

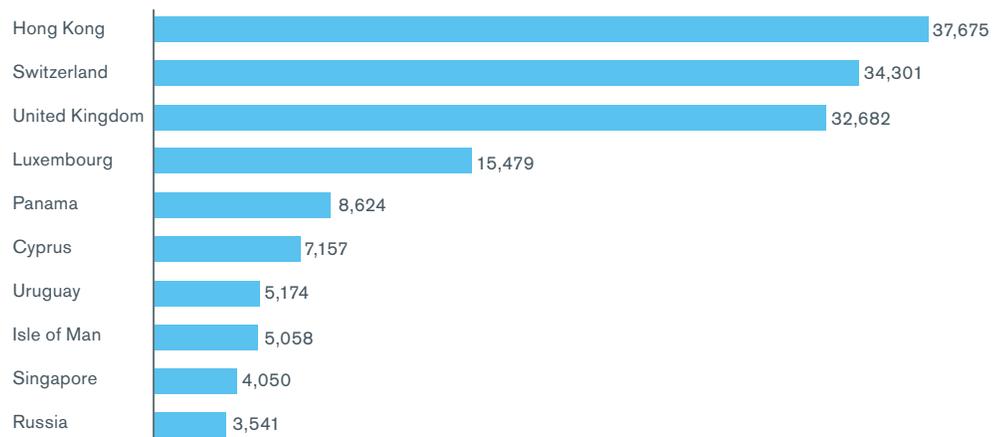
The Panama Papers

May 2016

Overview

The release of the Panama Papers by the International Consortium of Investigative Journalists (“ICIJ”) caused shockwaves across the globe after some 11.5 million leaked documents from Panamanian law firm Mossack Fonseca revealed that, over the last forty years, tens of thousands of people, including prominent public figures, their families and close associates, formed offshore companies in which they held funds anonymously. This is part of a larger industry in which reportedly trillions of dollars are held in offshore tax havens around the globe. According to the ICIJ, the leaked documents showed that Mossack Fonseca worked with more than 14,000 intermediaries globally, including 617 operating in the United States, and that major international banks utilized the firm to create more than 15,000 shell corporations. Although the use of such corporations is not inherently illicit, the leak has focused significant attention on the abuse of the offshore industry to hide illegitimate funds and will increase the scrutiny from law enforcement, regulators and even the public on financial institutions, law firms, private equity and hedge funds that use or interact with shell structures.

Panama Papers: Countries with the most active Intermediaries

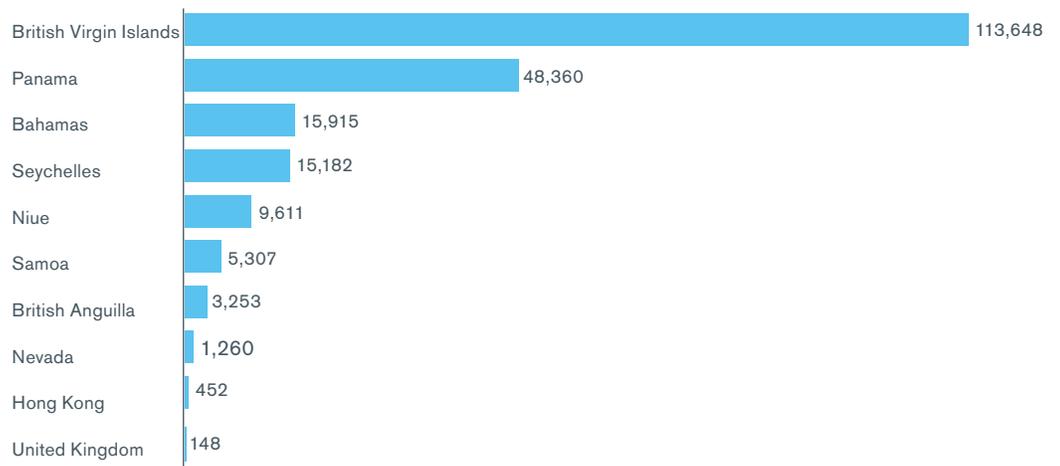


source: <https://panamapapers.icij.org/graphs/>

Although this is not the first time this issue has reached the public eye, this leak is different. Not only is the size of the breach staggering – equal to the contents of the Library of Congress – but its reach into the highest political echelons is consequential. Over 140 politically connected people have been identified as holding secret accounts. The Prime Minister of Iceland has stepped down as a result, while China has stepped up internet censorship after it was revealed that at least three of the seven members of China’s ruling council were clients of Mossack Fonseca. Public figures implicated by the leak also include close associates of Vladimir Putin, Ukrainian President Petro Poroshenko, and at least 33 people and companies appearing on U.S. sanctions lists. Criminal authorities in several jurisdictions have opened investigations that will focus on tax evasion, money laundering, sanctions evasion and other potential crimes.

The story of the Panama Papers lends itself to sensationalism – there are legitimately shocking revelations in the papers – and those aspects of the leak will likely continue to be at the forefront for some time. Sensationalism aside, there are areas where we can expect practical fallout. The Panama Papers has already led to increased pressure on global lawmakers and regulators to push through regulatory reforms that have been in the works for some time as part of a global trend toward financial transparency. In fact, just weeks after the leak, on May 5, 2016, President Obama announced a series of actions intended to address some of the issues raised by the leak. These include issuance of the Treasury Department’s final rule requiring financial institutions to obtain and verify the identity of beneficial owners of a company; support for a bill requiring U.S.-formed companies to disclose the beneficial owners at the time of formation or ownership transfer; requiring single-member limited liability companies and other foreign-owned U.S. entities to obtain a tax identification number and share ownership and transaction data with the Internal Revenue Service; expansion of prosecutors’ jurisdiction over money launderers for acts committed in other countries. The EU is also exploring enhanced beneficial ownership identification. Additionally, there will likely be significantly increased scrutiny of tax haven entities, also a trend that existed before the leak.

The 10 Most Popular Tax Havens in the Panama Papers



Source: ICIJ. <https://panamapapers.icij.org/graphs/>

Regulatory implications

While years of public reporting have brought attention and regulation to shell corporations and corporate entity non-transparency, the latest breach involving Mossack Fonseca can be expected to bring about calls for rapid regulatory changes. Panama was removed from the Financial Action Task Force (FATF) blacklist of non-cooperative jurisdictions on February 19, 2016, a decision which may now be revisited. Law firms in the United States are currently subject to cyber breach reporting laws in most states, but no Federal rule exists as it does for other industry segments. The Panama Papers incident and other recent

breaches within global law firms may change this. Unlike other jurisdictions, current U.S. regulation does not require law firms to report suspicious activity by their clients. The Mossack Fonseca case may cause lawmakers to reconsider this and other exceptions.

Additionally, the Panama Papers leak has put a harsh spotlight on America's incorporation laws that make it easy to hide behind anonymous shell corporations. As noted, the U.S. government is poised to issue a long-delayed rule that will force banks and other financial institutions to seek the identities of people hidden behind shell companies. The new rule will require banks to find out the identities of any individuals who own 25% or more of a legal entity that opens a bank account, as well as the individuals exercising control over those legal entities. The latter would include senior managers or directors of an entity, such as CEOs and presidents. In both cases, the persons listed would have to be natural persons – not corporations. This rule may require institutions to pull back multiple, complex corporate and nominee layers to determine the true beneficial owner of an account.

What are Shell Corporations?

Shell corporations are non-publically traded corporations, limited liability companies (LLCs), and trusts that typically have no physical presence and in many instances serve no economic purpose and don't conduct any real business. Shell corporations are often formed and legally used for simple privacy reasons. Sometimes a person or a well-known company wants to purchase or hold assets in a way that obscures ownership. Shell corporations may be used to hold local property or to facilitate partnership interaction or cross-border funds and assets transfer. However, lack of transparency makes shell companies a common tool for tax avoidance, money laundering, terrorist financing and other criminal activities. Many jurisdictions that are highly permissive of shell corporations permit 'nominee' officers to serve as directors of the corporation, or as shareholders of the corporation. These nominee directors and shareholders may serve as such for thousands of corporations.

Also of concern are 'shelf' corporations, which are created by corporate agents and 'placed on a shelf' in order to establish a corporate entity that according to public records appears to be 'aged,' enhancing the legitimacy of the entity. Shelf corporations are often sold with prices linked to their age, with older companies fetching higher prices. In some jurisdictions, these shelf corporations can be purchased complete with bank accounts that have also been aged and minimally utilized. As a result of these factors, global financial sector regulators have taken increasingly harsh stances against shell corporations and global financial institutions are pressured to examine the sufficiency of enhanced due diligence applied to shell corporation clients and transactional counterparties.

Cases of Shell Corporation Misuse

Shell and shelf corporations have been utilized extensively in cases of reverse-merger fraud, market manipulation, weapons proliferation, tax evasion and money laundering. Both FINRA and the SEC have published investor advisories on this hazard, and in March 2015 the SEC proactively suspended trading in 128 dormant shell companies to prevent their potential use in microcap fraud.

As one example, in 2006, the New York County District Attorney's Office investigated the Alavi Foundation, a non-profit organization which owned a 60 percent stake in a midtown Manhattan office building. The remaining 40 percent stake was owned by the Assa Corporation, an entity incorporated in New York, and Assa Company Limited, which was incorporated in the Channel Islands. The investigation ultimately revealed that the Assa entities were shell corporations used to disguise the actual owner of the building, Bank Melli, an Iranian financial institution that was sanctioned by the U.S. for financing Iran's nuclear and ballistic missiles program.

While the world focuses attention temporarily on Panama, the United States continues to be a principal supplier of shell corporations to both United States citizens and foreigners. States such as Delaware, Nevada and Wyoming continue to create non-transparent shell

and shelf companies in vast numbers. The looming Treasury rule on beneficial ownership was prompted in part by a series of Senate hearings in 2011, in which cases of shell corporation abuse were highlighted, many of them within the United States. The hearings highlighted the difficulties that law enforcement authorities faced in tracing illicit funds that flowed through shell corporations. One case revealed more than 2,000 shell companies registered to a single family home located at 2710 Thomes Avenue in Cheyenne, Wyoming. A 2011 Reuters investigation found that one of the Thomes Avenue corporations was allegedly created by former Ukrainian Prime Minister Pavlo Lazarenko, who served eight years in a United States prison for corruption charges.

Country Rankings by largest average Illicit Financial Flows, 2004-2013 (HMN + GER)

Rank	Country	Average IFF
1	China, P.R.: Mainland	139,228
2	Russian Federation	104,977
3	Mexico	52,844
4	India	51,029
5	Malaysia	41,854
6	Brazil	22,667
7	South Africa	20,922
8	Thailand	19,177
9	Indonesia	18,071
10	Nigeria	17,804

"U.S. \$1.1 trillion flowed illicitly out of developing and emerging economies in 2013, the latest year for which data is available. The illegal capital outflows stem from tax evasion, crime, corruption, and other illicit activity."

Addressing the Issue of Cyber Security

While much of the fallout from the Panama Papers has focused on the high-profile individuals implicated and concerns about the opaque nature of shell corporations, there are important lessons to be learned about data security, particularly for professional services firms.

The Panama Papers leak is reportedly one of the biggest data breaches in history, comprising over 2.6 terabytes of data, and highlights again the vulnerability to external breach or internal leak of the most sensitive information. This breach follows close on the heels of a cyber-attack against several prominent global law firms, and it is still unclear what was taken in those data breaches.

What is clear is that the financial and reputational costs associated with a significant data breach can be devastating. Law firms and other financial institutions that retain sensitive and confidential client data, such as banks, private equity firms, and hedge funds, should review their cybersecurity programs, identify relevant threats to their organizations or threats directed through third-party entities, and implement any necessary improvements to their data security policies and processes. Institutions should develop a plan for how they will communicate to clients and the public should they become a victim of a data breach and practice this response plan across their organization.

Going Forward

When dealing with shell corporations, understanding risk is essential. This applies to financial institutions, investment firms, law firms and non-financial corporations. Financial institutions should conduct risk assessments to identify customers who may pose heightened money-laundering or terrorist financing risks. To prepare for upcoming regulatory changes, financial institutions may consider enhancing their client due diligence policies and procedures to ensure that beneficial owners of legal entities are identified and verified and that reasonable efforts are made to understand the source and use of funds in their accounts and the relationship between the customer and the beneficial owners. Private equity funds should consider whether the benefits of using on or offshore shell companies is worth the reputational risk.

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