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EUROSHORE

Protecting the EU financial system from the exploitation of financial centres and off-shore facilities by organised crime

Executive Summary of the
Final Report

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EUROSHORE. EXECUTIVE SUMMARY

Project "*EUROSHORE. Protecting the EU financial system from the exploitation of financial centres and offshore facilities by organised crime*" was awarded by the European Commission under Programme Falcone 1998 and carried out by TRANSCRIME, Research Centre of the University of Trento (Italy) in co-operation with CERTI – University Bocconi (Italy) and the Faculty of Law, Erasmus University of Rotterdam (The Netherlands). The project proposal was prepared in August 1998, following Recommendation no. 30 of the EU Action Plan against organised crime of April 1997. In implementation of this recommendation, Member States "should examine how to take action and provide adequate defences against the use by organised crime of financial centres and offshore facilities, in particular when they are located in places subject to their jurisdiction. With respect to those located elsewhere, the Council should develop a common policy, consistent with the policy conducted by Member States internally, with a view to prevent the use thereof by criminal organisations operating within the Union". The aim of the research reported here was to foster the development of the promising path of 'organised crime prevention' that the European Union has undertaken with its Action Plan and the Forum "Towards a European Strategy to Prevent Organised Crime" held in the Hague on 4-5 November 1999. Its rationale is that there is a broad area of regulatory measures that could be used to hamper the growth of organised crime. This action, if properly pursued, would be less costly and more effective in terms of reducing the amount of organised crime than crime control action alone, with which, however, it should be combined. Acting on the regulation of the markets infiltrated and exploited by organised crime requires understanding and explanation of why and how the demand of organised crime is matched by opportunities which facilitate its development. The policy implications of this understanding should be a re-regulation of the mechanisms that produce such opportunities.

The existence of under-regulated and non co-operative financial centres and offshore jurisdictions is the cause of serious concern for international efforts to combat organised crime. The problem has been placed high on the agendas of numerous international organisations (United Nations, FATF, OECD, Council of Europe and European Union) and national governments. The final report, with its Annexes A, B and C, intends to furnish a better understanding of the problem and of its policy implications. The seven recommendations set out at the end of the final report are suggestions on how the European Union might protect its financial system more effectively against the exploitation of offshore financial centres by organised crime.

Euroshore report begins by examining the point at which the demand for financial crime meets the supply of financial services furnished by financial centres and offshore jurisdictions. This is the point at which the facilities provided by these jurisdictions, compared with the other more co-operative and more closely regulated ones, may be exploited by criminals in order to reduce the 'law enforcement risk'. The latter is the sum of the probabilities that members of criminal organisations will be intercepted, arrested and convicted and the proceeds of their crime confiscated, and that the organisation itself will be disrupted. After discussing the rationale for such exploitation by organised crime – and after concluding that the combination of the facilities provided by offshore jurisdictions and the increasing availability of information about them (through the media, Internet and professionals) may heighten the risk of their exploitation by organised criminals – in order to suggest effective remedies, the report seeks to determine and to explain in which jurisdictions and sectors of regulation these financial facilities are to be found, and endeavours to quantify them.

The facilities offered by financial centres and offshore jurisdictions are often, but not always, the result of asymmetries in regulation. These asymmetries may be defined as the differences between a certain type of regulation and the integrity standards established by the international community to protect financial systems.[1] The underlying assumptions on which this research has been based are: (1) the risk of exploitation is a function of asymmetries in regulation, and (2) protection of the EU financial system is a function of the risk of exploitation. Summarising the two functions implies that the protection of the EU financial system depends on the level assumed by asymmetries in regulation between EU countries and offshore jurisdictions.

Given that the risk of exploitation is determined by the asymmetries in regulation and that legislation plays a considerable role in reducing them, and consequently that the level of protection of the EU financial system depends on the level of the risk of exploitation, the final report seeks to answer the following questions:

Which group of jurisdictions deviates most markedly from the general integrity standards and in which sector/s?

How substantial are the asymmetries in each of these sectors and in which group of jurisdictions?

What remedies can be suggested to reduce the risk of exploitation and ensure the better protection of the EU financial system?

Three groups of 'financial centres and offshore jurisdictions' were selected according to their level of (geographical, political, economic) 'proximity' to the European Union member states, which were treated as another homogeneous group (Group 0). The four groups selected were:

- *Group 0 - EU member states*
- *Group 1 - European financial centres and offshore jurisdictions* – those that are not member states of the Union but have special geographical, political or economic links with the European Union. Using these geographical, political and economic links as selection criteria, the countries and territories considered by the research were the following: Andorra, the British Overseas Territories (which comprise Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Montserrat and the Turks and Caicos Islands), Gibraltar, the Channel Islands (which comprise Guernsey and Jersey), Cyprus, the French West Indies Departments, the Isle of Man, Liechtenstein, Malta, the Caribbean Territories of the Kingdom of the Netherlands (which comprises Aruba and the Netherlands Antilles), the Principality of Monaco, San Marino and Switzerland.
- *Group 2 - Economies in transition* – those jurisdictions belonging to the ex-Soviet Bloc and those located in the Balkan region. Some of these countries are connected with the European Union by Association Agreements and have commenced the process of gaining entry to the European Union. The research therefore considered the following jurisdictions: Albania, Bulgaria, the Czech Republic, the Baltic States (which comprise Estonia, Latvia and Lithuania), Hungary, Moldova, Poland, Romania, the Russian Federation, Slovakia, Slovenia and Ukraine.

[1] As explained in Section 10 of the final report, this concept has been operationalised as 'integrity standard', which may be defined as the 'optimal level of regulation' in different sectors of law (criminal, administrative, commercial, banking, international co-operation regulations). The 'optimal level of regulation' is that which ensures the optimal integrity of a country's financial system.

- *Group 3 - Non-European offshore jurisdictions* – those jurisdictions entirely unconnected with the European Union. The non-European offshore jurisdictions considered are the Bahamas, the Barbados, Jamaica and Puerto Rico (these four are connected to the United States by co-operation agreements, including fiscal issues), the Cook Islands, Hong Kong and Macao (China), Malaysia, Nauru, Niue, the Philippines, the Seychelles, Singapore and Vanuatu.

Analysis was then conducted for each jurisdiction of the organised crime activities to which its facilities were vulnerable, followed by detailed description of regulations in the sectors of criminal law and criminal procedure, as well as of administrative, commercial and banking regulations and international co-operation (Annex A).

A number of primary and secondary sources were used to conduct this analysis.

The primary sources were:

- replies to the questionnaires prepared by the three research units and sent via Interpol to respondents (Police, Justice, Central Bank and Finance authorities) in most of the jurisdictions mentioned (see Annex B to the report for the full text of the questionnaires).
- the reactions by the various jurisdictions to their country profiles (which were sent to each of them), and this enabled the information in Annex A to be checked for accuracy and updated;
- the replies to a questionnaire drawn up by TRANSCRIME - University of Trento on company law regulations and sent to members of the International Organisation of Securities Commissions (IOSCO) in most of the jurisdictions considered.

The secondary sources were: white literature (research reports, scientific and professional journals), police and press reports.

In order to minimise the risk that information might be out-of-date or invalid, the results of the analysis on objectives A) and B) were sent to various jurisdictions to obtain their reactions. Their replies have been incorporated, when possible, in Annex A.

The overall levels of these asymmetries were then quantified for the purpose of comparative analysis. Two comparisons were made: a) among asymmetries representing the distance of the regulatory systems of the three groups from the optimal levels of integrity established by operationalising the concept of standards as adopted by the international community; b) among asymmetries representing the distance of the regulatory systems of the three groups of jurisdictions considered from the levels of integrity set by the European Union members states.

The research provides a detailed analysis of the country profiles, having previously operationalised criteria, indicators and standards. The findings consist of (a) quantification of the deviation by Groups of jurisdictions from the general integrity standards; (b) deviation by Groups of jurisdictions from EU standards.

The general conclusions of this analysis and the consequent policy implications may be summarised as follows.

NOT ONLY OFFSHORE

The distinction between offshore and onshore is losing much of its conventional meaning if construed as the opposition between opacity and transparency. Some offshore jurisdictions are moving towards tougher criminal law legislation and international co-operation, and somewhat more transparency (Group 1 - EU financial centres and offshore jurisdictions and Group 2 - Economies in transition), while others (Group 3 - Non-EU offshore jurisdictions) adhere to their traditions of lenient criminal law, non-cooperation and opacity. At the same time, countries with long traditions as financial centres display the same or lower standards of regulation with respect to those officially termed 'offshore'.

ASSOCIATION AGREEMENTS WORK : INCOMING MEMBERS TO THE EUROPEAN UNION ARE CHANGING THEIR CRIMINAL LAW AND INTRODUCING FINANCIAL REGULATION

The results of the research show quite clearly that, as offshore and onshore compete to attract capital (and sometime obtain 'dirty' capital as well), so countries belonging to Group 2 are tightening their criminal legislation and giving greater transparency to their financial regulations. The influence of the European Union is evident in this process, highlighting the positive role of regional institutions like the European Union in improving the integrity standards of surrounding countries.

ECONOMIC AND POLITICAL PROXIMITY WORKS: THE CLOSER OFFSHORE JURISDICTIONS ARE TO EUROPEAN UNION, THE LESS THEY DEVIATE FROM THE INTEGRITY STANDARDS SET BY THEIR REGULATIONS AND FROM THOSE OF THE EUROPEAN UNION

Not only do Association Agreements work but also proximity with the European Union seems to be beneficial. The results of the research show that offshore jurisdictions belonging to Group 1 (those with geographical, economical and political links with the European Union) deviate less from integrity standards than do other jurisdictions in Group 3 (offshore with no links with the European Union). With the exception of company law, all the other sectors of regulation obtain better results than do equivalent sectors of Group 3.

THE EUROPEAN FINANCIAL SYSTEM SHOULD BECOME MORE TRANSPARENT BEFORE IT CAN CREDIBLY ASK OTHERS TO 'CLEAN UP THEIR ACT'

The first two conclusions assert that a regional approach works, and that when offshore financial centres remain in the political and economical periphery of the European Union greater integrity arises in their standards of regulation, with the consequent reduction of the risk that their financial facilities may be exploited by organised crime. This holds for almost all the regulatory systems analysed by this research project with the exception of one, namely company law. Comparing the score for the deviation by the company law of European member states from the integrity standards shows that EU company law deviates by 0.22 from the general integrity standards, which is slightly less than the deviation by Group 2 (0.30) and significantly less than that by Group 1 (0.46) and Group 3 (0.47) of financial centres and offshore jurisdictions. This signifies that in at least one crucial sector of regulation, the European Union members states have not 'cleaned up their act' before asking others to do so. This 'cleaning-up' process should be accelerated for two reasons. Firstly for the sake of credibility. The European financial system cannot ask others to change their regulatory systems with a view to improving the integrity of their financial systems without itself having done so first.

Secondly, because company law regulation is the most essential factor in the transparency of a financial system.

COMPANY LAW EXERTS A 'DOMINO' EFFECT ON THE OPACITY OF OTHER SECTORS OF REGULATION

Company law contributes more than other sectors of regulation to the level of a financial system's transparency/opacity. It sets share capital and regulates the issue of bearer shares by limited liability companies, the possibility that legal entities may act as directors, the requirement of establishing a registered office, and also the obligatory auditing of financial statements in the case of limited liability companies and the keeping of share-holders' registers. According to the type of regulation, company law produces the greater transparency or the greater opacity of a financial system, thereby influencing the other sectors of regulation and determining the effectiveness of police and international judicial co-operation. This is the 'domino' effect of company law: if this type of regulation seeks to maximise anonymity in financial transactions, enabling the creation of shell or shelf companies whose owners remain largely unknown (because other companies own them), such anonymity will be transferred to other sectors of the law. Thus the names of ultimate beneficial owners or the beneficiaries of financial transactions will remain obscure, which thwarts criminal investigation and prosecution. Police co-operation should concentrate on physical persons, not legal entities, and if company law maximises anonymity, then the ineffectiveness of criminal law and police and judicial co-operation is inevitable. The same effect arises in banking law, where bank secrecy becomes a marginal issue owing to the anonymity enjoyed by the companies operating bank accounts under surveillance. The 'domino' effect, therefore, influences the other sectors of regulation, producing much of the opacity surrounding a financial system. Consequently, this research suggests, if asymmetries are greater in this sector than in others, company law is the point from which action to protect financial systems against exploitation by organised crime should begin, both in Europe and elsewhere.

Better understanding of the exploitation of financial and offshore centres by organised crime is afforded by the case studies of 'offshore in action' (drawn from international law enforcement operations) comprised in Euroshore final report. The data and the case studies point to the policy implication that, since criminal law and criminal procedure law have reduced the distance between the less regulated and the well regulated jurisdictions[2], real changes would be brought about by introducing greater transparency into the rules on the establishment of corporations and their operations. This would enable law enforcement agencies and regulators to identify the physical persons whose interests are being managed. Rules of corporate governance combining efficiency with transparency of ownership should be extended to encompass a further kind of transparency: one targeted on the optimal level of integrity. This form of transparency will reduce the risk of the criminal exploitation of financial centres and offshore jurisdictions, rendering international co-operation with law enforcement agencies truly effective. Only in this case will 'following the money trail' yield investigative results that can be used to prosecute criminals and disrupt their organisations. Corporations and governments should be aware that facilitating identification of the physical persons who operate in financial markets will, in the long run, increase the transparency of financial systems without impairing their efficiency. The less it is likely that 'dirty money' can pollute competition among enterprises and infiltrate legitimate enterprises, the less it is likely that illicit operators will proliferate to the advantage of legitimate ones.

[2] See Group 1.

Partnership among corporations, regulatory and law enforcement authorities and governments would foster this process.

With these results in mind, and following consultations with experts in various fields, the final report proposes seven recommendations which suggest three different levels of action by the European Union Institutions to protect its financial system:

- harmonising and raising, when necessary, the level of regulation among EU member states (*harmonisation*);
- exporting the standards thus achieved to financial and offshore centres, the purpose being to reduce the asymmetries between the regulatory systems of financial centres and offshore jurisdictions and those of the EU member states (*active protection - reduction of asymmetries*);
- preventing EU financial mechanisms (financial and non-financial institutions) from receiving financial transactions originating in financial and offshore centres outside the EU unless they meet the level of regulation of the EU member states (*passive protection - exclusion*), the purpose being to prevent pollution of the EU financial system.

Described for each recommendation is its background and rationale, the remedy proposed and its aim. The seven recommendations are outlined on the next page.

THE SEVEN RECOMMENDATIONS BY THE EUROSHORE PROJECT TO THE EUROPEAN UNION

1. The introduction of an 'all crimes' anti-money laundering legislation is recommended, accompanied at the same time by a well-defined list of predicate offences to be included as distinct crimes in each jurisdiction.
2. The enactment in other jurisdictions of money laundering legislation consistent with the standards set by the EU Money Laundering Directive, as amended.
3. The introduction of the liability of corporations, either administrative (short term) or criminal (long term), as a generic sanction on crimes committed by corporations.
4. The requirement that EU financial institutions accepting transactions from countries outside the EU must impose the disclosure – together with the name of the person ordering the transaction – of the names of the director of the corporation and of the trustee, together with those of the ultimate beneficial owner (i.e. main shareholder) of the corporation itself and of the beneficiary and settlor of a trust. If the EU institution fails to require this disclosure, it should be subjected to sanction.
5. Exploration of the feasibility of establishing a system of incentives for credit and financial institutions (from minimum measures of involvement intended to show these institutions the concrete results of their anti-money laundering action, to maximum measures consisting in economic rewards when reporting has been essential for the conviction of criminals and/or confiscation of criminal assets), the purpose being to enhance and give greater effectiveness to co-operation between credit and financial institutions and law enforcement authorities.
6. Examination of the feasibility of eliminating the issuance of bearer shares and of eliminating nominee shareholders; of setting minimum capital requirements for the incorporation of companies; of mandating the drafting and depositing of audited financial statements; of creating public registers of companies. Examination of these possibilities is especially recommended as regards companies located in financial and offshore centres with a view to preventing the use of companies as vehicles for money laundering. This recommendation, if implemented, would assist in ascertaining the real identities of the persons on whose behalf financial transactions are conducted, and it is therefore closely connected with recommendation no. 4.
7. The introduction of certain minimum requirements, such as the registration of trust deeds and disclosure of the identities of the settlor and the beneficiary, for the purpose of enhancing transparency in trust law. This recommendation, if implemented, would assist in ascertaining the identities of the persons on whose behalf transactions are conducted and is therefore closely connected with recommendations no. 4.