a financial institution (who is not able to see the big picture). Without access to full information it is impossible to cross-check information to prevent underreporting or misreporting.

There are two recent measures that bring more transparency to the investment industry: beneficial ownership registries and the OECD's Common Reporting Standard (CRS) for automatic exchange of information. However, different loopholes and exemptions described below undermine the new measures. Even when the measures do apply, they are not enough to bring an acceptable level of transparency to the investment industry. At most, they can only help cross-check what the end-investor reports when filing taxes.

The OECD's CRS for automatic exchange of financial account information helps in the fight against tax evasion, whenever an end-investor fails to declare income from investments. However, loopholes and a limited scope (described in section 4 below) prevent it from being truly effective.

Box 2. The importance of beneficial ownership transparency

Permitting individuals to own assets and operate in the economy through secretive companies, trusts and other legal vehicles rather than under their own name is the main strategy used to commit financial crimes. For example, a politician may set up a shell company to receive bribes, a wealthy person may create an offshore trust to evade taxes or to shield assets from a spouse or other creditors, and a drug cartel may set up hundreds of companies and bank accounts to launder money.

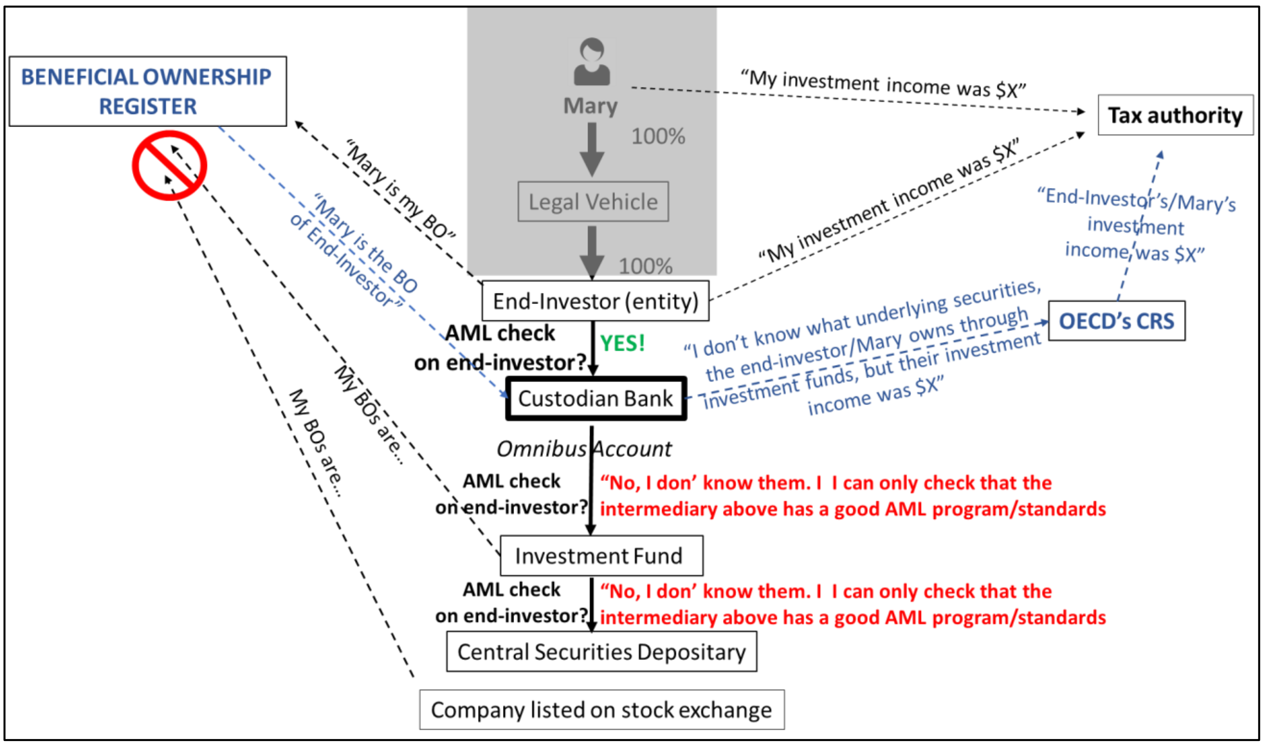
Beneficial ownership transparency makes a secretive legal vehicle obsolete by revealing the individuals that operate behind it, so that they are held liable for any wrongdoing (since a company, that is just a piece of paper, cannot go to prison).

Beneficial ownership registries refer to requiring companies and other legal vehicles to identify the individuals (natural persons) who ultimately own, control or benefit from these legal vehicles. However, not all companies or legal vehicles are covered by these beneficial ownership registries, especially many involved in the investment industry. In addition, definitions of beneficial owners usually have very high thresholds requiring a person to own more than 25% of the shares to be considered the beneficial owner of a company. In contrast, any investor could easily have less than 1% of an investment fund, and even less than 0.001% of a company listed on a stock exchange. Therefore, even if an investment entity is required to register in the beneficial ownership registry, investors would not pass the threshold to be disclosed. Beneficial ownership registries thus are unable to identify the end-investors who put money in investment funds or who own shares of companies listed on a stock exchange.

Where beneficial ownership registries are indeed useful is when it comes to identifying the beneficial owners of the end-investor, supposing that the end-investor is a company or another type of legal vehicle (instead of an individual). However, no one knows which individuals and legal vehicles are end-investors who have put money in investment funds. The only ones that would know this are the intermediaries holding the end-investor’s interests in the fund, very likely a custodian bank. In other words, beneficial ownership registries, at best, only help custodian banks or similar intermediaries to identify the beneficial owner of a company or entity that is investing in investment funds.

As will be discussed below, the investment industry deliberately chooses to pool together investments from many investors into ‘omnibus accounts’, making it easier to undertake transactions on behalf of all investors and to obtain liquidity (by circulating securities as collateral to support financial transactions), but also making it harder for other intermediaries to identify the end-investors behind those transactions. Intermediaries justify this secrecy for efficiency and liquidity and as a method to prevent other intermediaries from stealing their clients (the end-investors). Given that in principle only one intermediary will have access to the end-investor’s identity (very likely the custodian bank or broker that holds the end-investor’s interests in investment funds), this intermediary will be responsible for doing any know-your-customer (KYC) or anti-money-laundering (AML) checks. These checks are necessary to verify the identity of the end-investor (and if the end-investor is an entity to identify its beneficial owners); to make sure the origin of the funds is legitimate (instead of drugs, corruption or other illegal origins); and to confirm that no sanction or restriction applies to the end-investor. Other intermediaries will have no choice but to rely on the checks performed by the intermediary that has access to the end-investor's identity and its assessment of the origin of their funds. All intermediaries may have to comply with anti-money laundering provisions, but if they are unable to identify the end-investor, they will merely be able to check whether the other intermediaries have good anti-money laundering programs and other good practices, without being able to run checks on the end-investor itself.

Figure 1. Access to information under the investment industry



Beneficial ownership (BO) registries and the OECD's Common Reporting Standard (CRS) for automatic exchange of information [in blue] help, at best, to confirm information self-declared by the end-investor. Given that only one intermediary (a custodian bank) has access to the end-investor's identity, it is the only one able to perform know-your-customer and anti-money laundering (AML) checks on them. Other intermediaries, given the use of omnibus accounts, cannot run checks on the end-investor itself, but may merely check that the other intermediaries have good AML programs/standards.

1.3 Asking the fox to watch over the chicken house

Given that only one intermediary will have access to the identity of the end-investor, the whole industry's effective prevention of illicit financial flows essentially relies on that intermediary, usually a custodian bank.

The first problem with this approach is that the checks on the end-investor that should be done by many intermediaries are performed only once, at the beginning, and this could have taken place at a foreign country. To put this in perspective, it would be similar to checking the identity and luggage of a passenger flying from India to San Francisco via Dubai and New York only once in New Delhi, and assuming that the passenger does not ever need to be check again because the airline and security guard at origin performed the checks.

Second, the whole prevention system relies on intermediaries such as banks that, although regulated and supervised, have in many cases proven not to be able to detect illicit financial flows.

In relation to money laundering, in 2011 the UN reported that "the 'interception rate' for anti-money-laundering efforts at the global level remains low. Globally, it appears that much less than 1 per cent (probably around 0.2 per cent) of the proceeds of crime laundered via the financial system are seized and frozen." In 2014, OCCRP exposed the Russian Laundromat scandal that involved a USD 20 billion money laundering scheme. The scandal revealed how banks failed for years to shut the scheme down, despite warnings. Billions were moved from Russia into 112 bank accounts in eastern Europe and then into banks around the world.[26] In 2018, the Danske Bank scandal broke out, revealing that USD 200 billion of suspicious transactions flowed through Danske's Estonian branch.[27]

Global Financial Integrity[28] listed other money laundering scandals involving banks that took place in 2018. The list includes UBS, Rabobank, the Commonwealth Bank of Australia, US Bancorp, ING, ABLV Bank Latvia and Deutsche Bank.

The third problem is that banks have not only failed to detect crimes (second problem): they've been caught actively facilitating them. For example, banks have helped kleptocrats hide their wealth in the offshore world, not only by accepting their money, but also by suggesting how to set up secretive companies and trusts and how to transfer money without being detected. This is what the US Senate Subcommittee on investigations had to say about Riggs bank's role in relation to former Chilean dictator Augusto Pinochet:

> "Riggs had served as a long-standing personal banker for Mr. Pinochet and deliberately assisted him in the concealment and movement of his funds

[26] https://www.occrp.org/en/laundromat/the-russian-laundromat-exposed/; 27.9.2019.
[27] https://www.theguardian.com/business/2018/sep/21/is-money-laundering-scandal-at-danske-bank-the-largest-in-history; 27.9.2019.
[28] https://gfintegrity.org/taking-stock-of-2018-part-1/; and https://gfintegrity.org/taking-stock-of-2018-part-2/; 5.8.2019.

> while he was under investigation and the subject of a Spanish court order directing a worldwide freeze of his assets. Riggs opened multiple accounts for Mr. Pinochet with the knowledge and support of the Bank's leadership; accepted millions of dollars in deposits from him with no serious inquiry into the source of his wealth; set up offshore shell corporations and opened accounts in the names of those corporations to disguise Mr. Pinochet's ownership of the account funds; altered the names of his personal account to disguise his ownership; transferred $1.6 million from London to the United States while Mr. Pinochet was in detention in the United Kingdom and under a Spanish court order freezing his assets; conducted transactions through Riggs's own administrative accounts to hide Mr. Pinochet's involvement in some cash transactions; and delivered over $1.9 million in four batches of cashiers checks to Mr. Pinochet in Chile to enable him to obtain substantial cash payments in that country."[29]

One could argue that anti-money laundering regulations have become stricter in the past years. However, new scandals kept emerging as recently as 2018[30,31], bringing new records on the value of money being laundered or abusing tax laws.

As for tax evasion, the US found out how costly it was to blindly trust banks. The US had relied on banks to identify the residence of investors investing in the US financial market so that the appropriate (lower) withholding taxes would apply to these foreign investors, based on double tax agreements between the US and the country of residence of the investor. However, the US found out that banks such as UBS[32] and Credit Suisse[33] were abusing this trust to actually help American taxpayers evade US taxes. As a result of this, the US enacted the Foreign Account Tax Compliance Act (FATCA) for all banks in the world to automatically inform US tax authorities about Americans' foreign bank accounts. Incidentally, in 2019 it was revealed that once the US criminal investigation against UBS became public, US tax dodgers went to another Swiss bank: Liechtensteinische Landesbank (Schweiz), or LLB-Switzerland. This Swiss bank began a relationship with a Swiss asset manager

[29] Permanent Subcommittee on investigations of the committee on homeland security and governmental affairs of the United States Senate, *Supplemental Staff Report on U.S. Accounts Used by Augusto Pinochet*, 2005 <https://www.hsgac.senate.gov/imo/media/doc/SUPP%20REPORT-Money%20Laud%20&%20Foreign%20Corrup%20(March%202005).pdf> [accessed 5 August 2019].

[30] https://www.om.nl/actueel/nieuwsberichten/@103952/ing-pays-775-million/; 27.9.2019.

[31] https://www.theguardian.com/business/2018/sep/21/is-money-laundering-scandal-at-danske-bank-the-largest-in-history; 27.9.2019.

[32] United States Senate - Permament Subcommittee on Investigations, *Tax Haven Banks and U.S. Tax Compliance*, July 17, 2008 (Washington, DC, 2008) <http://www.hsgac.senate.gov/download/tax-haven-banks-report-july-17-08> [accessed 6 April 2012].

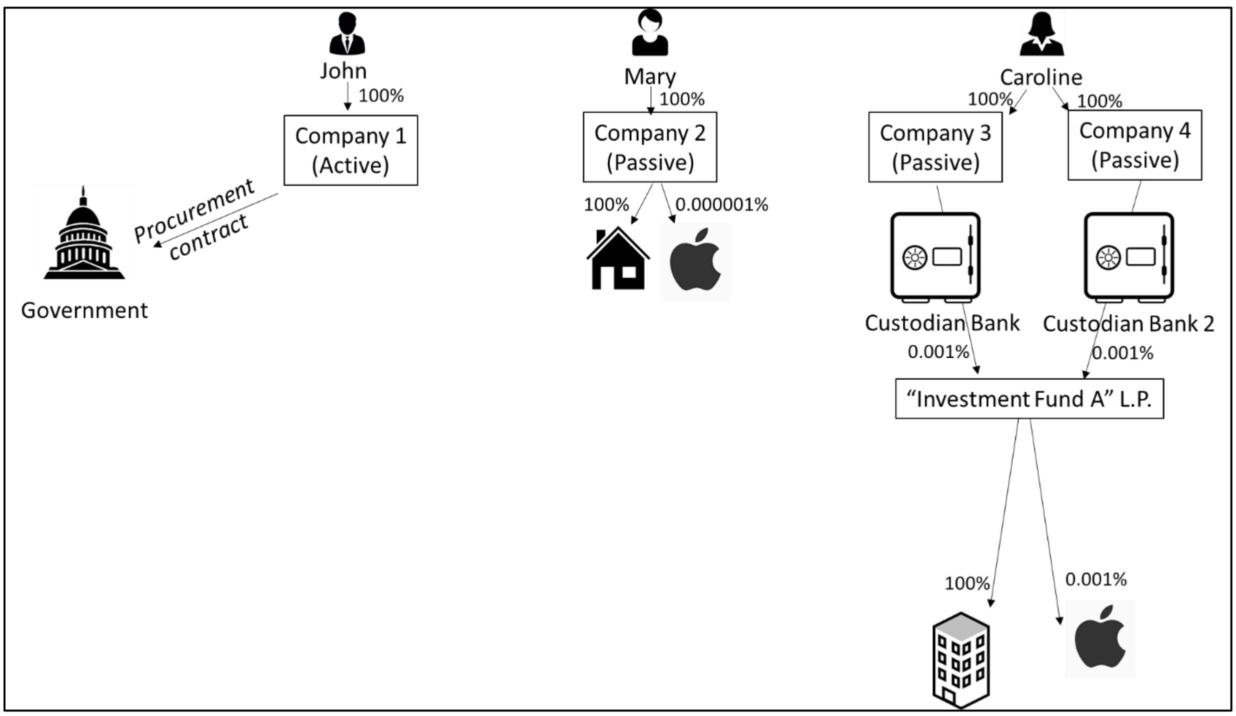
[33] United States Senate - Permanent Subcommittee on Investigations, *Offshore Tax Evasion: The Efforts to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts* (Washington, DC, 26 February 2014) <https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20OFFSHORE%20TAX%20EVASION%20(Feb%2026%202014,%208-20-14%20FINAL).pdf> [accessed 21 June 2019].

to help conceal US taxpayers bank accounts in Switzerland through Swiss bank secrecy protections and nominee companies set up in tax haven jurisdictions.[34]

2. Overview of the investment industry secrecy

To understand the different levels of secrecy available in the investment industry, consider the example in Figure 2, comparing an active company involved in procurement contracts with the government, a passive entity that directly holds assets, and passive entities that have interests in an investment fund.

Figure 2. Complete transparency: assets and owners of different types of companies



Access to asset ownership information vs investment ownership information in real life

Authorities, journalists, civil society organisations and academic researchers will likely have little access to all the information shown in Figure 2 above.

Imagine if any of these actors wanted to investigate inequality or wealth concentration, or illicit financial flows related to tax evasion, corruption or money laundering. They may start by researching the individuals involved in procurement contracts (to investigate corruption), those who own real estate (to investigate

[34] https://www.justice.gov/opa/pr/justice-department-announces-resolution-llb-verwaltung-switzerland-ag; 7.8.2019.

money laundering) or those who own securities (to investigate wealth concentration or tax evasion).

Figure 3. Available contract and asset ownership information in real life

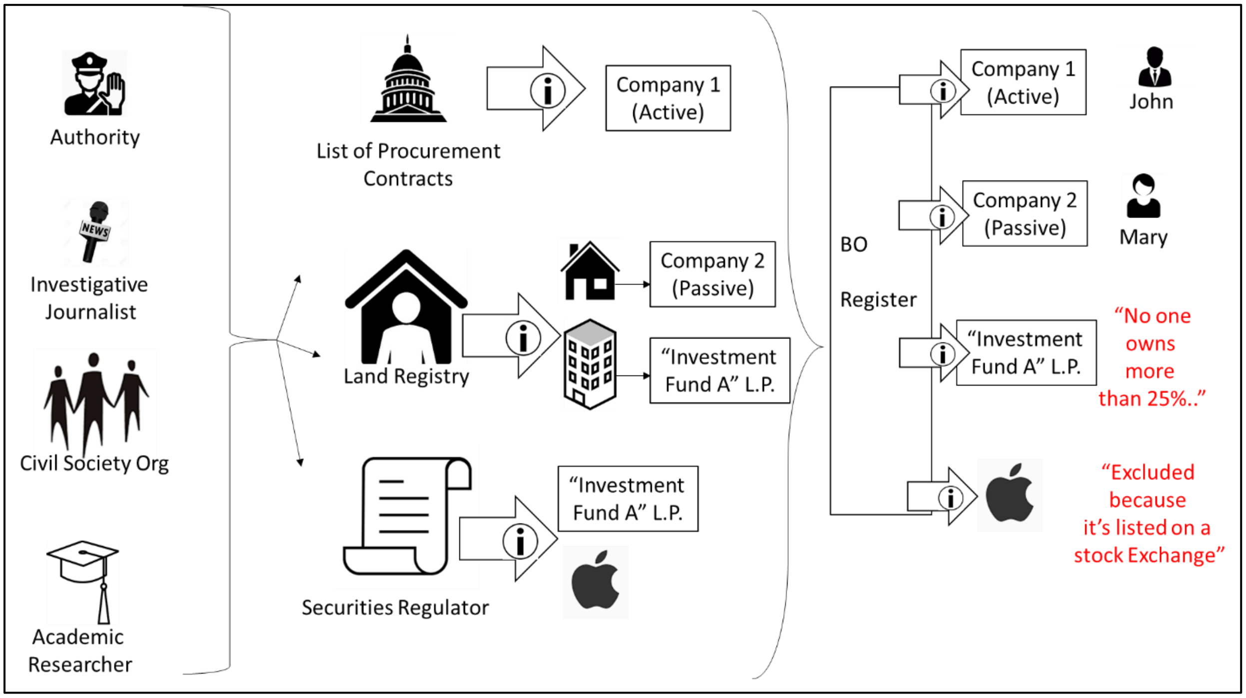


Figure 3 illustrates the routes that may be available to authorities, journalists, civil society organisations and academic researchers for obtaining information. From the national registries of procurement contracts, land or the securities regulators' records, they may obtain information about the legal owners of assets and contracts, ie the direct person or entity holding title over assets or under whose name a contract was signed. They would not be able to obtain information about the beneficial owners of the assets.

From looking at lists of procurement contracts, an investigator would be able to find out that Company 1, in this example, received a procurement contract. Assuming the country has a beneficial ownership register, the investigator can discover that John is the beneficial owner of that company. The investigator could then try to find out if John is involved in any corruption. For example, John may be a close relative of a politician connected to the procurement process.

Inquiring the land registry would reveal that the house in the above example is owned by Company 2 and that the building is owned by Investment Fund A, a limited partnership (LP). The beneficial ownership register would then reveal that Mary is the beneficial owner of Company 2. However, the beneficial ownership register may not have any information on the investment fund if, for example, the register excludes investments with publicly traded interests or if the register excludes limited partnerships. Even if the beneficial ownership register did cover investment funds with publicly traded shares and limited partnerships, given that each investor would likely have less than 1% ownership over the fund, no one would pass the "more than 25% threshold" that applies in most beneficial ownership definitions. Nobody would be identified as the beneficial owner of the fund - at best, the fund manager would be disclosed.

The securities regulator may also disclose that a public investment fund exists, but not who the beneficial owners of the fund are. It would also list securities that are publicly traded, such as shares of Apple, which is listed on a stock exchange. However, the beneficial ownership register would not record the owners of Apple's shares because of the widely used exemption for companies with shares listed on a stock exchange. Therefore, it will not be possible to identify the individuals that own Apple shares, either directly or through an investment fund.

Box 3. Exclusion of companies listed on a stock exchange

Most beneficial ownership registration laws exclude companies listed on a stock exchange from beneficial ownership registration, very likely based on a wrong interpretation of the Financial Action Task Force's (FATF's) anti-money laundering recommendations. Interpretative Note to FATF Recommendation 10.C establishes that

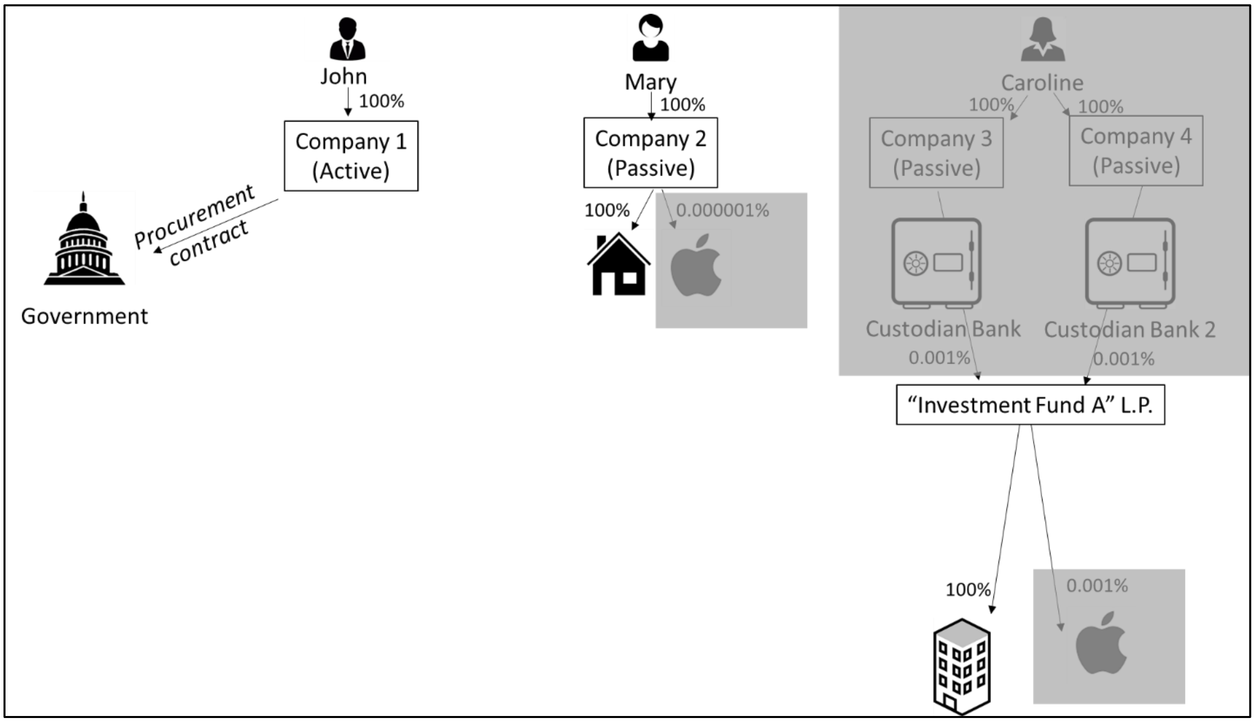
> "where the customer or the owner of the controlling interest is a company listed on a stock exchange and subject to disclosure requirements (either by stock exchange rules or through law or enforceable means) which impose requirements to ensure adequate transparency of beneficial ownership, or is a majority-owned subsidiary of such a company, it is not necessary to identify and verify the identity of any shareholder or beneficial owner of such companies."

In other words, there is no need to identify the legal and beneficial owners of listed companies for redundancy purposes, because there is a condition that "there are disclosure requirements that ensure adequate transparency of beneficial ownership". However, most regulations, including the Fifth Anti-Money Laundering Directive (AMLD 5) and the OECD's Common Reporting Standard (CRS) for automatic exchange of information, exclude listed companies from the requirement to identify the beneficial owners, without ensuring that there are disclosure requirements that ensure adequate beneficial ownership transparency.

Investment ownership information that remains hidden from the public

Based on the above descriptions on the lack of information on certain assets, Figure 4 below illustrates with grey squares the blind spots created by the investment industry's secrecy: there won't be any public information about the securities owned by Company 2, or by the investment fund A. Companies 3 and 4 are also hidden because no one would have a reason to look into them. Although they would be covered by the beneficial ownership register, no one would be able to know that they are investing in Investment Fund A.

Figure 4. Asset ownership information in real life: public vs secret data



The intermediaries that have access to the secret investment ownership information: custodian banks

As explained above, the only actors in this scenario that would have access to information on the identity of end-investors holding interests in investment fund A are the banks. The problem with this situation is two-fold. On the one hand, banks have the wrong incentives. As the cases described above have shown, banks have on several occasions helped their clients engage in financial crimes or failed to detect these cases. Doing business with criminals only becomes bad business if the bank is caught and if hefty sanctions are imposed. Low sanctions may have no deterrent effect.

For example, the US imposed penalties against securities broker Oppenheimer & Co. for money laundering violations on three separate occasions: in 2005 (USD 2.8 million), in 2013 (USD 1.4 million) and again in 2015 (USD 20 million)[35].

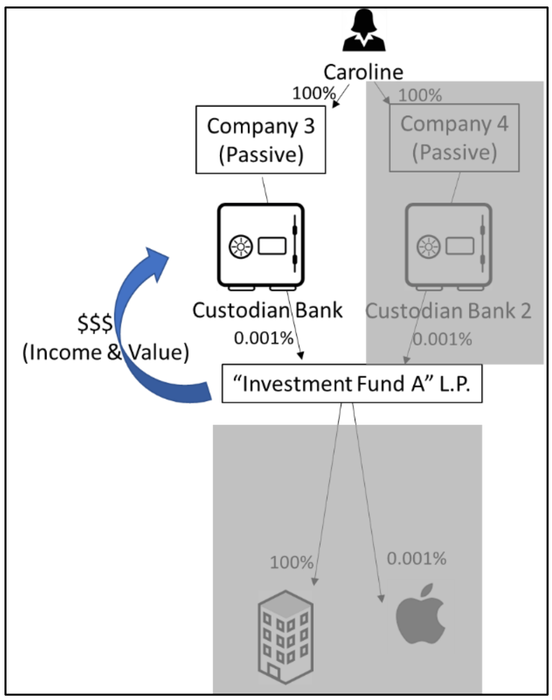
Joshua Kirschenbaum describes that sanctions have actually been lower for financial institutions involved in investment and securities trading, than for regular depositary banks:

[35] https://www.fincen.gov/news/news-releases/fincen-fines-oppenheimer-co-inc-20-million-continued-anti-money-laundering; 5.8.2019.

> "UBS moved $83 billion through non-resident accounts over two years without properly screening the transactions, including $9 billion involving high-risk jurisdictions. Morgan Stanley failed to properly monitor $55 billion in transactions over five years, including $3 billion involving high-risk jurisdictions. And Merrill Lynch for many years did not apply software screening at all to certain types of accounts. In a three-year period, this resulted in over $100 billion in transactions going unmonitored. For these infractions, UBS, Morgan Stanley, and Merrill Lynch were fined between $10 and $26 million by the Securities and Exchange Commission and the Financial Industry Regulatory Authority (an industry body known as a self-regulatory organization). Compare this with U.S. Bank, a traditional depository institution, which was fined over $600 million by bank regulators and the Justice Department for similar lapses."[36]

On the other hand, even if banks tried to comply with the law, they would also have limited information. Banks may know the identity of the end-investor who opened a custodial account with them to hold interests in an investment fund, but they would not know the actual underlying securities held by the fund. Nor would they know if the end-investor holds more interests in the fund through other banks and other entities.

Figure 5. Information available to the custodian bank



As figure 5 shows, the custodian bank would know the identity of the account holder (Company 3) and its beneficial owner (Caroline), and the fact that it has interests in investment fund A. However, the custodian bank would not know the actual securities held by the investment fund. They would only know the total value and income earned by Company 3 through its investment in the fund.

This information is what is being exchanged under the OECD's CRS for automatic exchange of information: the total value and income related securities held in a custodian bank, but not the identification of each security. This, and other loopholes described in section 4 below, demonstrate why automatic exchange of information is not enough to tackle the investment industry's secrecy.

[36] https://www.the-american-interest.com/2019/08/08/closing-todays-illicit-finance-loopholes/; 27.9.2019.

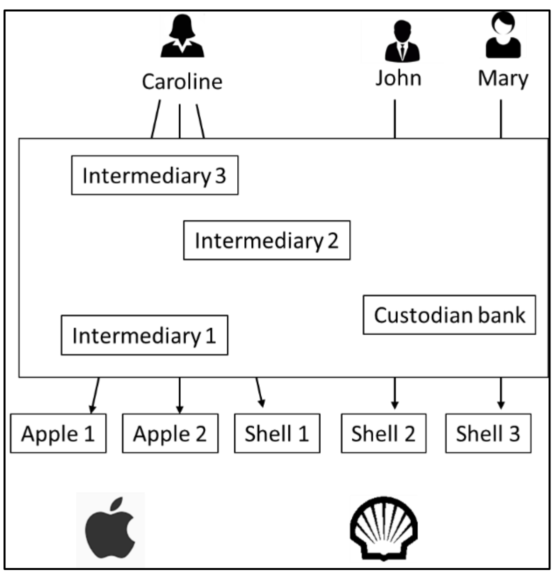
Secret or partial investment ownership information affecting investors and authorities

Continuing with our example, if Mary (or a foreign country like Iran) owned a controlling interest in the investment fund through many banks and many different entities, no one other than Mary (or the foreign country) would know this. But even Mary (or the foreign country) might not know what underlying securities they actually own though the investment fund, especially if they employ many funds. If Mary (or the foreign country) ultimately owned more than 5% of the interests in a company listed on the stock exchange, they would have to report this, but they may not know it, and even if they do, no one else would know about it, so enforcement would be impossible.

This lack of comprehensive knowledge also makes it difficult to cross-check and verify information reported by banks or by investors.

The ideal scenario: complete investor ownership information

Figure 6. Ideal access to investment ownership information

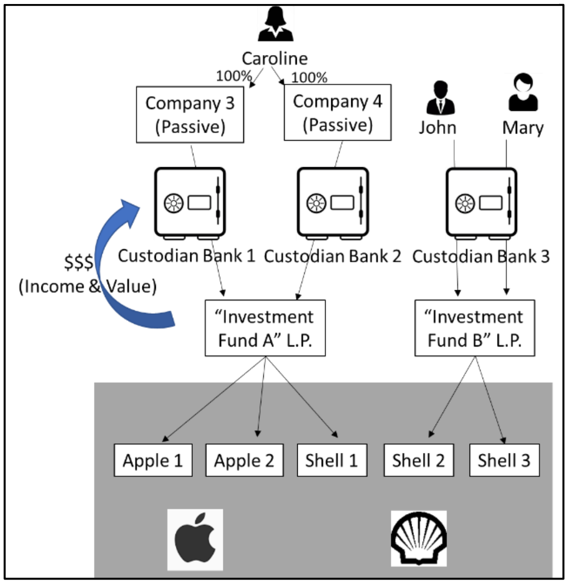


If authorities had access to the full picture and could identify the beneficial owners of each security (ideally also knowing which intermediaries they own these securities through), misreporting and underreporting would easily be spotted. Figure 6 presents a simplified example where authorities know that there are a total of five shares in the market. If custodian banks only reported that Caroline owned three shares and John owned one, authorities would be able to know that there is underreporting. Even if authorities do not know that Mary owns the last share, they would know that reporting on one share is missing because the market has a total of five shares, but only four were reported. Authorities could then try to obtain the missing information.

Having a complete picture would also help authorities detect misreporting. Using the same example illustrated in figure 6 where only two Apple shares exist, if one bank reported that Caroline owned two shares in Apple and another bank reported that John owned two shares in Apple, the authorities would spot the double reporting of Apple’s shares. Such an ability to detect misreporting could have prevented a scandal like the Cum-Ex tax fraud where the same shares were reported as belonging to two different investors.

The present: incomplete investment ownership information

Figure 7. Current access to investment ownership information



Under current regulations, custodian banks only know the value and income related to each account but not the ultimate underlying securities held through the account. The grey box in Figure 7 illustrates the blindspot in the current approach. Custodian banks currently have to report on the value and income related to each account for automatic exchange of information under the OECD's CRS. If the custodian banks in the example presented by Figure 7 only reported to authorities that Caroline owns $1000 in shares and that John owns $500 in shares, it would be impossible for authorities to know that one of the custodian banks failed to report on Mary. It would also be impossible for authorities to determine whether the separate shares that John and Caroline were reported to own were actually the same shares. Only by knowing the total number of securities and their values in the market, would it be possible to know if all securities were properly reported.

Box 4. The need to know the underlying securities held by end-investors

One could argue that the OECD's CRS for automatic exchange of information framework need not identify the underlying securities held by investors, but only their total value and income because after all this is what is relevant for tax authorities. In fact, the information currently obtained through automatic exchanges under the CRS is only permitted to be used for tax purposes. The obtained information cannot be used to investigate corruption, money laundering or other financial crimes. History shows, however, that only full transparency can ensure compliance.

Before the OECD's CRS became a reality, Switzerland tried to push forward its own system: the Rubik agreements. Those in favour of the Rubik agreements made a similar argument about the irrelevance of collecting extra information: "authorities want to prevent tax evasion and collect taxes. They do not need to know the identity of the taxpayer (owning a Swiss bank account). Receiving the corresponding tax revenue should be enough". Under the Rubik agreements, Switzerland would collect tax from Swiss bank account holders who were resident in other countries on behalf of the account holder's country of residence. Switzerland would then give the tax revenues to the corresponding countries of residence without revealing the identity of the account holders. Only a few countries, among which was the UK signed these Rubik agreements. The UK obtained less than 10% of the expected revenues. The Rubik system eventually failed to become mainstream, allowing for the emergence of automatic exchange of bank account information based on the OECD's CRS, which required countries such as Switzerland to hand in information about account holders.

Now, to improve the fight against illicit financial flows in relation to the investment industry, the CRS should also increase its level of transparency and fix other loopholes, as described in section 4 below.

3. The secrecy risks of the investment industry's structure

The investment industry has different players: (i) investors such as households or regular citizens who want to obtain a return on their savings; (ii) the issuer, a company or country who issues shares or debt in exchange for investors' money; and (iii) intermediaries, such as brokers, custodian banks, investment funds, central securities depositaries and so on that channel the money from investors to issuers, by holding assets, settling trades and deciding where and how much to invest.

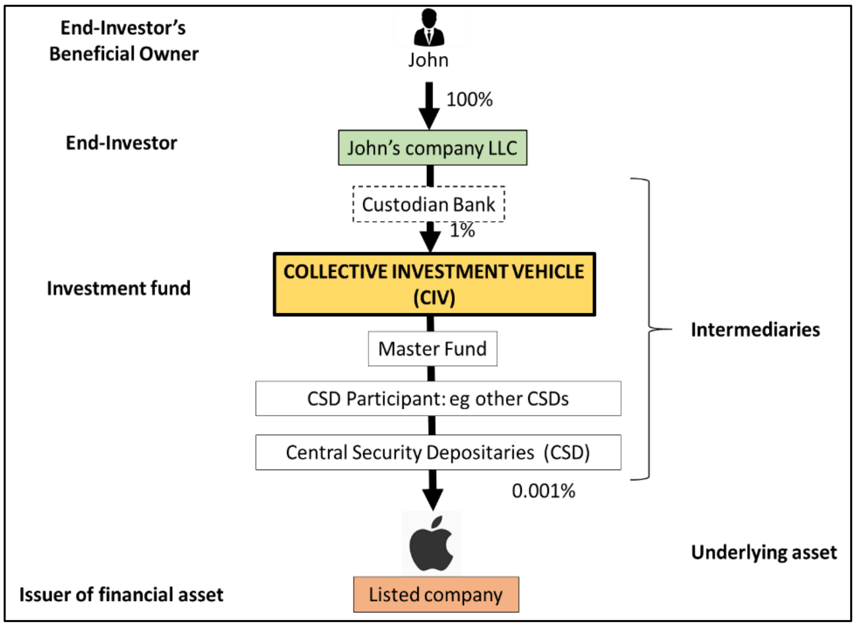
Unfortunately, the system's incentives are organised against transparency. Investors may want to keep their identity confidential (or known only to the fewest possible intermediaries, likely only the custodian bank where they hold their investments) so as to remain hidden from relevant authorities to evade taxes or engage in money laundering. The issuer (eg a company listed on the stock exchange or a country) is usually interested in financing (money), not in who is the ultimate individual end-investor giving it. Intermediaries, such as the investment fund or custodian banks may want to avoid sharing investors' details to prevent other intermediaries from stealing their clients and to make it easier to engage in financial transactions for collateral and liquidity reasons.

The fight against money laundering is not only distant, but opposite to the goals of the industry's players: identifying the end-investor, their beneficial owners and the origin of the money requires time and resources, and may even prevent the money from being invested in the first place if its legal origin or the identities of the end-investor cannot be determined. Given that intermediaries' fees depend on new clients and new transactions, any investor that is rejected means less money for the intermediary and eventually less money for the market and issuers. In other words, no private party has a real incentive to prevent illegal money from entering the investment industry, unless proper supervision and hefty sanctions are imposed for any wrongdoing. However, if there is secrecy and incomplete information (as described above), it becomes difficult for law enforcement and authorities fighting illicit financial flows to properly supervise the investment industry.

In addition to the wrong incentives, the investment industry creates secrecy through the use of several intermediaries with incomplete information, secretive types of legal vehicles, omnibus accounts that pool together money from many different investors and poor anti-money laundering requirements.

The mains risks involve:

Figure 8. The investment industry structure



- Multilayer structures, each with incomplete information
- Secrecy within each layer:
    - The end investor's beneficial owners
    - The end-investor
    - The investment fund's legal structure
    - The issuer recipient of the investment

3.1 Multilayer structures

The investment industry generally involves intermediaries: it would be strange for a person to directly acquire financial instruments or stock from the listed company or entity issuing them (the issuer). Intermediaries may include brokers, custodian banks, central securities depositaries and so on.

The FATF describes many of the possible intermediaries involved in the investment industry:

> "It is not uncommon that a number of different brokers are involved in a particular transaction, for example, an 'introducing broker' may pass orders on to an 'executing broker', who may execute the trade and give it up for clearing to a 'clearing broker'. Securities providers known as clearing members or clearing brokers may provide record-keeping, confirmation, settlement, delivery of transactions and related functions associated with securities transactions, usually on behalf of other brokers, such as introducing or executing brokers. Institutional brokers interact largely with large institutional clients and are often used to provide execution and custody services unaccompanied by investment advice. Customers of institutional brokers may and do use multiple institutional brokers to execute transactions. Prime brokers provide execution, custody and other services to other financial institutions, such as hedge funds. This can include providing centralised clearing facilities for investment funds and allowing customers to borrow shares or money. Prime brokers may also act as record-keepers for other securities providers (e.g. investment advisors or investment managers) that may in turn be acting on behalf of customers' transactions. Another type of securities provider, a custodial broker-dealer, can maintain custody of assets for its own customers (e.g. other broker-dealers, investment advisers, banks or other types of institutional clients) or their underlying customers. The underlying customers may be fully or partially disclosed to the custodial broker-dealer, while others may be non-transparent ('omnibus'). The global custodian provides safekeeping and settlement 'custody services' for fund-managers, their underlying funds, asset managers and other institutional clients across multiple markets globally through a network of relationships with sub-custodians, banks, national and international central securities depositories (CSDs). A sub-custodian provides safekeeping, clearing and settlement custody services in a domestic or international market on behalf of its customers. Although often employed by a global custodian, the sub-custodian, also referred to as an agent bank, might also service brokers and banks. A central securities depository (CSD) provides securities accounts and, in many countries, operates a Securities Settlement System. A CSD also provides central safekeeping and asset servicing and plays an important role in helping to ensure the integrity of securities issues. The CSD will service many customers including sub-custodians, banks, brokers, global custodians, prime brokers, and issuers."[37]

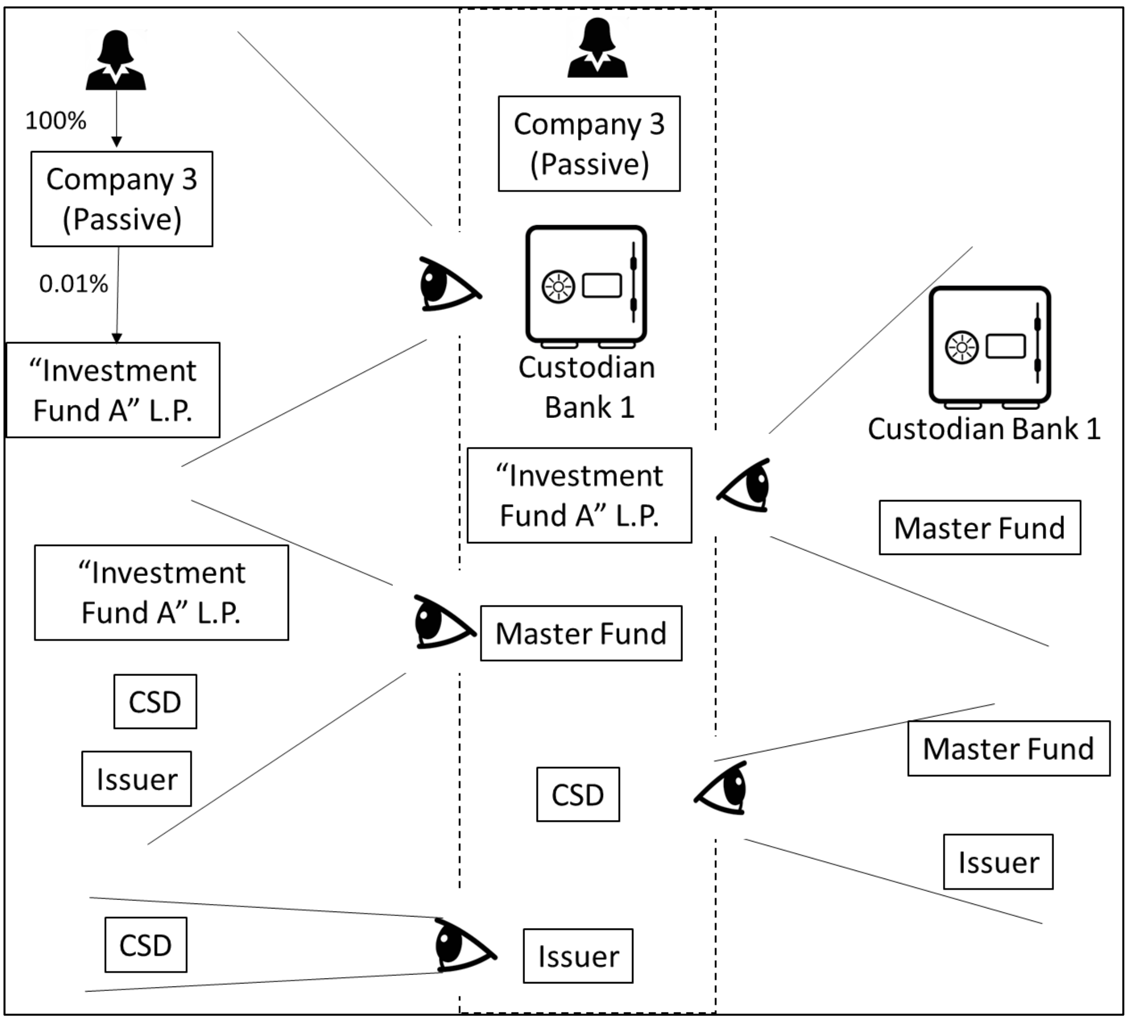
The presence of several intermediaries between the financial asset issued by the issuer (eg a stock, a bond or another financial instrument) and the end-investor's beneficial owner creates secrecy risks because intermediaries hold incomplete information, usually referring only to the immediate party above and below the chain, but not beyond that.

---

[37] FATF, *Guidance for a Risk Based Approach for the Securities Sector*.

The financial institution dealing with the end-investor (eg a custodian bank) likely knows the identity of the end-investor, and should know the identity of the end-investor's beneficial owners, the origin of funds and so on for anti-money laundering purposes. However, the custodial bank may not know what underlying securities or financial assets (eg shares in Apple or Google) the end-investor ultimately owns. The custodian bank would only know that the end-investor has interests in some investment funds, that in turn hold the underlying securities or financial assets.

Figure 9. Visibility by each intermediary

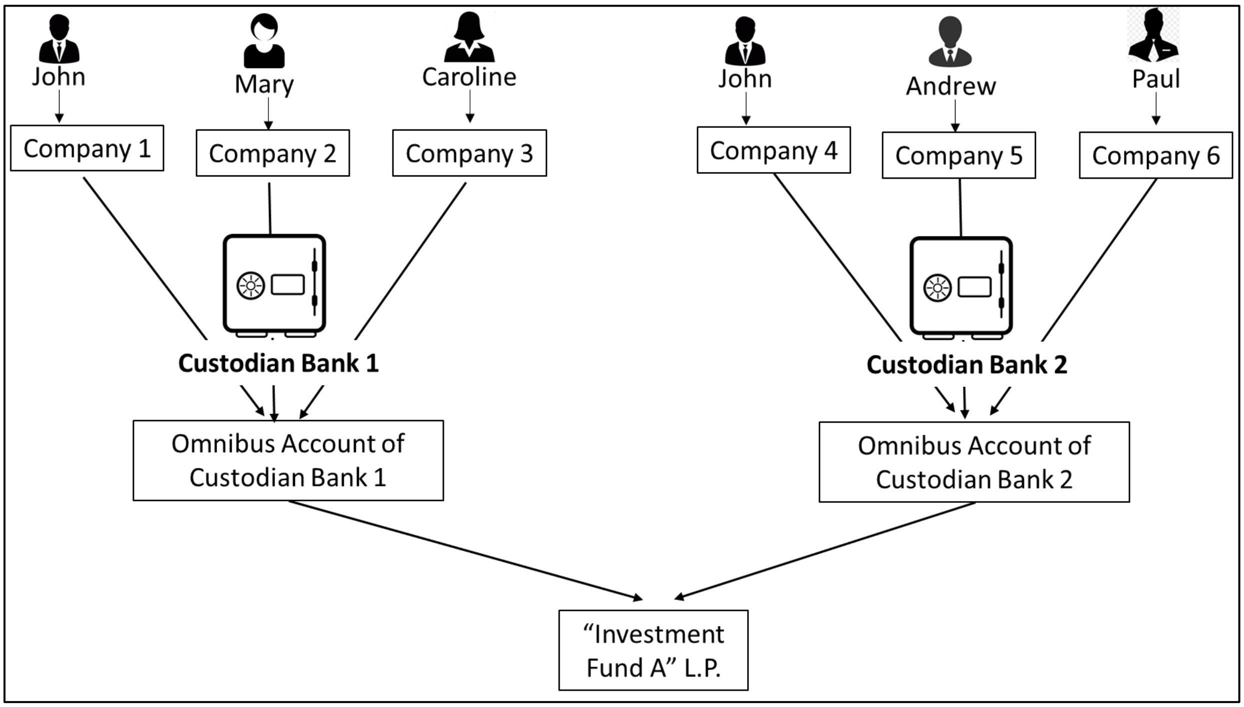


Intermediaries further below the chain may know nothing about the end-investors (let alone their beneficial owners), but the closer the intermediary gets to the issuer, the more likely the intermediary will know the actual underlying financial assets held by the fund.

The lack of visibility beyond the immediate links in the chain is exacerbated (and often caused) by the use of omnibus accounts.

Financial institutions acting as intermediaries usually employ omnibus accounts where money from different investors is pooled together. This may have legitimate uses, such as bringing liquidity into the system and improving efficiency and investing all applicable money in another fund, company or asset instead of conducting thousands of micro-investments on behalf of each end-investor.

Figure 10. Omnibus accounts



In 2010 the OECD described the use of these omnibus accounts by collective investment vehicles (CIV):

> "interests in CIVs acquired through intermediaries often are registered at the CIV level through nominee/street name accounts. One reason for this is competitive – intermediaries view customers' identities as highly valuable proprietary information. Another reason is efficiency – intermediaries aggregate their customers' purchases and sales each day and effect only a net purchase or a net sale each day in the nominee account. Whilst investments in a CIV are typically long-term, a CIV's shareholder base may change every day, as new shares are issued and existing shares are redeemed (or as shares trade on an exchange). When interests in the CIV are held through such nominee accounts, the CIV's manager may not be aware of changes in its underlying investors."[38]

[38] OECD, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, 2010 <https://www.oecd.org/tax/treaties/45359261.pdf> [accessed 5 August 2019].

While it may be easier or more efficient to manage just one account belonging to many different investors (an omnibus account) instead of administering one separate account for each investor (segregated account), this creates secrecy by mixing the money from all investors and removing their identities.

This secrecy helps intermediaries protect the identity of their clients, so that other intermediaries will not steal them, but at the same time it creates secrecy and prevents the subsequent intermediaries from being able to apply know-your-customer policies to identify the end-investor and prevent money laundering. For instance, the US Government Accountability Office (GAO) described the use of omnibus accounts (called concentration accounts) in Citibank's involvement in the alleged money laundering by Raul Salinas (the former Mexican President's brother). Omnibus accounts were used to interrupt the money trail and to obscure the identity of the criminal:

> "The other transfer went into a concentration account—a Citibank New York business deposit account that commingles funds of a number of bank branches/affiliates and bank customers. Subsequent wire transfers on behalf of Mr. Salinas went to the concentration account. The use of … and the concentration account deposits all served to break the paper trail of the Mexican funds by disguising the origin and destination of the funds."[39]

3.1.1 Anti-money laundering in the payment vs the investment industry

The payment industry is subject to more anti-money laundering checks than then investment industry. People engaging in global money laundering by transferring funds from a local bank account to a bank account in a foreign country would have had to open both of the accounts, and so would have been subject to anti-money laundering checks twice. Moreover, they would be subject to anti-money laundering checks each time they opened an account in a different bank. Regulations for banks have also changed to allow correspondent banks (facilitating an international transfer between two local banks) to identify the underlying customer and to be able to run their own anti-money laundering and other checks. For example, the SWIFT messaging system used for bank transfers increased the information available to correspondent banks (the upgraded SWIFT messaging standard for correspondent banks is called MT 202 COV). [40]

In contrast, a person engaging in money laundering through the investment industry would only need to open one custodian account and be subject to know-your-customer checks just once (other intermediaries would not be able to know their identity). Their money would then be mixed together in different omnibus accounts without a trail.

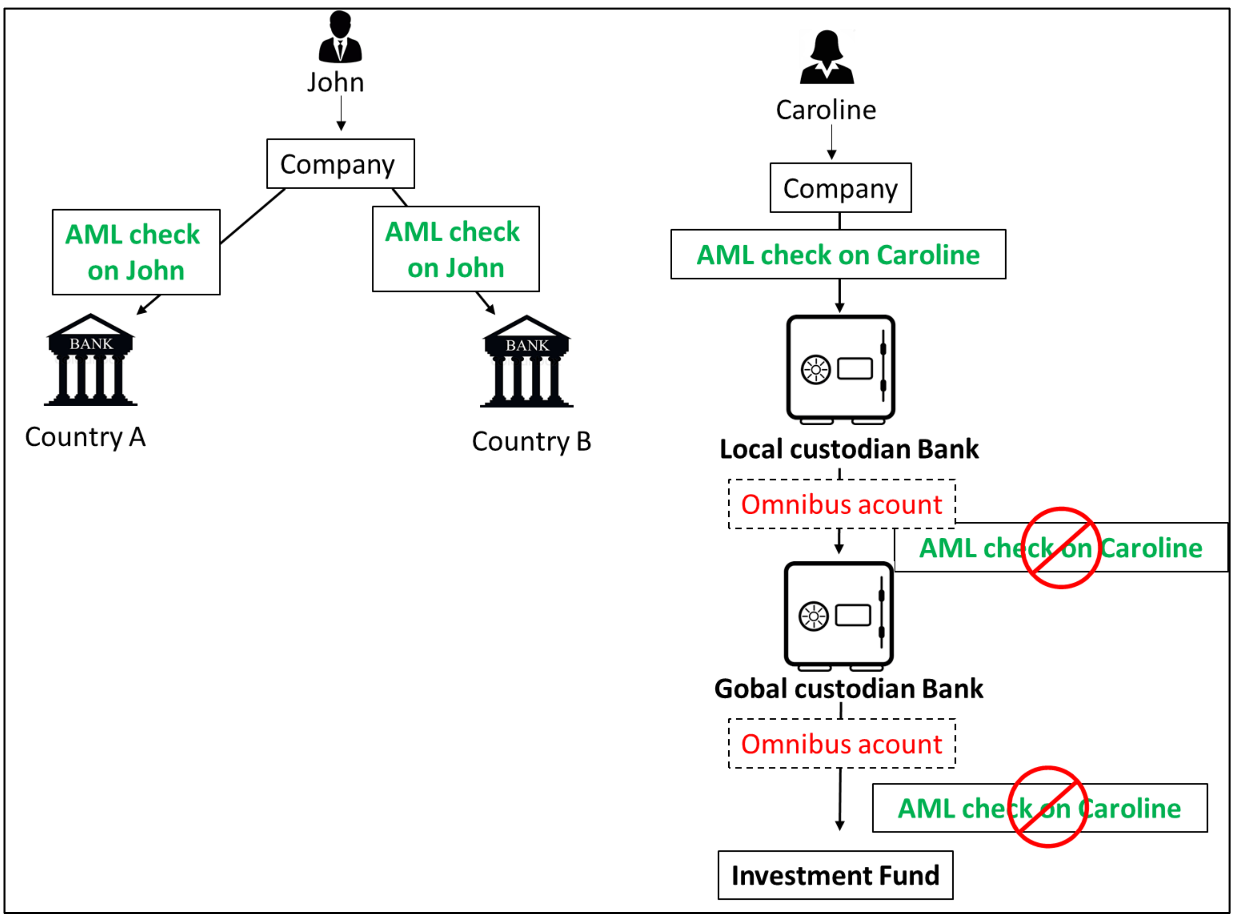
---

[39] United States General Accounting Office, *Private Banking: Raul Salinas, Citibank, and Alleged Money Laundering*, 1998 <https://www.gao.gov/assets/230/226687.pdf> [accessed 5 August 2019].
[40] https://www.lexology.com/library/detail.aspx?g=b95dc3ab-5d61-42d4-9918-61324414e616; 27.9.2019.

This one-intermediary-only check is confirmed, and apparently endorsed by the FATF, which suggests that investment funds unable to know the end-investor (the 'underlying customer') should at least ask the intermediary for the anti-money laundering procedures that they applied:

> "where an intermediary is treated as the investment fund's customer, the investment fund may not have visibility on the intermediary's underlying customers. This includes not having comprehensive identification nor transaction related information on the customers of the intermediary in cases such as, for example, where the intermediary nets all of its customers' orders and submits a single net order to the investment fund each day. Securities providers should also obtain (and intermediary should provide) information about the intermediary's AML/CFT controls, including information regarding the intermediary's risk assessment of its underlying customer base and its implementation of risk mitigation measures."[41]

Figure 11. AML in the payment vs the investment industry



In an article published by Clearstream, Mark Gem, head of compliance at Clearstream, described the changes in the investment industry: "Until recently,

[41] FATF, *Guidance for a Risk Based Approach for the Securities Sector*.

regulators themselves thought reliance on the first gatekeeper in the chain was sufficient, provided it was a regulated entity. Because it was a regulated entity, every entity behind it was deemed to be okay too." However, the Clearstream article described that "these expectations are now changing, initially in the payments industry. In February 2013, the Financial Action Task Force (FATF) obliged banks to conduct full due diligence on their correspondent banks, including an assessment of their anti-money laundering controls, seeking senior management approval of the relationship, and ensuring the correspondent conducted thorough customer due diligence of their own."[42] Gem proposed the new measures available in the payment industry could be applicable for the investment industry. For example, SWIFT messages for bank transfers increased the details in the messaging system (MT 202) to allow intermediaries to also know the identity of the customers involved in the bank transfer and perform anti-money laundering checks: "Gem thinks the securities industry needs to develop messages which include at least the same level of information as the MT 202/5 messages."[43]

The opposite to omnibus accounts are segregated accounts where all end-investors are identified for every intermediary. Weinstein et al described the benefits of segregated accounts for investors (more direct communication and voting by direct investors, apply appropriate tax benefits based on the investor's tax residence and asset protection for the investor in case an intermediary becomes insolvent) as well as in the fight against illicit financial flows: more transparency to perform due diligence on the investor, to tackle tax evasion and to monitor investment flows.[44] Maria Vermaas, Head of legal and regulatory matters at the South African central securities depository, recommended that from a legal, regulatory, and investor protection's point of view, proper segregation in fully segregated securities accounts must be offered to investors as the default standard."[45] Nougayrede found that several countries, including some in Europe and BRICS (Scandinavian countries, China, Brazil or South-Africa) already operate certain segregated account systems at the level of key institutions like the central securities depositories.[46]

---

42 https://www.clearstream.com/resource/blob/1312332/bc8ff5e084310b7a98ec5f39eff47c0a/hobsonseries14mgem-data.pdf; 5.8.2019.

43 Idem.

44 Stuart Weinstein and Sina Yekini, *Study on the Benefits and Costs of Securities Accounting Systems* (2015) <https://swiftinstitute.org/wp-content/uploads/2015/09/2015-08-ISSA-Transparency-in-Custody-Chains.pdf>. These authors conclude, however, that no one account structure offers a "magic bullet" to solve illicit financial flow problems (p. 26).

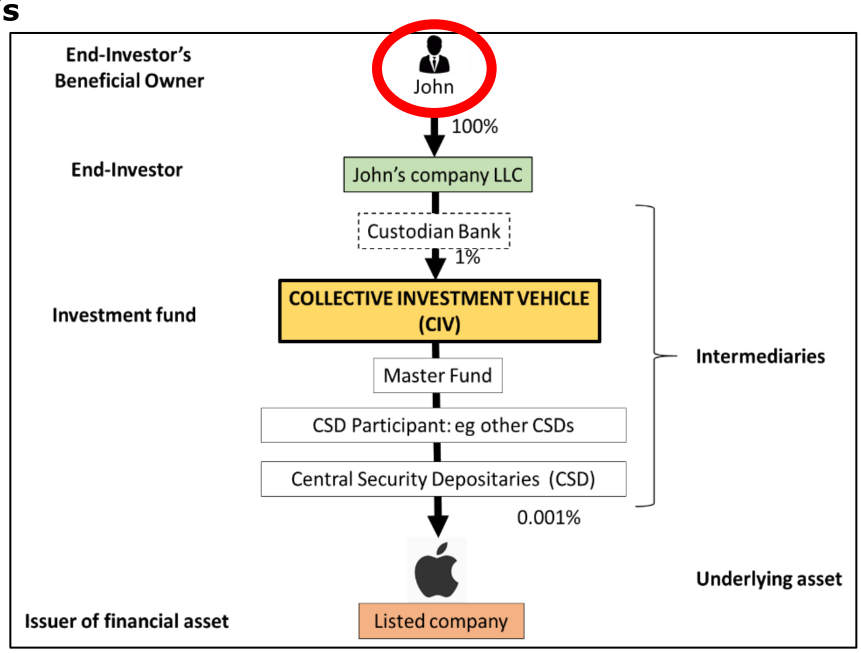
45 Maria Vermaas, *The Call for proper segregation in intermediated systems,* Uniform Law Review 2013 pp. 589-605, 605).

46 Nougayrède, Delphine, 'Towards a Global Financial Register? The Case for End Investor Transparency in Central Securities Depositories', *Journal of Financial Regulation*, 2018 <<https://academic.oup.com/jfr/article/4/2/276/5067182> [accessed 6 August 2019].

3.2. Secrecy within each layer

The secrecy risks that arise from having multiple layers are compounded by the specific secrecy risks each layer offers.

3.2.1 The end-investor's beneficial owners



As explained above, an individual could invest in an investment fund either directly under their own name, or using a company or other type of legal vehicles. In this case, it will be necessary to identify the individual investing through the legal vehicle.

The term beneficial owner refers to the individual (natural person) who ultimately owns, controls or benefits from a legal vehicle, like a company, trust, partnership, foundation, association, cooperative, etc.

There should be enough information about an individual to determine their identity with certainty. Names are usually not enough because they may be thousands of people with the same first and last name. In addition, names can be written in different ways if they are a transliteration from a foreign language (eg Mohamed, Muhamed, Mohammed, Muhammed, Mohamid and so on). Identity numbers such as passport numbers or tax identification numbers are better suited to determine the identity of a person with certainty (1 is always 1) and to automatically cross-check information. However, passport numbers can also change, and so can tax identification numbers, especially if individuals acquire golden visas or other citizenship-for-sale schemes offered by tax havens. One solution would be to use unique individual identifiers that do not change (for example based on the place of birth) to know whether John Smith owning company A and a 2% interest in investment fund 1 is the same as person as John Smith owning company B and a 3% interest in investment fund 1.

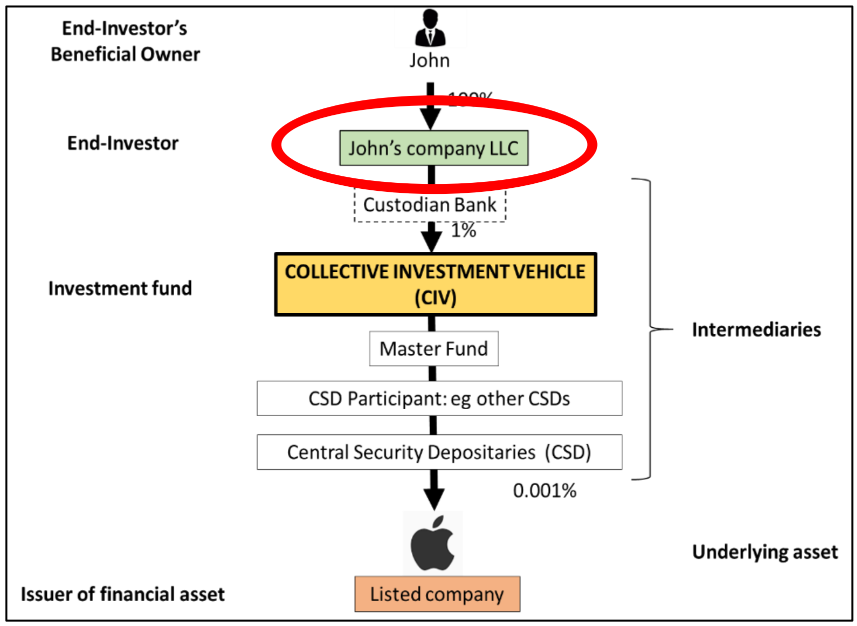
However, even unique individual identifiers will not be enough to prevent nominees, straw men or front men from being fraudulently registered as beneficial owners. Sophisticated analysis as proposed by the Tax Justice Network policy paper on beneficial ownership verification[47] (including on the origin of their funds and the

[47] Andres Knobel, *Beneficial Ownership Verification: Ensuring the Truthfulness and Accuracy of Registered Ownership Information* (2019) <https://www.ssrn.com/abstract=3320600> [accessed 5 August 2019].

beneficial owner's profile) may be the only way to determine whether a person is the real beneficial owner, or just a nominee.

Financial institutions subject to anti-money laundering regulations are already required to verify the identity of these beneficial owners. However, lack of incentives (especially if there is no supervision nor stringent sanctions for failing to correctly identify the beneficial owner) and lack of sources to verify the information prevent financial institutions from being able to identify beneficial owners with certainty.

3.2.2 The end-investor organised as an entity



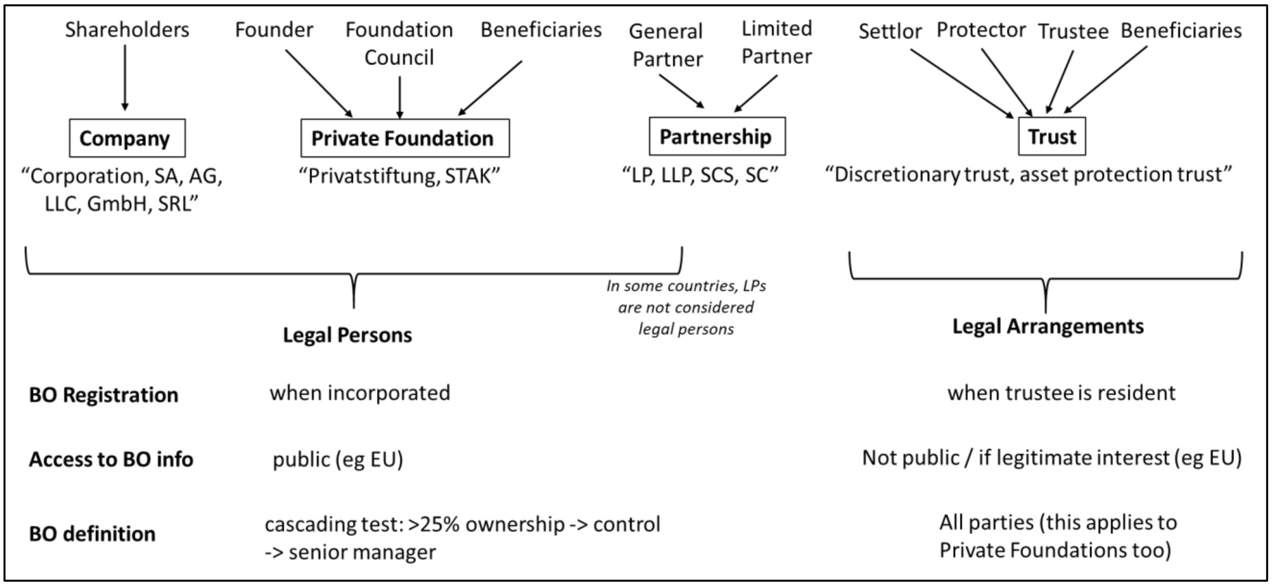
Individuals may set up different types of legal vehicles to operate in the economy and hold their assets, including interests in investment funds. For example, they may set up joint stock companies (known also as societe anonymim or SA), limited liability companies (LLCs), companies limited by guarantee, limited partnerships (LPs), limited liability partnerships (LLPs), trusts, foundations, Anstalts, cooperatives and associations, to name a few.

Given that legal vehicles may be set up online, remotely and in less than 24 hours, knowing only the identity of a legal vehicle that holds an interest in the investment fund as an end-investor without knowing the identity of the beneficial owner behind the legal vehicle is not enough to prevent money laundering and other illicit financial flows. While some financial institutions are required to identify the end-investor (the direct customer) and the customer's beneficial owners, there are many obstacles that prevent this from happening effectively.

First, the financial institution has little incentives to identify the beneficial owner and the origin of the funds because having to a decline client that don't meet the necessary checks reduces business. Second, current definitions of beneficial owners based on FATF recommendations, apply very high thresholds for legal persons such as companies, usually requiring more than 25% of ownership or voting rights to be considered a beneficial owner. Consequently, few individuals may be required to be identified. Third, there may be no official database (such as a commercial registry) where financial institutions may verify the information. For example, the Tax Justice Network published a report[48] in 2018 based on the Financial Secrecy Index indicating that only 34 countries held beneficial ownership registries.

On top of all this, there may be additional transparency challenges related to registration requirements and public access to information, depending on the type of legal vehicle, as illustrated in Figure 12.

Figure 12. Summary of secrecy risks based on the type of legal vehicle



3.2.2.1 Companies

Companies are the most widely used type of legal vehicle in general, not just in the investment industry. They are considered legal persons (or entities) and that is why there are usually subject to more transparency than other legal vehicles. For example, most countries require companies to register with a commercial register to obtain legal validity or at least to enjoy limited liability. The FATF for instance, requires countries - under recommendation 24 - to publish basic information about companies and other legal persons, including their name, address, and their legal owners and directors[49]. According to the Tax Justice Network's report "State of beneficial ownership registration"[50] based on the Financial Secrecy Index, as of 2018, only 26 jurisdictions required companies to register and update their shareholders' details (legal owners). Information on legal owners is useful but not

[48] Andres Knobel, Moran Harari and Markus Meinzer, *The State of Play of Beneficial Ownership Registration: A Visual Overview*, 2018 <https://www.taxjustice.net/wp-content/uploads/2018/06/TJN2018-BeneficialOwnershipRegistration-StateOfPlay-FSI.pdf> [accessed 19 July 2018].

[49] Financial Action Task Force, *The FATF Recommendations. International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation* (Paris, February 2012) <http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf> [accessed 6 June 2013].

[50] Knobel, Harari and Meinzer, *The State of Play of Beneficial Ownership Registration: A Visual Overview*.

always enough, because shareholders may be either individual nominees or other entities. As for beneficial owners (the natural persons who ultimately own or control the company), only 18 jurisdictions required companies to register and update them. Registration on both beneficial owners and legal owners (including the whole ownership chain up to the beneficial owner) is necessary to allow authorities to verify the accuracy of registered information, as described by the Tax Justice Network's policy paper "Beneficial ownership verification"[51]. However, countries lack proper verification systems.

An even more basic problem than outdated or unverified legal and beneficial ownership information is that not all the relevant companies or people have to register in the first place. One of the most advanced and comprehensive legal frameworks for beneficial ownership registration is the amendment to the European Union's Anti-Money Laundering Directive approved in 2018 (called AMLD 5[52]), which requires companies and other legal persons established in the EU to register their beneficial owners in public registries (but this does not apply to non-EU companies owned or controlled by EU individuals). However, the AMLD 5 still applies a very high threshold to identify an individual as a beneficial owner: anyone holding more than 25% of the shares or voting rights over a company.

3.2.2.2 Partnerships with limited liability

Partnerships with limited liability may be either limited partners (LPs), where the general partner has unlimited liability while the limited partners limit their liability, and limited liability partnerships (LLPs) where all partners may enjoy limited liability.

Given the different level of responsibility and power to make decisions, limited partners usually enjoy limited liability (they are only liable up to the money they invested in the partnership) while general partners are fully liable (having to respond even with their personal assets). However, this difference is more theoretical than real because some countries allow any type of vehicle to be a general partner. In other words, if an entity enjoying limited liability such as a company becomes a general partner with full liability, liability will in practice be limited (because the company enjoys limited liability).

According to the Tax Justice Network's report "State of play of beneficial ownership registration"[53], as of 2018, 65 jurisdictions required partnerships with limited liability (both limited partnerships, LPs, and limited liability partnerships, LLPs) to register their "legal owners", and 17 countries to register and update their "beneficial owners". The EU AMLD 5 only requires partnerships to register their beneficial owners in public registries if they are "legal persons", such as companies. (It is not clear if limited partnerships which are not considered "legal persons" will

[51] Knobel, *Beneficial Ownership Verification*.

[52] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018L0843; 5.8.2019.

[53] Knobel, Harari and Meinzer, *The State of Play of Beneficial Ownership Registration: A Visual Overview*.

be subject to the AMLD 5 provisions for trusts and similar structures, or if they are simply outside the scope of AMLD 5).

For example, in Luxembourg although the special limited partnership (SCSp) has no legal personality, the assets are under the SCSp's name instead of under the general partner's name (see the Annex section on Luxembourg).

In the UK, for instance, limited liability partnerships (LLPs) are considered legal persons and subject to beneficial ownership registration, but not all limited partnerships (LPs)[54] are. Indeed, Scottish limited partnerships (SLPs) have been found to be abused for money laundering[55], and that prompted the UK to extend beneficial ownership registration for them. However, the same has not applied yet to LPs from Northern Ireland or those from England and Wales. Global Witness showed that when beneficial ownership requirements for Scottish LPs were imposed, fewer of them were created, while the number of LPs from Northern Ireland, and England and Wales went up, suggesting that people were switching to less transparent types of LPs[56].

Oddly enough, while UK LPs are not considered "legal persons", they are still required to register their general and limited partners at the "legal ownership" level with the commercial register and they may even obtain a certificate of registration. This creates confusion with risky consequences. If a vehicle has no corporate body (it is not a legal person), then it should not be able to operate as such: open a bank account, own real estate or enter into a contract. The general partner (or any partner) would have to do that in their own name. In this case, for purposes of opening bank accounts or owning assets, the partnership should be useless and would only be of significance to the partners. However, an LP with a certificate of incorporation from the UK commercial register may give the impression that it is a legal person separate from its members, and thus be allowed to own assets or enter into contracts. This not only creates confusion within the UK, but could easily be exploited abroad (since most countries are not aware of every other country's domestic law provisions). A UK LP may thus be abused to set up or own other legal vehicles abroad, as if it were a legal person. For instance, a UK LP could be used like any UK company to act as an end-investor putting money in any investment fund in the world. In addition, given that the LP is not a legal person, the UK will have no beneficial ownership about this LP (unless it is a Scottish LP).

There is currently a process to reform the UK's partnership law[57] for all UK LPs to be considered entities, or at least to subject them to the same beneficial ownership registration requirements that apply to entities.

[54] https://financialsecrecyindex.com/database/UnitedKingdom.xml#b179; 5.8.2019.
[55] https://www.nakedcapitalism.com/2018/12/uks-reform-limited-partnership-law-dead-arrival.html; 5.8.2019.
[56] https://www.globalwitness.org/en/blog/three-ways-uks-register-real-owners-companies-already-proving-its-worth/; 5.8.2019.
[57] https://www.nakedcapitalism.com/2018/12/the-uks-reform-of-limited-partnership-law-dead-on-arrival-ii.html; 5.8.2019.

3.2.2.3 Trusts

Trusts are usually considered legal arrangements (instead of "legal persons") where one party (the "settlor") transfers assets to be held and managed by another party (the "trustee"), for the benefit of another party (the "beneficiaries"), according to instructions written by the settlor in the "trust deed". A classical example of a trust arrangement would involve a father (the settlor) transferring assets to a trust to be managed by a lawyer (the trustee) in favour of the settlor's spouse and children (the beneficiaries). Importantly, assets are held and managed by the trustee without interference form the beneficiaries. In some cases, a "protector" or "enforcer" is appointed to ensure that the trustee is properly managing the trust assets based on the settlor's instructions, or at least that the trustee is not using the trust assets for their own benefit.

Usually a settlor cannot also be a trustee or a beneficiary, and the trustee cannot also be a beneficiary. Nevertheless, some countries, especially tax havens, allow self-settled trusts, where the settlor is also a beneficiary.

Unlike legal persons that may directly own assets, trust assets are legally owned by the trustee not by the trust, but only under strong constraints: they do not belong to the trustee's personal assets. The trustee is not allowed to use the trust assets for their own benefit, nor can the trustee's personal creditors make claims against the trust assets.

Trusts are usually subject to less transparency requirements compared to legal persons such as companies. According to the Tax Justice Network's report "State of play of beneficial ownership registration"[58], as of 2018, only 19 jurisdictions required "domestic law trusts" (those created according to, or governed by, a country's domestic laws) to be registered. Of these, only 3 required the legal owners to be registered and updated, and only 5 required beneficial owners to be registered and updated. As for foreign law trusts managed by a local trustee (those created according to, or governed by, a foreign country's laws but managed by a local trustee), only 19 jurisdictions required their registration. Of these, only two required the legal owners to be registered and updated, and 6 required beneficial owners to be registered and updated.

The EU AMLD 5 only requires trusts to register their beneficial owners if they are managed by a trustee located in the EU, or if a trust (without a trustee located in the EU) acquires real estate or establishes new professional relations in the EU[59]. Other trusts need not register their beneficial owners, including an EU domestic law trust (created according to the laws of an EU country) but managed and with assets and operations outside the EU. The same lack of registration applies to any trust

---

[58] Knobel, Harari and Meinzer, *The State of Play of Beneficial Ownership Registration: A Visual Overview*.

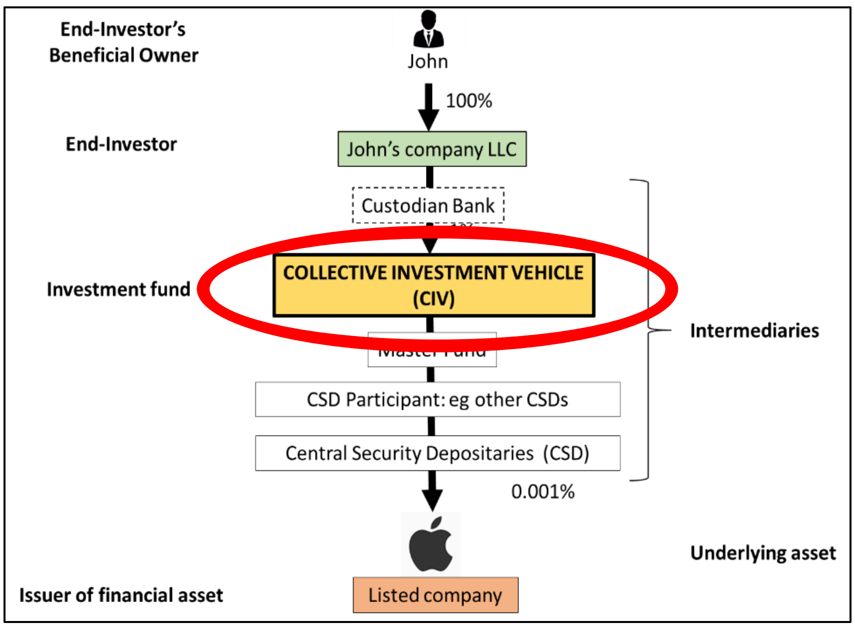
[59] https://www.taxjustice.net/2018/04/09/the-eus-latest-agreement-on-amending-the-anti-money-laundering-directive-still-further-to-go/; 5.8.2019.

with an EU settlor or EU beneficiary, if the trust is managed and operates outside the EU.

In conclusion, it will be difficult to determine who the beneficial owners of the end-investor are depending on the legal vehicle used to hold the interests in an investment fund.

Public beneficial ownership registries will make it easier to know the beneficial owners of the end-investors. This will mostly benefit intermediaries who have to perform know-your-customer procedures on the end-investors. In the case of other intermediaries or the general public, they would not know that such a legal vehicle is actually the end-investor of an investment fund, unless there is more transparency on the fund's investors.

3.2.3 The investment fund



The basic structure of an investment funds involves investors who put money into the fund and a manager with financial expertise who manages the fund. Investment funds usually publish a prospectus describing the manager's qualifications and experience, and the fund's investment focus (eg emerging countries or natural resources). Investors usually have little oversight and control over the manager, who is supposed to follow the prospectus' details. It is usually the regulator who ensures that managers comply, rather than investors.

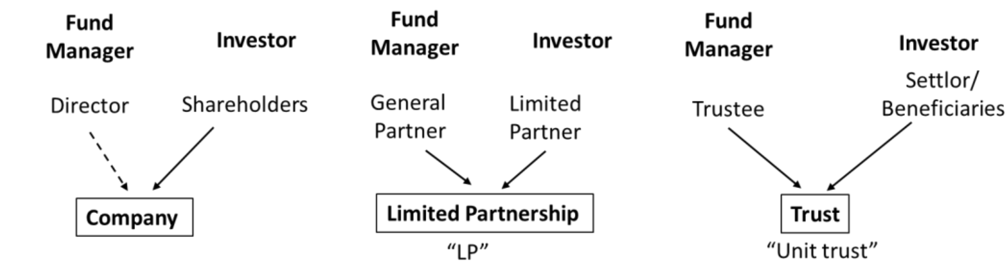
Investment funds are also legal vehicles. They are usually organised as trusts or limited partnerships, and less frequently as companies. For example, in 2010 the OECD reported:

> "in Canada and the United States, both companies and trusts are commonly used. In Australia, New Zealand and Japan, the trust is the predominant form; this also used to be the case in the United Kingdom, but that country has recently introduced corporate vehicles. In many European countries, both joint ownership vehicles (such as fonds communs de placement) and

companies (such as sociétés d'investissement à capital variable) are commonly used."[60]

Therefore, the same transparency challenges mentioned above that apply to legal vehicles acting as end-investors, also apply to investment funds. However, in the case of investment funds, the secrecy is augmented.

Figure 13. Types of legal vehicles for investment funds



BO Registration:	May be exempted if listed on a stock exchange	May be exempted if LP not considered a legal person	Usually not subject to registration to legally exist, or only with tax authorities. Or registration depends on the location of the trustee
BO definition (if it was subject to registration):	">25%" (but most investors would own less tan 1% of the fund, so no one would be identified)	">25%" (but most investors would own less tan 1% of the fund, so no one would be identified)	All investors, as beneficiaries, would have to be identified (if subject to registration)

There are four main factors that worsen an investment fund's secrecy.

First, investment funds usually take the form of trusts or LPs because they already have a suitable structure: one party in charge of managing the vehicle (eg a trustee or general partner), while investors (eg settlors-beneficiaries or limited partners) provide money but have no day-to-day control over the investment and other decisions. However, these two types of legal vehicles represent secrecy risks as mentioned above, because they hardly ever need to register in order to legally exist (especially trusts), and even if they do register, they need not always have to disclose their owners, controllers or beneficial owners.

[60] OECD, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*.

Box 5. Unit trusts

In the case of a trust used as an investment vehicle (usually called investment trusts or unit trusts), the fund manager is the trustee (or someone appointed by the trustee) who holds legal title over the money and manages and invests it. Investors are the settlor-beneficiaries, because they are the ones who transfer the money, but who also have a right to receive the investment (distributions from the investment trust) in the future.

Most investment trusts take the form of unit trusts, where investors acquire units in the trust (similar to interests in an investment fund). One positive aspect of unit trusts is that at least they prevent the abuse of common trusts in relation to shielding assets from outsiders (eg from personal creditors of the settlor). As explained in the Tax Justice Network's papers "Trusts: Weapons of Mass Injustice" and "Trusts: Weapons of Mass Injustice – A response to the critics", under a common trust arrangement, especially those focusing on asset protection, once the settlor put assets in the trust, trust assets may be considered to be in an 'ownerless limbo' because they do not belong to the personal wealth of any party (neither to the settlor nor to the trustee or to the beneficiaries, so no personal creditor of them could access trust assets). In contrast, in the case of a unit trust used for investment, investors (settlor-beneficiaries) hold "units" (interests) in the trust, similar to a shareholder holding shares in a company. Therefore, personal creditors of the investor (settlor-beneficiary) could at least access the "units" in the unit trust, if the investor is insolvent or refuses to repay the debt.

Investment trusts, however, have the same transparency risks as any common trust.

Second, even when investment funds take the form of companies, the same high thresholds apply such as having more than 25% of ownership or voting rights. In a typical company acting as an end investor (holding interests in an investment fund on behalf of the beneficial owner), appointing more people as owners so that no one passes the threshold may be a small challenge, eg a person would have to include a spouse and two children or other family members as shareholders (so that each holds 25% but no one more than that to trigger beneficial ownership identification). However, in the case of an investment fund, most investors would already be far below the threshold, holding likely 1% or less of the interests in the fund, making it impossible for any of them to be identified as a beneficial owner.

Third, beneficial ownership registries usually exempt companies listed on a stock exchange and similar regulated firms from registration. The investment fund may also be exempted from registering with the beneficial ownership register.[61]

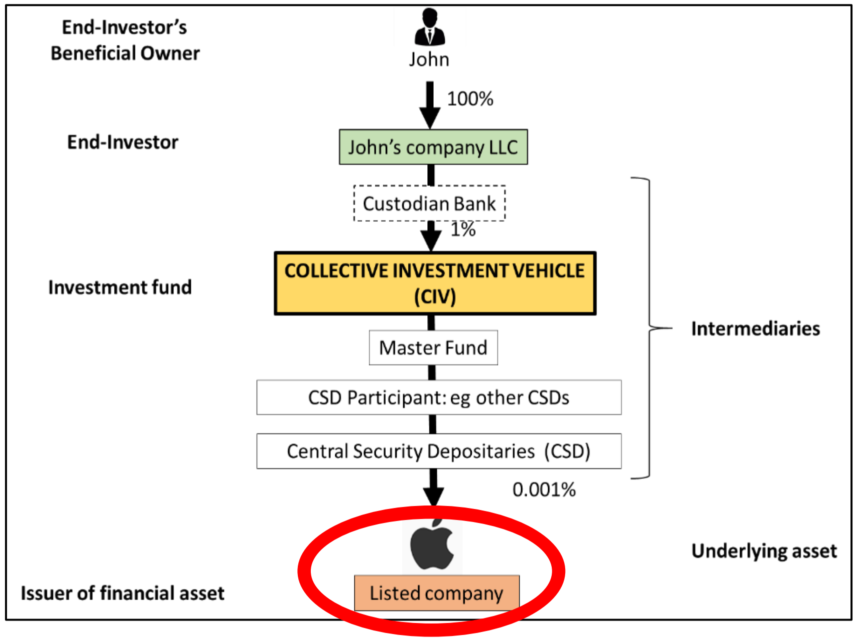
Lastly, investment funds may oppose disclosing their investors for commercial secrecy purposes. In the case of a regular company, eg Coca Cola, investors own shares in the company, but they do not manage it, let alone are they necessarily the company's clients. Disclosing all the owners of Coca Cola shares would have no impact on the company's business, so its competitors would hardly obtain any advantage. In contrast, in the case of investment funds, investors (holding interests

[61] OECD, *2016 TERMS OF REFERENCE TO MONITOR AND REVIEW PROGRESS TOWARDS TRANSPARENCY AND EXCHANGE OF INFORMATION ON REQUEST FOR TAX PURPOSES*, 2016, 4, footnote 10. <https://www.oecd.org/tax/transparency/about-the-global-forum/publications/terms-of-reference.pdf> [accessed 6 February 2017].

in the fund) are the clients of the fund, so if their names are disclosed, competitors could attempt to poach them. A counter-argument however, would be that if all funds have to disclose their investors/clients, then all of them would have the same disadvantages, but also advantages to compete for clients.

3.2.4 The issuer

Generally, the issuer of shares or debt, as recipient of an investment, does not know (and may have no right to know) who its end-investors are (eg "John's company LLC"), even if these end-investors are ultimately shareholders. The same obscurity applies to the end-investor's beneficial owners (eg John).



Imagine a non-listed company where the founder retains 20% of the shares, and the remaining 80% is held by fund A that specialises in private equity investments. The company would know that 80% of the shares are held by the fund, and the fund manager would likely use their shareholding's voting power to vote in the company's shareholder assembly, and maybe join the company's board of directors. The fund would also be entitled to receive dividends that the company pays, which would increase the funds' income (in favour of the fund's end-investors). However, the company would have no idea about who ultimately owns the fund that owns 80% of its shares. The fund may have for instance 1000 end-investors, all with equal 0.1% interest in the fund. One of these end-investor's may be a Panamanian company, in turn owned by John (its beneficial owner).

Ideally, the issuer company should be informed (or have the right to be informed) about the identity of the end-investors who own the fund (eg the Panamanian company) and about the beneficial owners of the end-investors (eg John). This would enable a company to prevent sanctioned persons, or the wrong people or countries from acquiring strategic technologies or assets (eg companies involved with voting machines). It would also prevent anti-trust measures undertaken by investors who own many interests in many competitors.

The same should apply to any company listed on the stock exchange. Given that its stock may constantly be traded, who a companies' shareholders are can change many times over within a single day. The company should be able to know at the end of each business day the identity of its shareholders, their ownership stake and their beneficial owners. Currently, disclosure rules imposed by securities regulators only apply when an investor acquires a relevant stake in a company, eg 3% or 5% of the stock, but not for smaller holdings. The problem with this is that it depends on self-reporting (the owner of the 5% may own that much stake through many different vehicles or funds, so no one may be able to find out about the 5% ownership).

Nougayrede describes that in the UK, and similarly in France, "a corporate issuer has the theoretical right to request ad hoc disclosure at any time of all persons holding 'an interest' in its shares, i.e. all the beneficial owners behind the intermediaries in the custodial chain". However, "difficulties occur when intermediaries are not in the UK."[62] The author also explains that in the US, under existing SEC rules, end-investors may choose not to be disclosed to the issuer.

Conclusion

In conclusion, the presence of numerous intermediaries (all with partial information), the use of omnibus accounts and the lack of transparency on the shareholders and beneficial owners of legal vehicles create several illicit financial flows risks.

Beneficial ownership registries on their own do not solve this secrecy because neither the issuer nor the investment fund are required to disclose their interest-holders, shareholders and beneficial owners in public registries, especially if they are organised as trusts or limited partnerships that are exempt from registration. Even if the issuer or the investment fund is organised as a company which does have to register, current beneficial ownership definitions for companies have high thresholds (usually more than 25% ownership) that exempt end-investor beneficial owners from being identified.

The only improvement for the investment industry brought by beneficial ownership registries is to help first-level intermediaries who contract directly with the end-investor. If the end-investor is not an individual but an entity, beneficial ownership registries can help intermediaries identify the beneficial owners who control the end-investor entity. This way, intermediaries could cross check the beneficial ownership information reported by their customer (the end-investor), with the information available on that entity at the beneficial ownership register. However, the end-investor may be organised as a limited partnership or trust which may not need to register with the beneficial ownership register. In this case, beneficial ownership registries would add no transparency to the investment industry.

Section 4 of this report will explain why the OECD's CRS for automatic exchange of information brings some transparency but not enough to solve the investment

[62] Nougayrède, Delphine, 'Towards a Global Financial Register? The Case for End Investor Transparency in Central Securities Depositories', (p 300).

industry’s secrecy. In essence, not all investment funds and not all end-investors will be covered by automatic exchanges, and the number of end-investors beneficial owners may depend on the organisational form of the investment fund (either a company, trust or limited partnership). Even when an investment fund and an end-investor are covered by the CRS, information will only refer to the value and income related to the investment, but not to the actual underlying securities (eg shares of Apple or Google) held by the end-investor via the investment fund. Lastly, information exchanged based on the CRS may in principle only be used for tax purposes, but not to tackle money laundering and corruption.

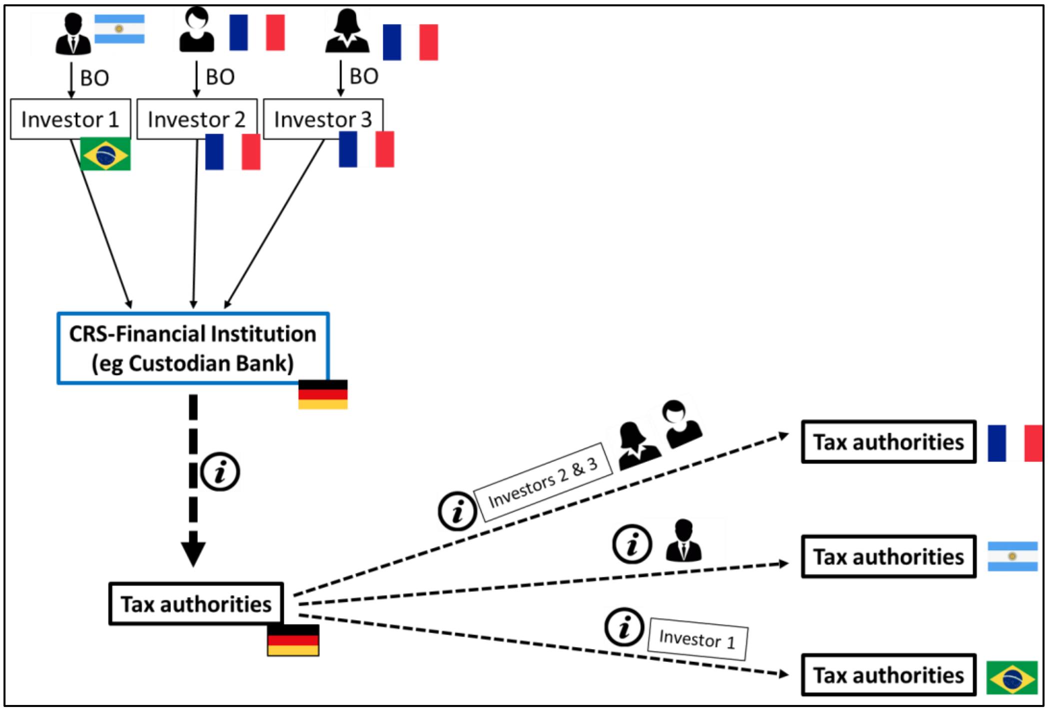
4. Automatic exchange of information: insufficient to solve the investment industry’s secrecy risks

The OECD’s Common Reporting Standard (CRS) for automatic exchange of financial account information[63] improves – but does not resolve - the investment industry’s secrecy by requiring, under certain conditions, some information on end-investors to be collected and reported to tax authorities. In some limited cases, the end-investor beneficial owners will also be identified - either all of them without a de minimis holding (regardless of the amount of their investments) or only those holding more than 25% interest in the investment vehicle or in the end-investor (depending on the case).

Under the CRS framework for automatic exchange of information, financial institutions (classified as such by the CRS) have to identify their account or equity holders (eg the end-investor) and report this identity information and their financial information (account balance and income) to local authorities. Authorities will then exchange this identity and financial account information relating to end-investors to their corresponding country of residence: information on French-resident end-investors will be sent to France.

[63] Organisation for Economic Co-Operation and Development, *Standard for Automatic Exchange of Financial Account Information. Common Reporting Standard* (Paris, 2014) <http://www.oecd.org/ctp/exchange-of-tax-information/Automatic-Exchange-Financial-Account-Information-Common-Reporting-Standard.pdf> [accessed 3 November 2014].

Figure 14. Overview of automatic exchange of information under the CRS



However, for end-investors and their beneficial owners to actually be identified and reported, different conditions must be met at different levels. Without them, there will be no reporting at all under the CRS.

A. The CRS-financial institution level

There must be a financial institution subject to CRS reporting. For this to happen, the financial institution will have to (i) meet the CRS definition of a financial institution, and (ii) be resident in a country participating in the CRS.

(i) The CRS definition of "financial institution" includes a custodial institution, a depository institution, an investment entity, or a specified insurance company. However, the definition excludes: a governmental entity, international organisation or central bank; a broad or narrow participation retirement fund (used mainly for employees of a company), an entity that presents a low risk of being used to evade tax (eg it is regulated by an authority and has not issued bearer shares nor is promoted as a tax minimisation vehicle), or an exempt collective investment vehicle (because those holding interests in the exempt investment vehicle would not be considered reportable in any case, for example for being financial institutions). The CRS Commentaries contain more details on these definitions.

(ii) The financial institution meeting the CRS definition of a "financial institution" must be resident in a country implementing the CRS. As of

August 2019, 109 jurisdictions had committed to implement the CRS[64]. However, this does not mean that all 109 jurisdictions will be exchanging information with each other, although that would be expected to happen eventually among all countries implementing the CRS. The United States will in principle not join the CRS claiming that they have signed Inter-Governmental Agreements (IGAs) with many countries based on the US domestic legal framework for automatic exchange of information called the Foreign Account Tax Compliance Act or FATCA. FATCA's framework ensures that the US will receive as much information as it would by implementing the CRS, but the US will not send a reciprocal level of information to other countries as required under the standard. For instance, the US will not send any information about the beneficial owners of accounts held in US financial institutions.[65]

B. The end-investor level

If the end-investor is an individual, being resident in a country implementing the CRS is the only relevant factor.[66] In contrast, if the end-investor is an entity (not an individual), the identification and reporting of its information will depend on the end-investor entity being a (i) "reportable person" and (ii) being resident in a country implementing the CRS. Corporations with stock regularly traded in a securities market, governmental entities and another CRS-financial institutions are not considered "reportable persons" under the standard and their information will not be reported.

C. The end-investor beneficial owner

For beneficial owners[67] of an end-investor entity to be identified and reported, two conditions must be met: (i) the end-investor entity must be classified as a "passive entity"[68] and (ii) the beneficial owner must be resident in a country implementing the CRS. An end-investor entity will be considered a "passive entity" if its incomeis predominantly passive, such as from interests, dividends, royalties, rent, etc. The organisation form of the end-investor entity as either a legal person (eg a company) or a legal arrangement (eg a trust) will have consequences for the number and type of beneficial owners to be identified, because the CRS refers to FATF definitions which differ for legal persons and for trusts (more details below).

---

[64] https://www.oecd.org/tax/transparency/AEOI-commitments.pdf; 5.8.2019.

[65] https://www.taxjustice.net/2015/01/26/loophole-usa-vortex-shaped-hole-global-financial-transparency-2/; 5.8.2019.

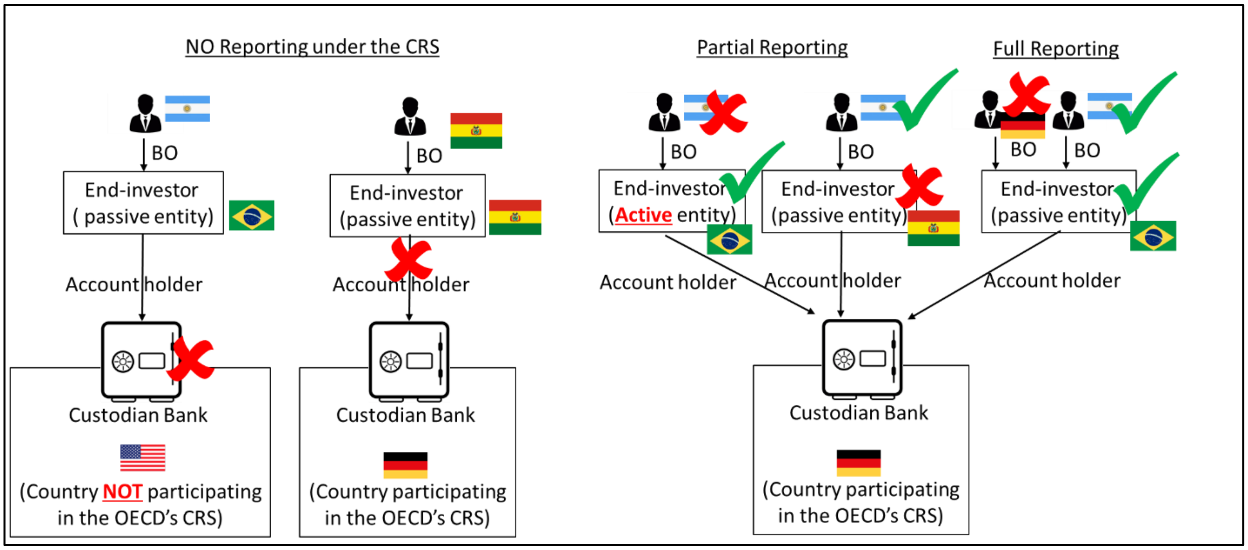
[66] However, there will be no reporting if the end-investor is resident in the same country as the CRS-financial institution because the CRS is essentially about exchanging information with foreign countries. From the perspective of a CRS-financial institution, "reportable persons" are "non-residents" who are resident in a participating jurisdiction. This excludes (i) residents in the same jurisdiction as the CRS-financial institution and (ii) non-residents who reside in a non-participating country. These reporting rules apply to both end-investors (entities or individuals) and end-investor beneficial owners.

[67] The CRS uses the term "controlling person" to refer to a beneficial owner.

[68] The CRS uses the term "passive non-financial entity or passive NFE" to refer to passive entities.

Importantly, the residence of the end-investor entity is irrelevant for the purposes of identifying its beneficial owners. End-investor beneficial owners may still have to be reported (if the conditions are met), even if the end-investor entity is not resident in a country implementing the CRS.

Figure 15. Overview of reporting and non-reporting cases



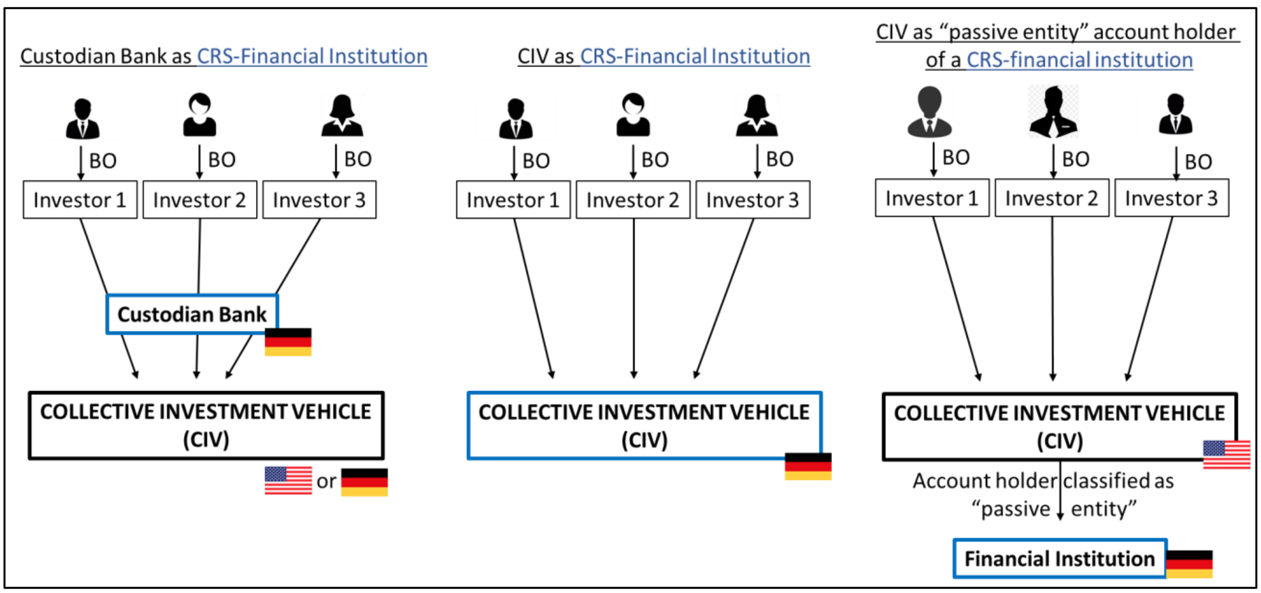
In the first case from the left described in Figure 15 above, reporting does not take place under the CRS because the US is not participating in the CRS. In the second case, while the financial institution is located in a country participating in the CRS, the account holder and its beneficial owner are located in Bolivia, which is not currently participating in the CRS, so reporting does not take place. In the third case, all parties (the financial institution, the account holder and the beneficial owner) are resident in a participating jurisdiction. However, the account holder is an "active" entity, so there is no reporting at the beneficial ownership level. In the fourth case, the account holder is a passive entity, so the account holder's beneficial owner (who is resident in a participating jurisdiction) will be reported but the account holder will not be reported since they are resident in a non-participating jurisdiction. In the last case, there is reporting at both levels, except for the German-resident beneficial owner (because he is resident in the same country as the reporting financial institution).

In summary, the end-investors of investment funds will be reported, and in limited cases so will the end-investors' beneficial owners, under one of three main scenarios. These scenarios (described in detail below) involve the end-investor holding interests

1. Indirectly in the investment vehicle, through a custodial institution (eg a custodian bank or central securities depositaries). The custodial institution (considered a "financial institution" for CRS purposes) will do the reporting. In this case, the residence of the investment vehicle is irrelevant.

2. Directly in an investment vehicle that is considered a "financial institution" for CRS purposes[69] (because it meets the conditions and is resident in a country participating in the CRS, eg in Germany), or
3. Directly in an "investment vehicle managed by a financial institution"[70] that (i) is resident in a non-participating country (like the US), and that (ii) holds an account with a CRS-financial institution, eg a depositary bank.[71] In this exceptional case, the "investment vehicle managed by a financial institution" will be considered a "passive entity" account holder in relation to the depositary bank[72]. The bank, as the CRS-financial institution, will report the beneficial owners of the "investment vehicle managed by a financial institution".

Figure 16. Overview of cases where end-investors of investment vehicles are reported



The blue border in Figure 16 indicates that the financial institution is considered a "financial institution for CRS purposes", and so is required to identify and report the end-investors.

[69] The CRS includes two types of investment entities as "CRS financial institutions": those (a) conducting as a business the trading, managing or investing in financial assets; or (b) whose income is predominantly from investing, managing or investing in financial assets, if it is managed by a financial institution (but not by an individual).

70 The CRS refers to these as "type B investment entities". This scenario applies only to type B investment entities: those whose income is predominantly from investing, managing or investing in financial assets, if it is managed by a financial institution (but not by an individual). See note above.

71 In this case, the "investment vehicle managed by a financial institution" is not a CRS-financial institution (thus reports no information), because it is resident in a non-participating country (the US).

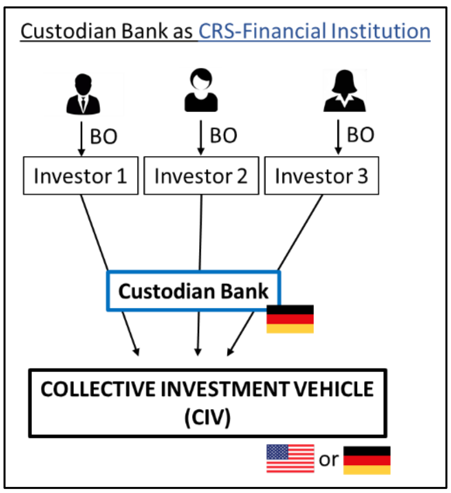
[72] This is an "exceptional" case because in principle investment entities (that hold accounts in a CRS-financial institution, like a depositary bank) are not "reportable persons". However, as an anti-avoidance measure, the CRS treats this "investment entity resident in a non-participating country" as "reportable". Specifically, it has to be reported as a "passive entity" account holder.

The German flag represents a country participating in the CRS, and the US flag represents a country that is not participating in the CRS.

4.1 A custodial institution as a "financial institution" for CRS purposes

As explained above, end-investors usually hold interests in an investment vehicle via intermediaries such as custodian banks. In such cases, the residence of the investment vehicle is irrelevant. The custodial institution (in this case, a custodian bank) would have to identify all end-investors who have accounts with it, regardless of the residence of the investment vehicle.

Figure 17. Custodian bank as CRS-financial institution



In cases where the custodial institution and the investment vehicle in which the end-investor holds interests are both resident in a participating jurisdiction, only one of these "CRS-financial institutions" would have to report on the equity holders (the end-investors) and, if applicable, their beneficial owners.[73]

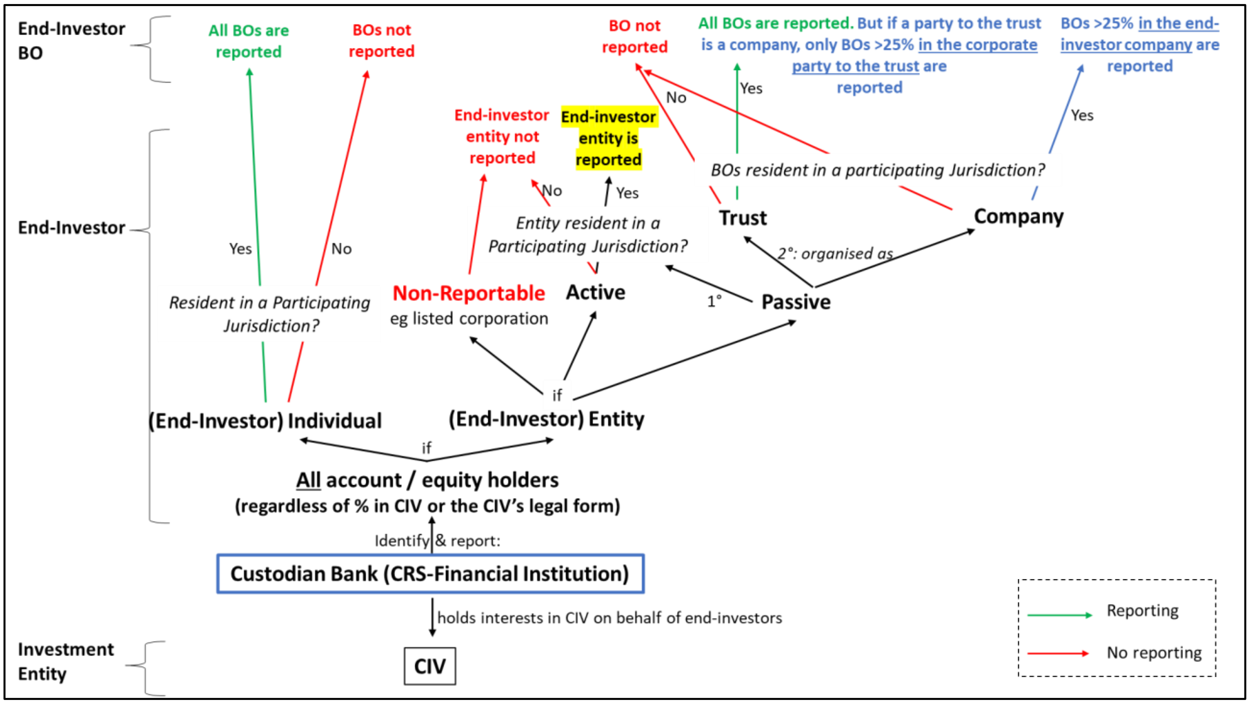
In practice, there may also be a central securities depositary (CSD) between the custodian bank and the investment vehicle. However, the CRS recommends the reporting be done by the custodian bank given that the custodian bank is closer to the end-investor and thus already has the necessary information.[74]

[73] The CRS Commentaries state: "Where Equity Interests are held through a Custodial Institution, the Custodial Institution is responsible for reporting, not the Investment Entity. The following example illustrates how such reporting must be done: Reportable Person A holds shares in investment fund L. A holds the shares in custody with custodian Y. Investment fund L is an Investment Entity and, from its perspective, its shares are Financial Accounts (i.e., Equity Interests in an Investment Entity). L must treat custodian Y as its Account Holder. As Y is a Financial Institution (i.e., a Custodial Institution) and Financial Institutions are not Reportable Persons, such shares are not object of reporting by investment fund L. For custodian Y, the shares held for A are Financial Assets held in a Custodial Account. As a Custodial Institution, Y is responsible for reporting the shares it is holding on behalf of A."

[74] The CRS Commentaries state: "For example, in some Participating Jurisdictions securities may be held in owner-registered accounts that are maintained by a central securities depository and operated by other Financial Institutions. In principle, the central securities depository would be treated as the Reporting Financial Institution with respect to the accounts and, thus, responsible for fulfilling all due diligence and reporting obligations. However, since the client relationships are managed and the due diligence procedures are applied by the other Financial Institutions in their capacity of account operators, the central securities depository may not be in a position to comply with such obligations. Participating Jurisdictions may address such a case, for example, by treating the relevant Custodial Accounts as held by such other Financial Institutions, and such other Financial Institutions as responsible for any reporting required with respect to such Custodial Accounts."

The following chart describes the circumstances under which end-investors and their beneficial owners would be identified.

Figure 18. Cases where end investors and beneficial owners are identified and reported



If the end-investors are entities instead of individuals, identification and reporting may occur at two levels: at the entity level (the company holding the interests in the investment vehicle or CIV, on behalf of the beneficial owners) and at the beneficial ownership level.

At the entity level, the end-investor entity will be reported if it is resident in a country participating in the CRS. By the same token, the end-investor entity will not be reported if it is considered a "non-reportable person" (ie, it is a government entity or a corporation regularly traded on a stock exchange) or if it is resident in a non-participating country.

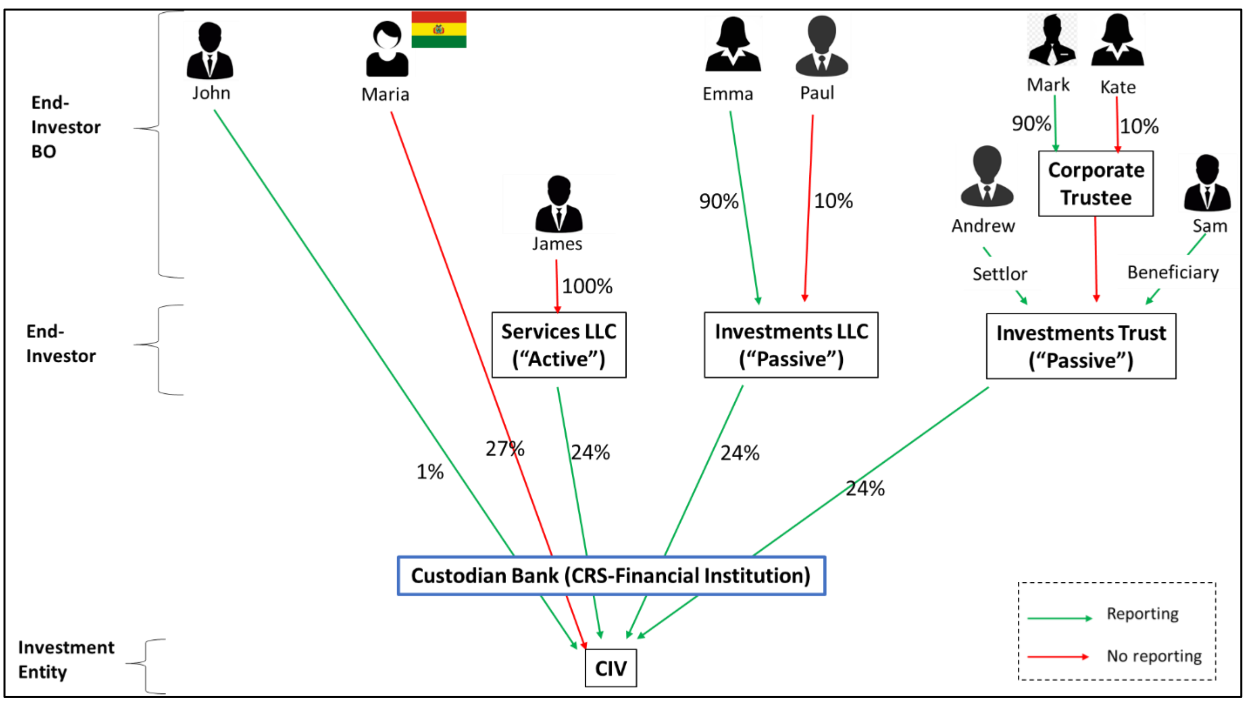
Even if the end-investor entity is not resident in a participating country, there may still be reporting of the end-investor's beneficial owners. However, this will depend on whether the end-investor entity is classified as a "passive entity", in which case the beneficial owner will need to be reported, or as an "active entity", in which case the beneficial owners will not need to be reported. As mentioned earlier, even if the end-investor entity is classified as a "passive entity", only beneficial owners that are resident in a country participating in the CRS will be reported.

Moreover, the number of beneficial owners to be reported will depend on whether the entity-end-investor is organised as a trust or as a company (legal person). In this case, it is not up to the CRS but rather the FATF definitions that come into play.

While FATF's recommendations on how to identify beneficial owners are somewhat complex and open (ie they refer to control, include cascading tests), in practice countries' regulations and the CRS adopt two basic rules based on the FATF's definitions. In the case of trusts, all parties to the trust have to be identified as beneficial owners. In the case of companies or other legal persons, in principle only those individuals that have more than 25% of the shares or voting rights have to be identified as beneficial owners. The case could be complicated even further if the ownership structure involves trusts owning companies, or vice-versa. For example, if an entity-end-investor is organised as a trust, but some of its parties, for example the trustee, is actually a legal person like a company, then in such case the FATF's definitions for legal persons would likely apply to the beneficial owners of the corporate trustee.

The following example in Figure 19 should clarify all these scenarios.

Figure 19. Cases where end investors and beneficial owners are identified and reported depending on thresholds and type of legal vehicle



In the case illustrated by Figure 19, the custodian bank (a custodial institution) is considered a "financial institution" for CRS purposes. This means that all of its account holders (anyone with interests in a collective investment vehicle, aka a CIV) should be identified and reported to the tax authorities, regardless of the interests they hold in the CIV (thresholds do not apply in this case) and regardless if the CIV is resident in a participating jurisdiction or not.

- John, an individual, has to be reported as an end-investor (and at the same time as the end-investor beneficial owner) even though he only holds 1% in the CIV.

- Maria won't be reported. Even though she holds 27% in the CIV, she is resident in Bolivia, a country not (yet) participating in the CRS. Maria is the only case in this example of a resident in a non-participating country.
- "Services LLC" will be reported as an end-investor. However, its beneficial owner will not be reported because Services LLC was classified as an "active" entity.
- "Investments LLC", a company, will be reported as an end-investor. In addition, its beneficial owners will also be reported because it was classified as "passive". However, only Emma passes the FATF threshold to be considered a beneficial owner of the company. Paul's identity will remain hidden.
- "Investments trust", a trust, will be reported as an end-investor. In addition, its beneficial owners will also be identified because it was classified as "passive". Under the FATF definitions, all parties to a trust (settlors, trustees, protectors, beneficiaries, etc.) have to be reported as beneficial owners of the trust regardless of the interest or control they actually hold (thresholds do not apply either). In this example: Andrew, the settlor, and Sam, the beneficiary, will be identified. The trustee, however, is not a natural person but a company (ie, a "corporate trustee"). Therefore, its beneficial owners will have to be identified and reported according to the definitions for companies. This means only Mark will be reported as a beneficial owner of the corporate trustee, and thus of the trust. Kate will not be reported because she does not pass the 25% threshold of the FATF beneficial ownership definitions for companies.

4.2 The investment entity or fund (CIV) as a "financial institution" for CRS purposes

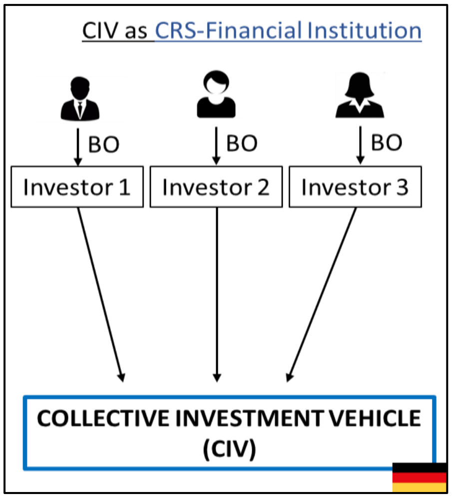
While in general there are often intermediaries between end-investors and an investment fund (also referred to as collective investment vehicle or CIV) like the example above, there may be the case that the investment funds' interests are directly held by end-investors[75].

The CRS Commentaries[76] acknowledge that the investment fund may not have all the information on the end-investors (eg their residency) needed to meet the

[75] In contrast, it appears that if the CIV's interests are held in a custodian bank, but the custodian bank is not resident in a country implementing the CRS, then no one will do the reporting. This loophole should be fixed so that, if no one else is carrying out the CRS reporting, then the CIV corporate investment vehicle should do it.

[76] The CRS Commentaries state: "A similar case may occur in some Participating Jurisdictions where trades of equity interests in an exchange traded fund are effected, and the due diligence procedures are applied, by brokers, but the end investors are directly registered in the fund's interest register. In principle, the fund would be treated as the Reporting Financial Institution with respect to the equity interests; however, it would not have the information to comply with its reporting obligations. Participating Jurisdictions may address such a case, for example, by requiring the brokers to provide all the necessary information to the fund, so that it may fulfil its reporting obligations."

Figure 20. Investment vehicle (CIV) as CRS-financial institution



standard's report requirements. The Commentaries thus suggest that countries should require the holders of the necessary information, may be to give all the relevant information to the investment fund for it to report on the end-investors pursuant to the CRS.

As for the identification and reporting of the end-investors and their beneficial owners, the same conditions that apply to custodian banks apply to investment funds (aka CIVs) that are CRS-financial institutions required to do the reporting: the end-investors are reported as "equity or account holders". However, in this case the residence of the investment fund is relevant, because if it is not resident in a participating jurisdiction, it would not be considered a CRS-financial institution. In contrast, when the custodian bank is the CRS-financial institution, the residency of the investment fund is irrelevant (because what matters is the residence of the custodian bank).

Figure 21. Cases where end-investors and beneficial owners are identified and reported

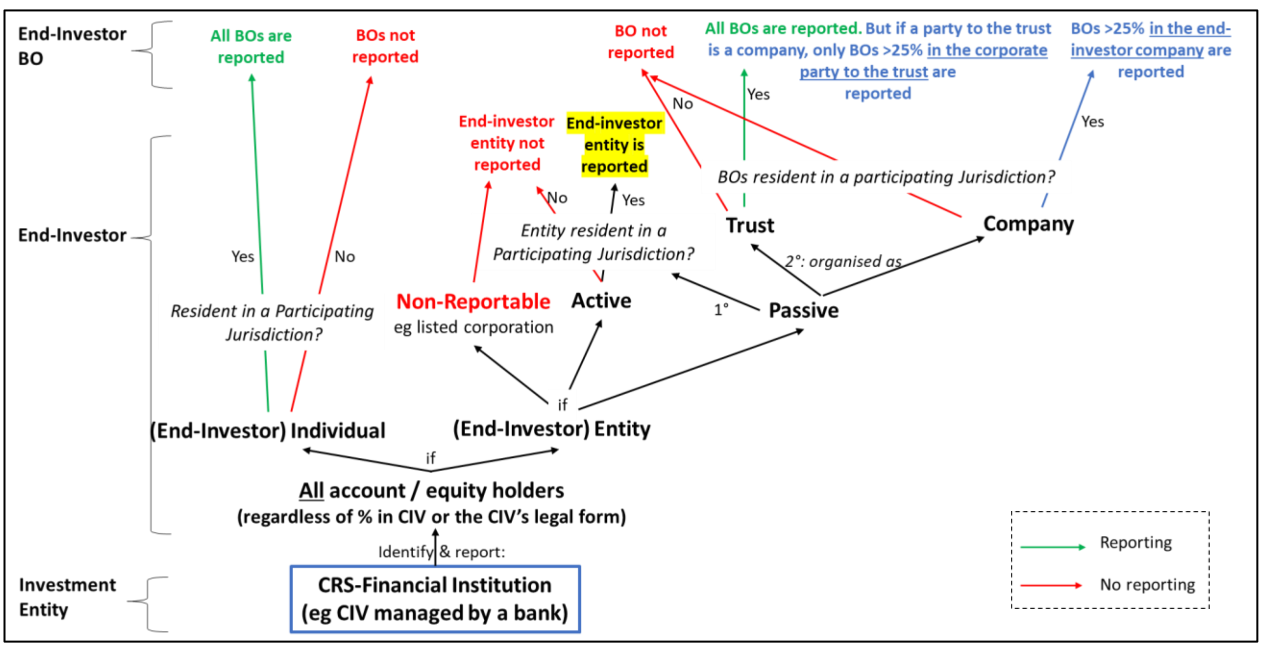
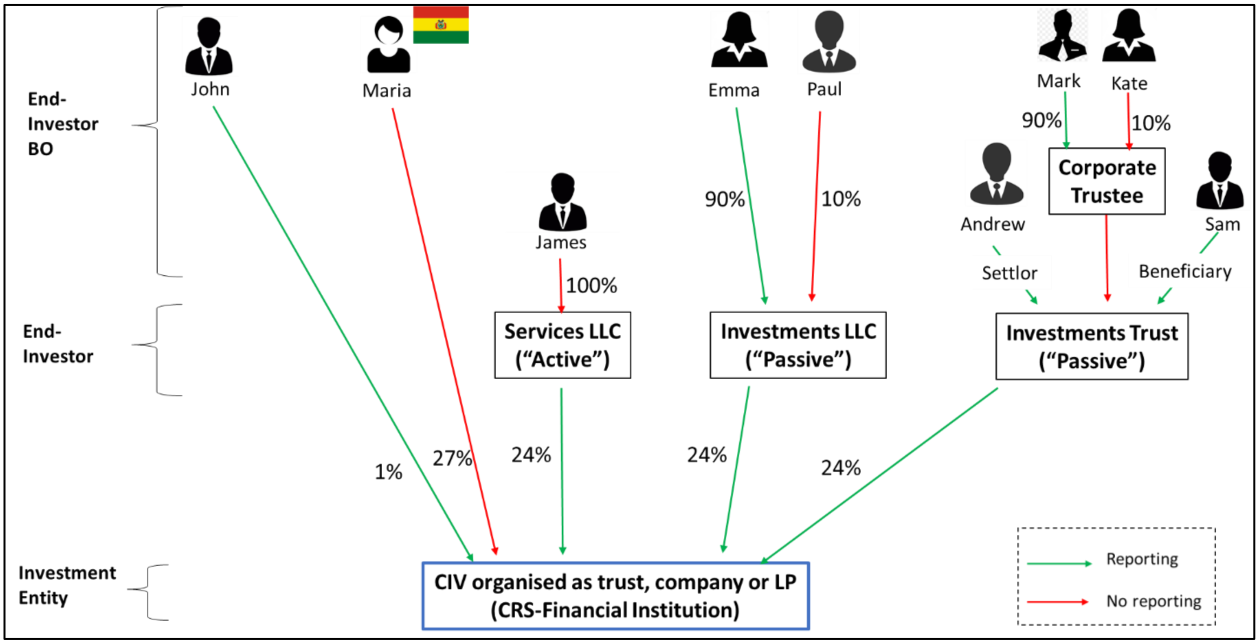


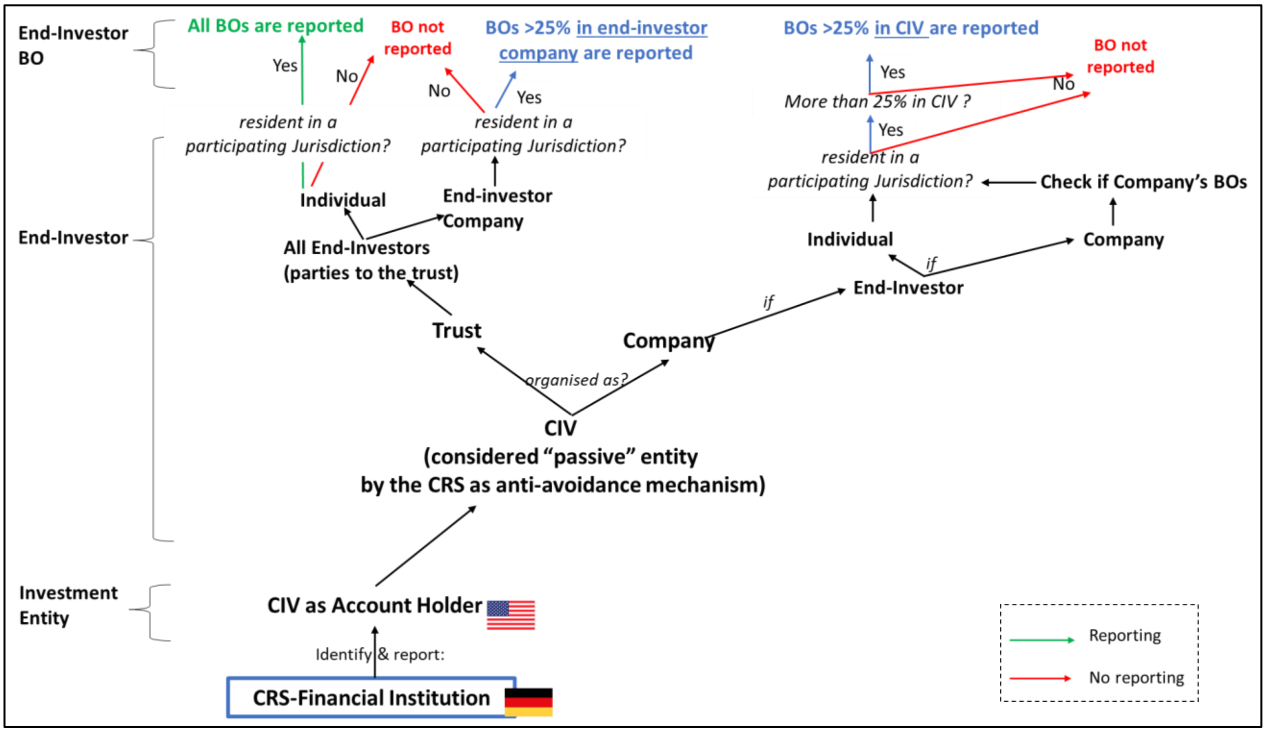
Figure 22. Cases where end investors and beneficial owners are identified and reported depending on thresholds and type of legal vehicle



4.3 The investment fund (or CIV) as a "passive entity" account holder of a CRS-financial institution

When an investment fund (CIV) is resident in a non-participating jurisdiction (eg the US), it will not be considered a CRS-financial institution and will thus report no information. However, if this "investment fund managed by a financial institution" holds an account with a financial institution (eg a depositary bank) that is considered a CRS-financial institution, this CRS-financial institution will have to treat the investment fund as a passive entity account holder (anti-avoidance measures required by the CRS). Consequently, the CRS-investment fund will have to report the investment fund's beneficial owners. Given that only beneficial owners will have to be reported, the investment fund's end-investors that are entities will not be reported.

Figure 23. Cases where end investors and beneficial owners are identified and reported

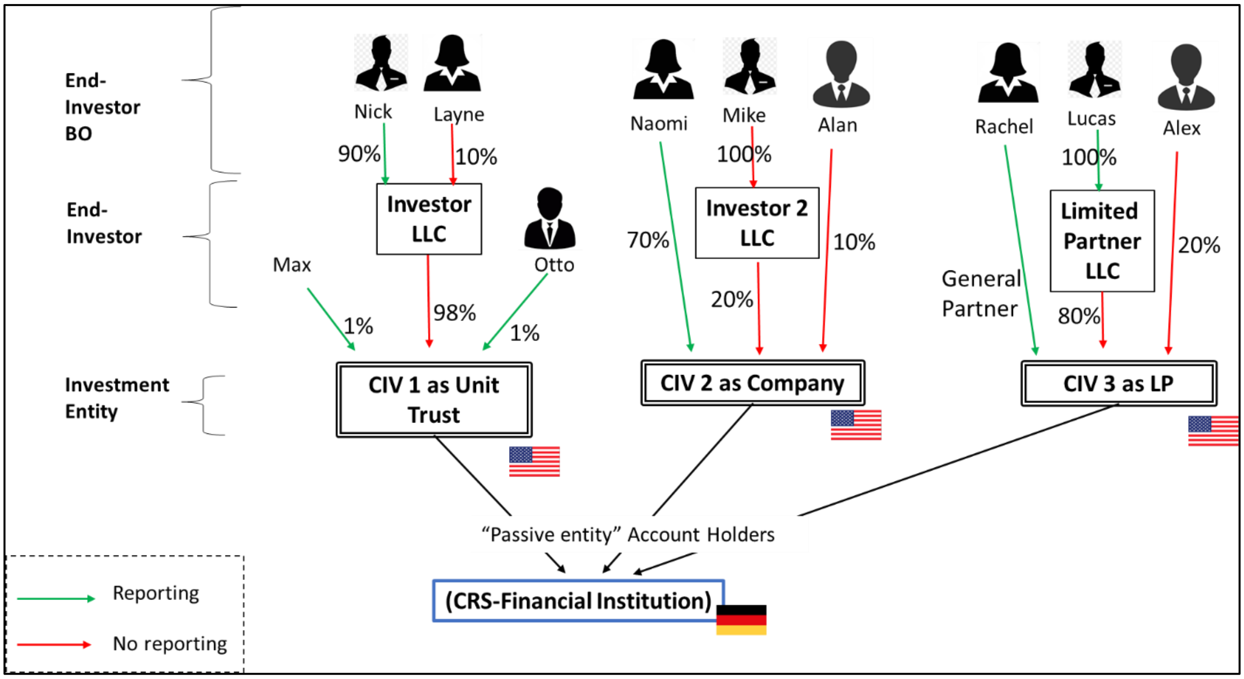


As an anti-avoidance mechanism, the CRS considers that an "investment entity managed by a financial institution" located in a non-participating jurisdiction that holds an account with a CRS-financial institution, should be considered a "passive entity" account holder. In this case, the organisation form of the investment fund or CIV (a trust, a company or an LP) will be relevant for the number of end-investor's beneficial owners that will be identified.

If the CIV is a trust, the FATF beneficial ownership definitions for trusts apply, and thus all parties to the trust will have to be reported. In this case, all end-investor beneficial owners will have to be identified, regardless of the value of their interests. If all end-investors of the trust are individuals, they will all be identified, provided that they are resident in countries participating in the CRS. If any of the parties to the trust (investors holding interests in the CIV-trust) is an end-investor company, then it is very likely that the definitions for beneficial owners of companies would apply. This means only those individuals holding more than 25% of shares in the company-end-investor (which is a party to the CIV-trust) would be reported as the beneficial owners.

If the CIV is a company, then the FATF beneficial ownership definitions for legal persons would apply, and only those individuals holding more than 25% of the CIV-company would be identified as beneficial owners, provided that they are resident in a country participating in the CRS. However, if interests in the CIV-company are held by the beneficial owners also through a company-end-investor, then the FATF definitions would again apply. The example in Figure 24 below should clarify this.

Figure 24. Cases where end-investors and beneficial owners are identified and reported depending on thresholds and type of legal vehicle



This example has three different scenarios, all of which involve CIVs not as CRS-financial institutions but merely as "passive entity" account holders who hold an account with a CRS-financial institution, eg a depositary bank. In addition, all beneficial owners and entities are resident in a country participating in the CRS.

- In the first case, the CIV classified as a "passive entity" account holder is a trust, and therefore all parties to the trust have to be identified, regardless of any threshold. Both Max and Otto, each with only 1% interest in the trust are reported. The party with the highest interest, however, is a company, "Investor LLC". In this case, the FATF beneficial ownership definitions for companies would likely apply, and thus only Nick, but not Layne, would be identified as end-investor beneficial owners of the CIV-trust. Layne would not be identified because, even though she holds 9.8% of interests in the CIV-trust (ie 10% of 98% owned by "Investor LLC"), which is more than what Max and Otto hold, Layne does not own more than 25% of the shares of "Investor LLC", which is what is required to be considered a beneficial owner of "Investor LLC". This example shows why when a company owns a trust, ideally all the owners of the company, and not just those owning more than 25% should be identified as beneficial owners of the trust.
- In the second example, the CIV 2, classified as a "passive entity" account holder, is organised as a company and therefore is subject to the FATF beneficial ownership definitions for companies. Only the individuals with more

than 25% of the shares in CIV 2 would be reported. This includes only Naomi. Alan directly holds only 10% in CIV 2, and Mike holds, indirectly, only 20%.

- In the last example, the CIV 3 as a "passive entity" account holder is organised as a limited partnership (LP). While neither the CRS nor the FATF specify any definition for LPs, the definitions for legal persons would likely apply if the LP is considered a legal person. In this case, it could be assumed that the "general partner" (very likely the fund manager) would have to be reported for having control over the CIV, even if the general partner has no interests in the CIV. As for limited partners, the threshold of more than 25% would likely apply, and thus only Lucas would be reported as an end-investor beneficial owner because he holds 80% of CIV 3 via "Limited partners LLC". Alex, in contrast, with only 20% of interests, does not pass the "more than 25%" threshold.

The above explanations show that, while the CRS increases transparency and could be used to cross-check information in some cases, end-investors and their beneficial owners are not always reported. This is especially the case for those who are resident in developing countries that are not participating in the CRS yet (or those who are resident in the same country as the financial institution in charge of reporting), or if the CIV and all the intermediaries are resident in a non-participating country like the US.

4.4 Details on the end-investors available under the CRS

Even for cases where the investment entity (CIV) or an intermediary are subject to the CRS and must report end-investors and beneficial owners, only limited information would be available: the balance account and income related to the interests held in investment entities, but not the details on the underlying securities (eg shares of Apple) held by these investment entities. If the reporting is done by the custodian bank, then not even the investment entity will be identified.

To illustrate with a simplified example, let's imagine John has:

- Units representing 1% of the ownership of CIV A, worth USD 1000, with a total dividends income of USD 10 in 2018
- Units representing 2% of the ownership of CIV B, worth USD 2000, with a total dividends income of USD 20 in 2018.

If John holds all units through a custodian bank, the bank would inform that in 2018 John had a balance account of USD 3000, and total income of USD 30, but there will be no information about which investment entity (CIV) he has interests in.

If John holds the interests in CIV A and B directly (not through a custodian bank), then each CIV would report John's corresponding balance account and income. In this case, authorities would find out in which investment entities (CIVs) John has interests, because they are the ones doing the reporting.

If both CIV A and B are investment entities managed by a financial institution, but they are resident in a non-participating jurisdiction (eg the US) and they hold an account in a depositary bank that is a CRS-financial institution, the bank will have to treat both CIVs as account holders that are "passive entities". The bank will have to identify the CIVs' beneficial owners. However, this will depend on how the CIVs are organised.

If the CIVs are organised as companies or limited partnerships, John will not have to be reported by the bank because he has less than 25% of interests in each CIV, not passing the threshold to be considered a beneficial owner. If the CIVs are organised as trusts, then John would be reported, because all parties to the trust are considered beneficial owners. In this case, the bank would have to report each CIV separately (they are likely two different account holders). John would be reported as one of the beneficial owners of both accounts. Instead of reporting John's balance and income, the total balance account and income of each CIV would be reported as belonging to John because when an account holder is considered a "passive entity" the balance account and income of the account holder is also reported for each beneficial owner.[77]

In conclusion, even when beneficial owners of investment entities are reported, there are many situations that either provide partial information or provide confusing information (eg, all the investment entity's account balance and income reported as belonging to each beneficial owner, if the investment entity is considered a "passive entity" account holder).

[77] The CRS Implementation Handbook establishes "Each holder of a jointly held account is attributed the entire balance or value of the joint account, as well as the entire amounts paid or credited to the joint account. The same is applicable with respect to: 1. an account held by a Passive NFE with more than one Controlling Person that is a Reportable Person;"

5. Proposals to increase transparency in the investment industry

Even though the 2014 Clearstream case involving Iran hiding behind intermediaries to invest in the US could have given enough momentum for fundamental changes to improve the transparency in the investment industry and securities trading, not enough has happened since. In 2018 the FATF published a guidance for a risk-based approach for the securities sector. It suggested no ramp up of transparency.

The following proposals, starting with the most comprehensive and ending with the less ambitious ones, attempt to improve the transparency that would enable intermediaries, authorities and the public to scrutinise the trillions of dollars that are invested and traded in financial assets. Such transparency could improve the fight against illicit financial flows and allow the measurement of inequality, given that financial assets represent a big part of high net worth individuals' wealth.

5.1 Full transparency on the individual ownership chain from end-investor to the underlying financial assets

The most comprehensive solution to secrecy underpinning the investment industry and securities trading would be to disclose every individual that directly or indirectly holds: (i) any interest in an investment fund, (ii) any interest in an underlying financial assets (eg a share in a company listed on a stock exchange), and (iii) how the individual holds these underlying securities, including all intermediaries involved. Given the current trend of super-fast trading where securities may be held for just a few seconds, in this case ownership could be reported about the end-investors who held each interest in the investment fund and in the underlying security as at the end of each business day.

For instance, in 2017 the UK amended its beneficial ownership registration laws for some companies listed on a stock exchange. Companies listed on a secondary stock market (eg AIM market of the London Stock Exchange) that used to be exempted from registration, are now required to register their beneficial owners in a public register.[78]

This identification of the end-investor and its beneficial owner (the individual end-investor) would involve replacing omnibus accounts (that pool together money from many different investors) and employ segregated accounts at the end-investor beneficial ownership level. (Or to keep using omnibus accounts but to have a parallel reporting mechanism to identify the beneficial owner holding any interest).

As for implementation, one option would be to require beneficial ownership registries or central securities depositories to register this information. To be comprehensive in its scope, beneficial ownership thresholds for legal persons (currently at "more than 25%" of ownership) should be lowered so as to require any individual holding any interest in an investment fund or in a financial asset (eg

[78] http://www.klgates.com/uk-implements-changes-to-beneficial-ownership-register-regime-07-03-2017/; 29.8.2019.

holding one share in Apple) to be registered as a beneficial owner.[79] This proposal assumes that “beneficial ownership” is not only about control, but also about any ownership, however small: an individual holding 0.1% in a listed company (let alone only one share) would have no decision making at all over the entity, but should still be registered as a beneficial owner. This no-de-minimis threshold approach already applies to trusts: all settlors, trustees, protectors and beneficiaries are considered beneficial owners, even if they have no control or interest in the trust.

Identifying only individuals with control over an investment fund or listed company, is not only complex but it also creates secrecy over those individuals who do not have control. In contrast, by identifying every individual holding at least one share or unit of interest it would be possible to account for every underlying financial asset, and every interest in an investment fund in the world (or at least in a given market).

This granular ownership detail about every existing investment fund and underlying financial asset would ensure that there is no case of underreporting or double reporting of financial assets (to prevent evading income tax, capital gains tax, or trying to obtain illegal tax refunds).

This very low thresholds (far lower than the current “more than 25%”) make sense especially in the investment industry that has trillions of dollars under management. Even a 0.1% could be relevant to measure inequality or to investigate whether a person is engaging in money laundering. For example, as of September 2019, merely 0.1% of Apple shares are worth USD 220 million.

5.1.a) Public access

With regard to access to this granular information on the beneficial owners of investment funds and underlying financial assets, in the ideal scenario it should be publicly available (as it already applies in the EU for beneficial ownership of companies). This would reduce costs of data security, handling access to the data, and would allow an extra pair of eyes to verify information. In addition, beneficial ownership information should be verified.[80]

5.1.b) Accessible to authorities

The second best option would be for this granular information to be available to authorities.

5.1.c) Accessible to intermediaries only

---

[79] Andres Knobel and Markus Meinzer, *Drilling down to the Real Owners – Part 1. “More than 25% of Ownership” & “Unidentified” Beneficial Ownership: Amendments Needed in FATF’s Recommendations and in EU’s AML Directive*, 2016 <http://www.taxjustice.net/wp-content/uploads/2013/04/TJN2016_BO-EUAMLD-FATF-Part1.pdf> [accessed 6 September 2016].

[80] Knobel, *Beneficial Ownership Verification*.

A third best scenario would be to ensure access of this granular transparency to all intermediaries within the investment industry and securities trading. In this case, any intermediary would be able to identify the end-investor and beneficial owner, being able to apply anti-money laundering checks on the origin of the money.

In essence, this scenario would involve the use of segregated accounts with information at the level of the beneficial owner of the end-investor.

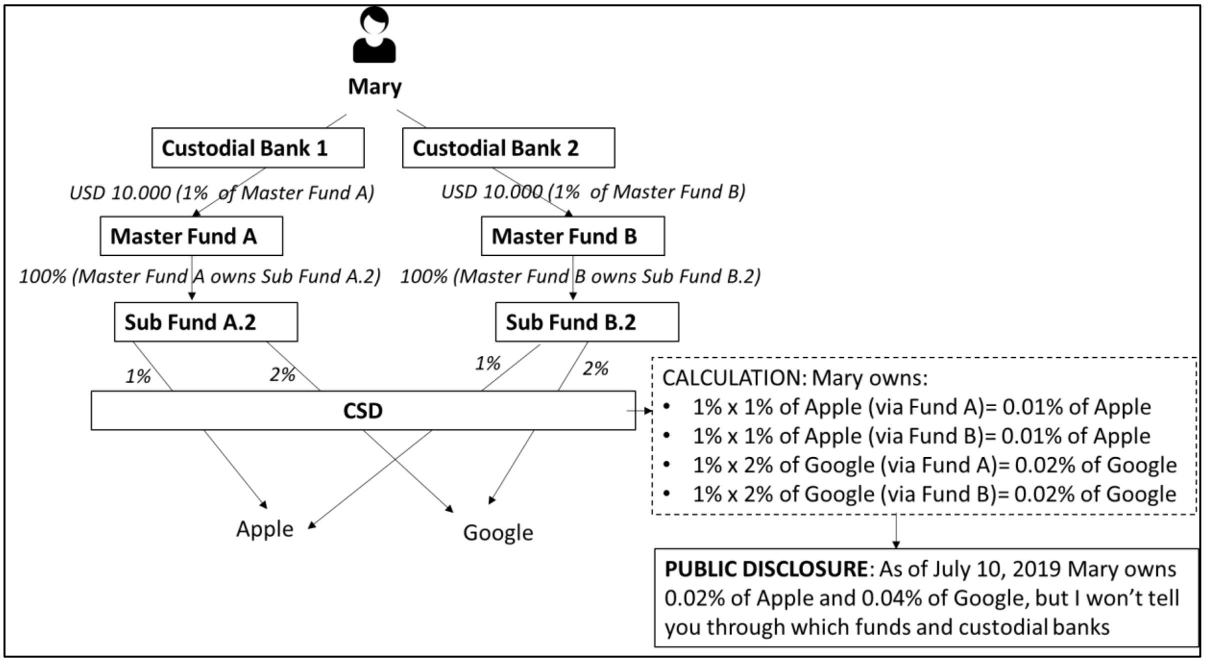
5.2 Transparency on the beneficial owner of financial assets (without disclosing through which intermediaries they are held)

A fourth, much less transparent option would be to have information on end-investors and beneficial owners over just underlying financial assets, even if there is no disclosure of how these interests are held (intermediaries, including investment entities would not be disclosed). In this case, for each intermediary could to disclose to a neutral party (eg the securities regulator or the central securities depository) the daily percentage of shareholdings ultimately owned by each individual end-investor. For example, if at the end of the business day, John owned 0.01% of company A through investment entity 1, custodian bank X and broker Y and 0.05 % of the same company A through investment entity 2, custodian bank Z and broker Q then the neutral party would report at the end of business day that John owned 0.06% of company A, without disclosing through which intermediaries. A similar reporting scheme called "securities holdings statistics" (SHS) is applied by the Europan System of Central Banks.[81]

This fourth transparency alternative scenario would not allow other intermediaries to run checks on John and the origin of his money, but would at least reveal the entire list of financial assets held in the world (or the applicable market). investment industry. This would make it possible to know the total number of securities held in the investment industry and who owns them, albeit without knowing how they own them. This would also prevent underreporting. For example, if only 99% of the world's securities are accounted for, authorities would know to investigate for the missing 1%. At the same time, this would reveal cases of misreporting or double-reporting, for example if two persons pretend to be the owners of a share when only one of them holds it (as it happened in the Cum-Ex tax fraud). It would also reveal ownership over securities directly held by end-investors (not through investment entities).

[81] https://www.ecb.europa.eu/pub/pdf/other/eb201502_article02.en.pdf?59ee8bfccc28ae92a937ec7b532ad89e; 27.9.2019.

Figure 25. Reporting overall shareholdings of financial assets



5.3 Transparency on the beneficial owners of investment funds, without disclosing the underlying financial assets

A fifth, and even less transparent option (opposite to the fourth scenario) would be to disclose the end-investors and beneficial owners of investment entities (instead of the end-investors of the underlying securities). This alternative is less relevant because investment entities ultimately hold securities or other assets, over which there would be no comprehensive transparency in this fifth case. Information on ownership over investment entities would add transparency and help for instance on tax issues, to make sure investment income is being taxed. However, it would not allow to detect cases of underreporting, misreporting or double reporting over securities by investment entities (eg Cum-Ex tax fraud) nor would it reveal cases where securities are held directly by end-investors (not through investment entities).

At the very least, this proposal should apply to alternative investment funds (hedge funds, private equity funds, etc).

5.4 Close the OECD's CRS loopholes related to the investment industry

5.4.1 All financial centres should implement the OECD's CRS, especially the US. Until this happens, other countries, starting with EU countries should impose withholding taxes on any investment done through US intermediaries.[82] In addition,

[82] See more details here: https://www.taxjustice.net/wp-content/uploads/2013/04/TJN2016_WithholdingTax.pdf; 5.8.2019.

lower-income countries should be allowed to receive information, even if they cannot send information. At the very least, countries should implement the "wider-wider" approach, meaning that banks should collect and report information to their local authorities about all account holder investors, regardless if they are resident in a participating jurisdiction or not.

5.4.2 Custodian banks should collect and report information on the underlying interests and securities held by their account holders, instead of only the account balance and income related to those holdings.

5.4.3 Reporting financial institutions, eg an investment entity resident in a participating jurisdiction, should collect and report information if no one else is doing it. For example, if the interests of an investment fund (resident in a participating jurisdiction) are held by custodian bank not resident in a participating jurisdiction, then the investment fund should be responsible for CRS reporting.

5.4.4 All investment entities should be considered reporting financial institutions under the CRS, not only those managed by another financial institution.

References

Dietz, Andrea, *Anti-Money Laundering and Counter-Terrorist Financing in the Luxembourg Investment Fund Market* (2017) <https://www.econstor.eu/bitstream/10419/162698/1/891246215.pdf> [accessed 7 August 2019]

FATF, *Guidance for a Risk Based Approach for the Securities Sector*, 2018 <https://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/RBA-Securities-Sector.pdf> [accessed 2 August 2019]

Fichtner, Jan, Eelke M. Heemskerk, and Javier Garcia-Bernardo, 'Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk', *Business and Politics*, 19/02 (2017), 298–326

Financial Action Task Force, *The FATF Recommendations. International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation* (Paris, February 2012) <http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf> [accessed 6 June 2013]

Knobel, Andres, *Beneficial Ownership Verification: Ensuring the Truthfulness and Accuracy of Registered Ownership Information* (2019) <https://www.ssrn.com/abstract=3320600> [accessed 5 August 2019]

Knobel, Andres, Moran Harari, and Markus Meinzer, *The State of Play of Beneficial Ownership Registration: A Visual Overview*, 2018 <https://www.taxjustice.net/wp-content/uploads/2018/06/TJN2018-BeneficialOwnershipRegistration-StateOfPlay-FSI.pdf> [accessed 19 July 2018]

Knobel, Andres, and Markus Meinzer, *Drilling down to the Real Owners – Part 1. "More than 25% of Ownership" & "Unidentified" Beneficial Ownership: Amendments Needed in FATF's Recommendations and in EU's AML Directive*, 2016 <http://www.taxjustice.net/wp-content/uploads/2013/04/TJN2016_BO-EUAMLD-FATF-Part1.pdf> [accessed 6 September 2016]

Nougayrède, Delphine, 'Towards a Global Financial Register? The Case for End Investor Transparency in Central Securities Depositories', *Journal of Financial Regulation*, 2018 <<https://academic.oup.com/jfr/article/4/2/276/5067182> [accessed 6 August 2019]

OECD, *2016 TERMS OF REFERENCE TO MONITOR AND REVIEW PROGRESS TOWARDS TRANSPARENCY AND EXCHANGE OF INFORMATION ON REQUEST FOR TAX PURPOSES*, 2016 <https://www.oecd.org/tax/transparency/about-the-global-forum/publications/terms-of-reference.pdf> [accessed 6 February 2017]

———, *Peer Review Report on the Exchange of Information on Request of Luxembourg*, 2019 <https://read.oecd-ilibrary.org/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-luxembourg-2019-second-round_7ba732bf-en> [accessed 7 August 2019]

———, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, 2010 <https://www.oecd.org/tax/treaties/45359261.pdf> [accessed 5 August 2019]

Organisation for Economic Co-Operation and Development, *Standard for Automatic Exchange of Financial Account Information. Common Reporting Standard* (Paris, 2014) <http://www.oecd.org/ctp/exchange-of-tax-information/Automatic-Exchange-Financial-Account-Information-Common-Reporting-Standard.pdf> [accessed 3 November 2014]

Permanent Subcommittee on investigations of the committee on homeland security and governmental affairs of the United States Senate, *Supplemental Staff Report on U.S. Accounts Used by Augusto Pinochet*, 2005 <https://www.hsgac.senate.gov/imo/media/doc/SUPP%20REPORT-Money%20Laud%20&%20Foreign%20Corrup%20(March%202005).pdf> [accessed 5 August 2019]

PwC, *The Luxembourg Limited Partnership*, 2017 <https://www.pwc.lu/en/private-equity/docs/pwc-private-equity-lux-limited-partnership.pdf> [accessed 7 August 2019]

Shaxson, Nicholas, *The Finance Curse: How Global Finance Is Making Us All Poorer*, 2018

Stuart Weinstein and Sina Yekini, *Study on the Benefits and Costs of Securities Accounting Systems* (2015) <https://swiftinstitute.org/wp-content/uploads/2015/09/2015-08-ISSA-Transparency-in-Custody-Chains.pdf>

United States General Accounting Office, *Private Banking: Raul Salinas, Citibank, and Alleged Money Laundering*, 1998 <https://www.gao.gov/assets/230/226687.pdf> [accessed 5 August 2019]

United States Senate - Permament Subcommittee on Investigations, *Tax Haven Banks and U.S. Tax Compliance*, July 17, 2008 (Washington, DC, 2008) <http://www.hsgac.senate.gov/download/tax-haven-banks-report-july-17-08> [accessed 6 April 2012]

United States Senate - Permanent Subcommittee on Investigations, *Offshore Tax Evasion: The Efforts to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts* (Washington, DC, 26 February 2014) <https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20OFFSHORE%20TAX%20EVASION%20(Feb%2026%202014,%208-20-14%20FINAL).pdf> [accessed 21 June 2019]

Walker, David I., *Common Ownership and Executive Incentives: The Implausibility of Compensation As an Anticompetitive Mechanism* (Rochester, NY, 1 March 2019) <https://papers.ssrn.com/abstract=3345120> [accessed 5 August 2019]

Annex I: Hubs to set up investment funds

Many of the world's most notorious tax havens or secrecy jurisdictions are also hubs for setting up investment funds. Bloomsbury-Professional lists many of the factors to consider for choosing a jurisdiction, including: investors' familiarity with the jurisdiction and perceptions of it; marketability of funds (from a regulatory perspective); investor tax and/or regulatory issues with the jurisdiction; accessibility and approach of local regulator; laws on confidentiality, commercial lending, banking, bankruptcy, enforcement, foreign exchange controls or other matters relevant to the strategy of the fund; local tax treatment of the fund and, if relevant, ease of access to double tax treaties relevant to the fund's investment strategy; convenience for holding board meetings; status of the jurisdiction according to the OECD; the legal vehicles available in the jurisdiction and their suitability for the asset class and the desired fund-raise; the popularity of the jurisdiction relative to others; the legal system of the jurisdiction, including the familiarity of the commercial courts with private funds matters and the speed, accessibility and ease of access to the courts or enforcement.[83]

PwC[84] lists 18 top jurisdictions for setting up investment funds based on the investment fund's assets by jurisdiction:

- Over €1 trillion: Ireland, Luxembourg, UK, Cayman Islands, Japan
- Between €500 billion and €1 trillion: Switzerland, Guernsey, Jersey, Bermuda, British Virgin Islands
- Less than €500 billion: Liechtenstein, Malta, Mauritius, Singapore, Cyprus, Hong Kong, Abu Dhabi, Dubai

Offshore hubs usually establish fund structures that make it possible to target investors resident in different countries with specific tax needs. For example, a fund structure may involve an offshore fund in the Cayman Islands and an onshore fund in the US, both being managed by the same investment manager with identical investment strategies.

Another option is to have 'feeder funds' established onshore to cater to the tax and other needs of local investors, say in the US. These feeder funds pool money from local investors from different countries and then invest the money in a 'master fund' in charge of the investment decisions. In other words, the 'master fund' is the real investment fund, while the feeder funds are structures that enable local investors to invest money in the master fund in a way to minimise their tax liability.

[83] https://law.bloomsburyprofessional.com/blog/comparative-analysis-major-private-fund-jurisdictions; 6.8.2019.
[84] http://www.fundjurisdictions.com/; 6.8.2019.

The following section describes the basic features of the legal framework for investment entities targeting non-residents in some of these hubs with over €1 trillion in assets: Cayman Islands, Luxembourg and Ireland.

Cayman Islands

According to Deloitte[85], the Cayman Islands is the leading jurisdiction for establishing offshore mutual funds with 10,500 regulated funds. These funds are organised mainly as exempted companies (68%), exempted trusts (12%), exempted partnerships (10%) and exempted segregated portfolio companies (9%).

While there are no income taxes in the Cayman Islands, 'exempted' entities are entities that have obtained a certificate that exempts them from any future tax for 20 years - in case the Cayman Islands decides to levy a tax in the future.

In cases where funds are organised as companies, investors obtain non-voting participating shares while the investment manager gets voting non-participating shares. The segregated portfolio company uses a very similar structure, but it entails many segregated portfolios or cells, each for specific investors or creditors. The goal of these segregated portfolios is to isolate liabilities within each cell or segregated portfolio, protecting the investors or creditors from other cells.

Some funds organised as limited partnerships. Since these are not considered legal persons with separate personality, all contracts are signed by the general partner. The fund manager (usually the general partner) signs a partnership agreement with the investors (the limited partners).

Funds organised as trusts are also not considered legal persons so the fund assets are held by the trustee, who signs an agreement with the fund manager. Investors (beneficiaries) receive units in the trust.

Regarding the transparency of legal vehicles in the Cayman Islands, the Financial Secrecy Index 2018 reported[86] that not all companies need to register their legal owners, although beneficial owners have to be registered in a non-public registry. Neither partnerships nor trusts need to register their legal or beneficial owners with a public authority.

Luxembourg

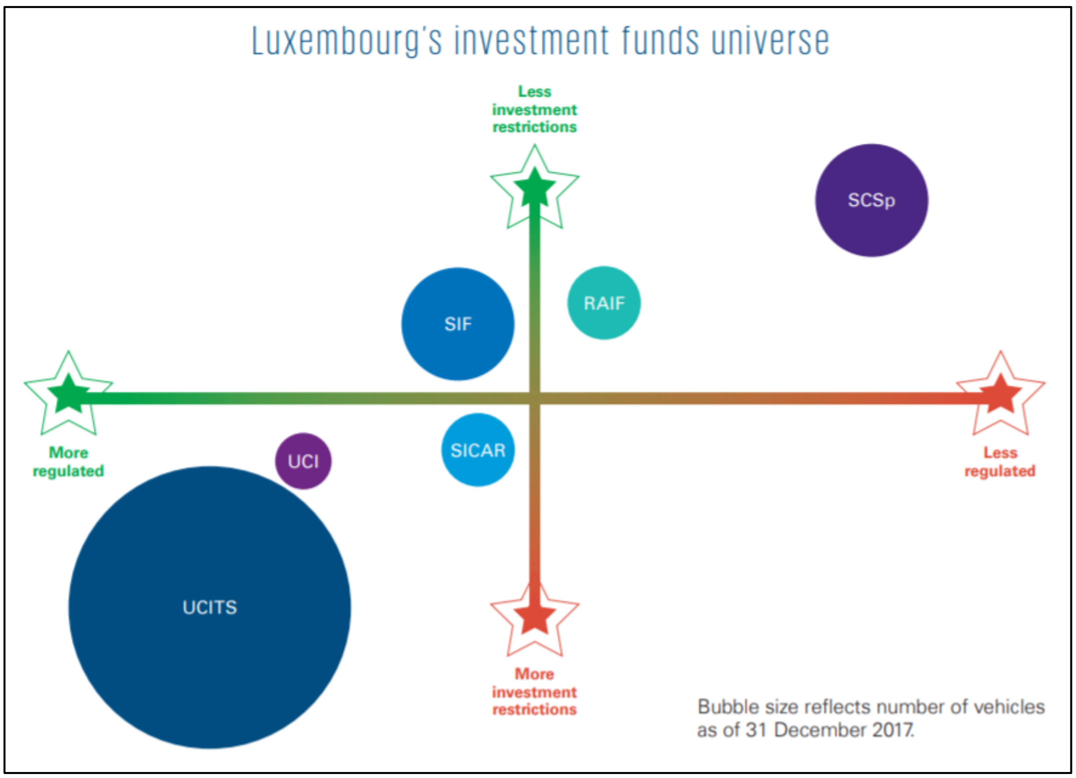
Luxembourg-for-Finance describes that Luxembourg has €4.3 trillion assets under management in investment funds and that it manages 62% of crossborder investment funds worldwide from over 70 countries.[87] By being a first implementer

[85] https://www2.deloitte.com/content/dam/Deloitte/ky/Documents/financial-services/Establishing%20Investment%20Funds%20in%20the%20Cayman%20Islands%20-%20May%202018%20DIGITAL.pdf; 6.8.2019.
[86] https://financialsecrecyindex.com/database/CaymanIslands.xml; 6.8.2019.
[87] https://www.luxembourgforfinance.com/en/financial-centre/asset-management/; 7.8.2019.

of EU fund regulation, Luxembourg became a favourited domicile for establishing international funds, both regulated and alternative funds. For example, "in Luxembourg, alternative funds are able to tailor solutions for clients and financial professionals alike by combining characteristics from various jurisdictions. Notably thanks to its limited partnership regime, the needs of clients from both common law based and civil law based jurisdictions can be accommodated."[88]

Funds available in Luxembourg include: UCITS (Undertakings for Collective Investment in Transferable Securities), which is a regulated fund for retail and institutional investors; SIF (Specialised Investment Fund), a flexible, efficient multipurpose vehicle; SICAR (Investment Company in Risk Capital), specifically designed for private equity investment and venture capital; UCI– Part II (Undertakings for Collective Investment), a flexible, more regulated pooled vehicle; and RAIF (Reserved Alternative Investment Fund), a fund with quick time-to-market, indirectly regulated va the alternative investment fund manager.[89]

KPMG[90] has mapped out the fund universe in Luxembourg, based on the level of investment restrictions and regulation:



Source: "Luxembourg Investment Vehicles", KPMG, 2018

[88] Idem
[89] Idem
[90] https://home.kpmg/content/dam/kpmg/lu/pdf/luxembourg-regulated-investment-vehicles-2018.pdf; 7.8.2019.

Andrea Dietz shows that these types of funds (both regulated and unregulated) may take three different legal structures:

> "Fonds Commun de Placement (FCP) also known as Common Investment Fund, which is a contractual structure similar to separate assets (Sondervermögen) in Germany. Being a contractual legal structure and therefore having no legal personality it needs to be managed by a Management Company. The second is the Société d'Investissement à Capital variable (SICAV) commonly known as an Investment Company with variable Capital… The third vehicle structure is the Société d'investissement à Capital fixe (SICAF) or referred to as Investment Company with fixed Capital."[91]

Confusingly, these different legal structures (SICAV and SICAF) as well as the SICAR (which is a type of fund) must be organised as a specific type of company or partnership. Deitz[92] described that depending on the case, they may be organised as: public limited company or joint-stock company (SA), European company (SE), partnership limited by shares (SCA), limited liability company (Sarl), limited partnership (SCS), special limited partnership (SCSp) or cooperative in the form of a public limited company (SCoSA).

In relation to the special limited partnership (SCSp), the fund at the top right of the KPMG chart (with less investment restrictions and less regulation) was described by Lawyer-monthly as such:

> "with respect to company law, which was inflexible for a long time, Luxembourg changed significantly with the arrival of the SCSp (a real 'Swiss army knife'!) now available to investors and UHNWIs [ultra high-net worth individuals], particularly in connection with private equity transactions. This tool, which we were among the first to use, both protects business confidentiality and is transparent for tax purposes with respect to application of double tax treaties with foreign countries, where the partners or shareholders may reside and where investments may be made."[93]

Importantly, the SCSp is not a legal person. In 2019, the OECD's Global Forum peer review on Luxembourg stated that despite not having legal personality, the SCSp must register with Luxembourg's commercial register. However, the identity of the limited partners (the investors) does not have to be published.[94]

---

[91] Dietz, Andrea, *Anti-Money Laundering and Counter-Terrorist Financing in the Luxembourg Investment Fund Market* (2017) <https://www.econstor.eu/bitstream/10419/162698/1/891246215.pdf> [accessed 7 August 2019].
[92] Dietz, Andrea, *Anti-Money Laundering and Counter-Terrorist Financing in the Luxembourg Investment Fund Market*.
[93] https://www.lawyer-monthly.com/2018/11/luxembourg-vs-switzerland-which-is-the-best-base-country-to-invest-in-the-eu/; 7.8.2019.
[94] OECD, *Peer Review Report on the Exchange of Information on Request of Luxembourg*, 2019 <https://read.oecd-ilibrary.org/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-luxembourg-2019-second-round_7ba732bf-en> [accessed 7 August 2019].

PwC describes some of the features of Luxembourg's special limited partnership (SCSp), which essentially is "the twin brother of the Anglo-Saxon limited partnership."[95] These features include secrecy and asset protection. The limited partners (investors) and their contributions may remain confidential because they need not be published by the commercial register. Second, while the SCSp has no legal personality, the assets are under the SCSp's name instead of under the general partner's name. The personal creditors of the investor (limited partners) have no right to the SCSp's assets. While the law oversees approval and filing of annual accounts for limited partnerships, the SCSp is required to register less financial information than other legal vehicles.[96]

Ireland

According to the Irish Funds Industry Association, Ireland's fund industry has more than 13,000 funds with €4.2 trillion assets under management. Ireland is the domicile for 5.4 % of worldwide investment funds assets, making it the 3rd largest global centre. 40% of global hedge fund assets are serviced in Ireland, making it the largest hedge fund administration centre in the world. Ireland offers a 'funds friendly environment', which includes knowledgeable and accessible regulators and exemptions from corporation tax on Irish domiciled funds.[97]

Irish funds have various legal structures: Investment Company or Variable Capital Company which are types of public limited companies; the Irish Collective Asset Management Vehicle (ICAV), a new corporate vehicle designed specifically for Irish investment funds; unit trusts; investment limited partnerships (without separate legal personality) and Common Contractual Fund (CCFs), which is a contractual arrangement established under a deed, which permits investors to participate as co-owners of the fund's assets. The Common Contractual Fund is not a separate legal entity and is transparent for Irish legal and tax purposes.[98]

As for the Irish Collective Asset Management Vehicle, Deloitte specifies that the "main benefits of the ICAV are its flexibility…its 'check the box' feature for US tax purposes and its simplified compliance"[99], suggesting that it is meant for non-resident investors.

---

[95] PwC, *The Luxembourg Limited Partnership*, 2017 <https://www.pwc.lu/en/private-equity/docs/pwc-private-equity-lux-limited-partnership.pdf> [accessed 7 August 2019].

[96] PwC, *The Luxembourg Limited Partnership*.

[97] https://irishfunds-secure.s3.amazonaws.com/1551880566-5648-Irish-Funds-Why-Ireland-Brochure_EU_WEB.pdf; 7.8.2019.

[98] https://www.irishfunds.ie/getting-started-in-ireland/fund-types-legal-structures; 7.8.2019.

[99] https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/investmentmanagement/2015_ICAV_Deloitte_Ireland.pdf; 7.8.2019.