A POLITICAL ECONOMY
ANALYSIS OF BANKING
TRANSPARENCY REFORM
IN THE UNITED STATES

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1. Introduction

The case for banking transparency is clear: transparent banking practices reduce vulnerabilities within financial and related systems, which are often exploited by nefarious actors at the nexus between financial integrity, matters of national and economic security, and commercial efficiency. This is by nature a global issue, compounded by lightly-regulated jurisdictions known as “tax havens”. Nonetheless, while there have been efforts toward an international coordinated response\(^1\), banking transparency regulation is still largely defined at the national level. In this context, the United States is a pace setter: the scale of its financial industry and its political clout in the world arena make it a central player in international banking regulation. Therefore, understanding the dynamics in the American setting may hold the key to assessing global prospects for reform.

Banking transparency remains a highly contested issue in American politics: while theoretically straightforward and easy to implement, it is in practice difficult to legislate. In the United States, the battle for banking transparency is fought between powerful competing interests: pro-transparency advocates highlight the benefits of enhanced accountability, traceability, and clarity in mitigating money laundering, terrorist financing, and tax evasion while advocates of the status quo argue against increased banking transparency in terms of additional costs, economic inefficiency, and legal rights to secrecy. Those competing forces tend to face a deadlock which prevents movement towards reform.

The battle for banking transparency is fought on multiple battlegrounds. At the federal level, \textit{legislative action} is the closest equivalent to conventional warfare, whereby lobbies and civil society groups jockey, largely in the open, for influence over the law-making process. Subsequent to legislative action, \textit{rulemaking} at the institutional level is the closest equivalent to guerilla warfare, whereby smaller, less representative actors jockey to influence the interpretation of law. Finally, political circumstances and material constraints influence enforcement at the federal level.

At the state level, the fight extends to \textit{incorporation law}, as there can be no banking transparency if lax requirements degrade the traceability of beneficial owners of corporations, which can be used as vehicles for illicit financial flows. Here, the closest equivalent is localized conflict, wherein state actors jockey to influence legislative and executive processes at the state level. The multiplicity of states, coupled with the sovereign privilege of incorporation, has led to a patchwork of incorporation jurisdictions that compete to attract businesses, and thus

\(^1\) Such as the work of the Financial Action Task Force
revenue, by relaxing incorporation requirements. In turn, the prerogative of revenue collection at the state level undermines the prerogative of financial integrity at the federal level.

In spite of the foregoing challenges, however, there are several reasons to suggest that the battle for banking transparency is nowhere near a foregone conclusion. First, there have been moments of significant change. The adoption of the Patriot Act in the wake of 9/11 and the Foreign Account Tax Compliance Act (FATCA) in the wake of economic turmoil demonstrate that crises create windows of opportunity to enhance banking transparency by generating must-pass bills to which transparency clauses can be attached. Second, as the Patriot Act and FATCA also demonstrate, decisive action toward banking transparency is not based on the merits of transparency for its own sake but the current political context. Third, as FATCA and the recent indictment of Swiss banks by the US government demonstrate, action toward banking transparency is more likely when it imposes costs on foreign rather than domestic actors through the logic of national interest. In turn, the foregoing insights highlight opportunities to leverage the law-making process in favor of banking transparency.

The goal of most banking transparency research literature has been to explore the nature and extent of illicit financial flows through theoretical modeling and empirical estimates. Any attempt to gauge forbidden financial flows — which generally strive to elude measurement — is problematic, however, and the reliability of empirical data is subject to caution. In its Stolen Asset Recovery Initiative report\(^2\), the World Bank reports widely variable estimates of illicit financial flows ranging from $800 billion to $3.4 trillion, and insists that “one should guard against cloaking them with an aura of scientific precision in view of the weaknesses in the estimation methods used.” In turn, the lack of empirical certainty means that theoretical work forms hypotheses that cannot be tested with confidence.

Moreover, while these studies simply sought to describe the symptoms and consequences of a lack of banking transparency, few, if any, have studied how best to solve this problem concretely within the political framework of national and international institutions. Considering the central role of the U.S., this report purports to determine what drives reform in the country, and what factors help or hinder progress in U.S. banking transparency.

Banking transparency reform in the U.S. is infrequent, and does not lend itself to a quantitative survey. Instead, this report presents a qualitative case study of recent attempted action towards banking transparency. Some of these attempts were successful, while others failed to bring about significant change. A comparison of those cases allows us to identify the actors at play and the factors driving reform.

In this report, we will map the forces at play through a snapshot of the arguments and key players in the transparency debate (Part 2) before analyzing the dynamics through which they engage in each of the reform battlegrounds (Part 3), and presenting our conclusions and recommendations towards effective advocacy in this context (Part 4).
2. The forces at play in banking transparency reform

In the US, banking transparency legislation has evolved slowly, and a few landmark acts account for most of the evolution of the legislative arsenal in the post-war period: the Bank Secrecy Act of 1970, the Anti-Money Laundering Act of 1986, Section 311 of the Patriot Act in 2001, and the Foreign Account Tax Compliance Act of 2010 (See Annex). This evolution results from the interplay of proponents and adversaries of banking transparency reform. What arguments are put forth for and against transparency, and what actors use them to weigh in? And what tips the balance of power one way or another and triggers reform or hinders it?

2.1. Pro-reform arguments

2.1.1. Transparency is a value

The banking transparency debate can be framed in ideological terms: transparency in financial transactions is desirable in its own sake, as a component of a functioning democracy. It is often argued that ‘sunshine is the best disinfectant’: transparency is seen as a catalyst for honest and legitimate business practices. In its pure form, the argument conjures common sense: ‘why wouldn’t you be able to know who you are doing business with?’ This perspective shifts the ‘burden of proof’ in the debate: it is transparency opponents who should have to justify their position, not transparency reform advocates.

This line of argument is espoused by transparency and anti-corruption advocacy groups such as Global Financial Integrity, Transparency International, or the Open Society Institute.

2.1.2. Lack of transparency causes threats to national security

A lack of banking transparency facilitates money laundering, the recycling of proceeds of crime into legitimate businesses: it makes it easier for criminals to evade prosecution and to profit from their illegal operations. Opacity also facilitates the channeling of resources towards nefarious activities such as organized crime but also terrorism. In 2006, it was revealed that the Sinaloa drug cartel had channeled $13 billion through correspondent bank accounts at Wachovia to purchase airplanes for drug trafficking in Mexico (see Annex). The terrorists who planned the 9/11 attacks were also able to direct the required funds through the banking system with relative ease. And lack of transparency hinders US national security efforts: a 2009 investigation revealed that shell companies in New York were used by Iran to bypass

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3 Interview with a Global Financial Integrity staffer, March 2012
international sanctions and purchase military equipment illegally, some of it potentially used in the build-up of a nuclear arsenal (see Annex).

Major proponents of the national security angle are, naturally, law enforcement agencies, which are a strong voice in the transparency reform debates. The crime enforcement wings of the Treasury and the Department of Justice came out in favor of a bill to expand the tools available to law enforcement to combat illicit financial flows introduced by Sen. Carl Levin (D-MI) in 2009, as well as law enforcement associations such as the United States Marshals Service Association, the Federal Law Enforcement Officers Association, the National Fraternal Marshals Order of Police and the Society of Former Special Agents of the FBI. Majority Financial Services Committee staffers in the U.S. House also noted that law enforcement agencies such as the FBI and FinCEN frequently inform and advise the committee on security aspects of legislation. What is more, Treasury and the Department of Justice are so committed to the reform that they have offered to provide $30 million in forfeiture funds to offset the costs of implementation that would be incurred at state level. It should be noted, however, that such key Hill players as majority House Financial Services Committee staff, in spite of their frequent interactions with the agencies, seem unconvinced that lack of banking transparency is an urgent problem. Since increased transparency regulation would increase enforcement agencies’ investigative reach and power, they are predictably unlikely to oppose such measures: but this does not mean that they necessarily regard them as a priority, and they might primarily use their influence to advance other interests.

2.1.3. Lack of transparency facilitates tax evasion

An opportunity to transfer funds unbeknownst to the government is not only appealing to drug lords: many tax-payers use it to limit their tax liabilities. The Tax Justice Network estimates the impact of tax evasion on US government revenue at over $300 billion annually. A lack of banking transparency facilitates illegal tax evasion by providing the tools needed to conceal funds from the IRS; it also eases legal loopholes primarily used by corporations and high net worth individuals in their “tax avoidance” strategies. In 2007, to mention a high-profile example, a whistleblower revealed that the Swiss bank UBS had systematically helped wealthy Americans avoid taxes on assets worth $20 billion (see Annex).

This argument has long been a major advocacy point for such groups as the Tax Justice Network, the Center of Tax Justice and the US Public Interest Research Group. In recent years, as the public deficit has risen as a major concern, tax evasion has generated increased interest in a broader audience.

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4 Interview with House Financial Services Committee staff, March 2012
2.1.4. Lack of transparency harms developing countries

Banking opacity is particularly detrimental to poorer countries, as it facilitates massive financial outflows which deprive the developing world of much-needed capital. Global Financial Integrity is a major advocate of this view, and estimates that developing countries as a whole "lose" up to $1 trillion to illicit financial flows per year\(^6\) (see Annex). The magnitude dwarfs the scale of foreign aid inflows. Since increased banking transparency would inhibit those illicit flows, proponents such as Global Financial Integrity argue that it could significantly contribute to local investment and development in the source countries.

2.2. Anti-reform arguments

2.2.1. Privacy is a value

From a libertarian perspective, increased transparency is a threat to privacy rights. This argument is articulated by such legislators as Sen. Rand Paul (R-KY). In an interview, an aide to the senator asserted that a bank account is “one of the most sacred property rights,” and that “violating every American’s privacy in order to catch a few bad people doesn’t necessarily make sense.” Along the same line of argument, Sen. Paul opposes the Patriot Act. While the ideological perspective does not appear to be decisive in legislative debates, it gives legitimacy to an anti-reform agenda otherwise closely aligned with particular business interests.

2.2.2. Banking secrecy has legitimate business justifications

From an economic standpoint, opacity has justifications: it can contribute to well-functioning markets. An oft-cited example is the case of Disney World. In the 1960s, when the Disney Corporation purchased land to build its theme park in central Florida, it did so through a number of seemingly unrelated shell corporations that concealed the beneficiary of the transaction. This protected the company from the exorbitant requests land sellers might make if they realized that they owned a plot within the park development plans. Shell corporations are also routinely used to channel assets in mergers and acquisitions, and other legitimate operations. Those corporate tools, often maligned for their reprehensible use, therefore serve lawful business purposes and increased transparency regulation risks impairing economic activity.

Pro-business groups such as the Chamber of Commerce draw on this line of argument, as well as banking industry lobbies, often identified as the most powerful voice in the

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transparency reform debates -- the American Bankers Association, the Financial Services Roundtable, and the Independent Community Bankers of America.

2.2.3. US legislation is adequate as it is

Opponents of reform do not only emphasize the merits of banking secrecy or the costs associated with transparency: some also question whether lack of transparency is a pressing problem, or even a problem at all.

This view currently seems widespread among Republicans in Congress. A House Majority staffer claimed that “today, systems in place in the US to ensure that financial institutions know who is on each side of a transaction are by and large OK,” and that problems are isolated and due to individual rather than systemic failures. An aide to Sen. Paul also estimated that the government already has strong authority and resources to stop tax evasion and money laundering: there is simply no need to strengthen their capacities any further.

2.2.4. Transparency regulation leads to excessive costs on business and government

Regardless of its expected benefits, transparency reform is often attacked for the costs it might impose on both corporations and government. For instance, in 2009, the U.S. Chamber of Commerce criticized Sen. Levin’s bill, which would require firms to report their beneficial owners to states (see Annex for details), by pointing to the compliance burden which might “harm growth and job creation.”7 Commenting on the same bill, the National Association of Secretaries of State denounced the administrative costs of reform at the state level, estimated at over $17 million for California alone8. The requirement to report beneficial ownership of every company would prompt the extension of state bureaucracies to manage the increased corporate information caseload, and to monitor and enforce the bill’s application.

Thus, this view brings together pro-business groups, banking lobbies, and defenders of states interests.

2.2.5. Federal transparency legislation encroaches on states’ rights

As incorporation law is a prerogative of the states, federal attempts to ensure incorporation transparency are often framed as Washington overreach. The constitutionality of federal legislation in this domain under the Commerce Clause is sometimes questioned. Beyond the legal question though, states’ rights advocates defend the historical precedent of states

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7 Letter from the Chamber of Commerce to Chairman Lieberman of the Committee on Homeland Security and Government Affairs; October 1, 2009
8 Testimony before the Senate Homeland Security and Governmental Affairs Committee, June 18, 2009
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responsibility in incorporation on the basis of efficiency, stability or ideological support for strong states.

Institutional actors who have made those claims in transparency reform debates include the National Association of Secretaries of States.

This overview of arguments and actors involved in transparency reform provides a static picture of the forces on either side of the debate. This alone does not reveal the drivers of reform, however: we now need to turn to a dynamic analysis of the political economy of transparency reform. Given these players, what tilts the balance of power one way or the other? What makes reform possible, and what hinders it?
3. A dynamic analysis of transparency reform

Banking transparency reform and enforcement in the US takes place in a variety of contexts and frameworks, which are governed by different political economies. Rather than artificially attempt to build a single, overarching model which would remain too broad to account for the specifics of our cases, we acknowledge this diversity, and choose to present our findings at two levels: federal and state governments. Moreover, we recognize that legislation, while a major focus of attention on such debates, represents only one step towards the implementation of sound transparency standards: it is also crucial to examine the political economy of rule-making and enforcement of such rules. Therefore our analysis of federal cases will be divided into legislative and executive sections.9

No analysis of banking transparency reform can be complete without a joint examination of federal and state legislation. This is due to the fact that incorporation law is a prerogative of states. Hence, however transparent banking regulations might be, they will not lead to the clear identification of beneficial owners if firms are free – under state law – to incorporate in an opaque fashion. Only if corporations reveal their beneficial owners can transparency be fully achieved.

3.1. Federal-level dynamics

3.1.1. Legislative action

Federal legislation readily appears as a crucial area for banking transparency reform: it can yield nationwide change, and it is more durable than regulatory-based reform, which successive administrations can more easily alter. In an attempt to determine the driving forces that shape banking transparency evolutions at this level, we will examine the influence of the context and specific characteristics of legislative projects on the reform outcome.

3.1.1.1. Reform is facilitated by crises that generate windows of opportunity to align transparency with other dominant concerns of the day

The political economy of banking transparency reform is shaped by a basic fact: relative to other political issues, banking transparency is rarely in itself a topic of major concern for the general public or most legislators. Regardless of its actual importance, this is a topic that infrequently comes up in political conversations or the platforms of Congress candidates when

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9 The executive part encompasses enforcement and thus technically covers judiciary actions as well. At the state level, the bulk of our findings concerns legislation.
compared to such issues as jobs, standard of living, security, or the environment. Majority
staffers at the House Financial Services Committee confirmed this: transparency is a rarely
debated, low-priority item. As such, banking transparency rarely advances independently of
reform-minded action on more hot-button issues such as fiscal reform, increased scrutiny on
the financial services sector, or security-related legislation. How, then, can transparency
advocates advance reform?

A major finding of this report is that banking transparency reform advances when a window
of opportunity – or “policy window,” in the terminology of Kingdon10 – aligns the goal of
transparency with other dominant concerns of the day. This means that a primary mode for
advancing transparency reform is for advocates to constantly pursue linking banking
transparency reform to legislation which is of greater concern to the electorate, and,
concurrently, lawmakers. A window of opportunity means that transparency advocates should
be prepared to tailor banking reform to context: again, supporting transparency as a means to
an end is often more effective than championing it as a value in itself.

Times of crisis are particularly conducive to this as they tend to shake the status quo and
create a sense of urgency for action and reform. They also often generate “must-pass”
legislation, which can open opportunities for log-rolling.

The Patriot Act is an obvious example of this phenomenon. The terrorist attacks of
September 2001 drew attention to their financing: banking transparency was suddenly seen as
a security issue, and therefore a matter of urgent attention. Many of the Patriot Act clauses
were not designed ex nihilo in the weeks succeeding the attacks, but rather were existing
legislative projects waiting for a suitable opportunity to pass.11 Similarly, it is interesting to
recall that the Banking Secrecy Act of 1970 and Money Laundering Control Act of 1986 were
largely presented as weapons against organized crime, at a time when crime and drug
trafficking were rising concerns among Americans.12

While security is still a major issue, a predominant concern in the US over the past few years
has been the economy, and in particular mounting unemployment and a ballooning public debt.
From this perspective, the passage of FATCA is added evidence of the role of crises as windows
of opportunity: FATCA was passed as a pay-for in the 2010 HIRE bill, under the rationale that
curbing tax evasion would provide much needed revenue to finance the Administration’s jobs
initiative. Justifications of banking transparency reform adapt to shifts in public opinion.

An important lesson for banking transparency advocates in advancing their own reform
efforts is to generate strategies for attaching transparency reform to legislation which address a

10 John W. Kingdon, Agendas, Alternatives, and Public Policies – 1984
11 Interview – American Bankers Association, March 2012
12 http://www.fincen.gov/news_room/aml_history.html
variety of vital concerns among the American electorate, such as: banking reform as a means of supporting security measures, increased scrutiny of financial services providers, anti-drug, and anti-crime laws.

Sometimes, however, exogenous shocks direct wide attention to financial transparency itself. In recent years, the revelations in the UBS case (see Annex for details) raised the awareness of the public and lawmakers, and generated a prevailing sense that “something has to be done.” This was a key factor in the window of opportunity that allowed for the passage of FATCA.\textsuperscript{13}

In this instance, transparency lobbies can leverage the uptick in relevance of banking transparency legislation by framing proposed reform efforts as directly related to such high profile cases. Again, while the UBS case increased the profile of transparency reform as a stand-alone issue, the greatest boon to transparency lobbies in this instance was the opportunity for transparency reform to feel less remote from the concerns of the electorate; even here, the most successful reform efforts (like FATCA), were the result of successfully linking the UBS case with reform, rather than attempting to rally support to pass banking transparency reform for reform’s sake.

3.1.1.2. The balance of power within political institutions affects the outcome of reform attempts

Aside from external forces, the political balance of power is another key determinant of reform.

Legislators’ reform efforts are boosted by a sympathetic administration. Within the international “Open Government Partnership” 2011 initiative, the Obama Administration vowed to “advocate for legislation that will require the disclosure of meaningful beneficial ownership information for corporations at the time of company formation.”\textsuperscript{14} This commitment provided political leverage in favor of the Levin bill, creating a window of opportunity to potentially push the legislation through the Senate in 2012. Conversely, Republican control of the House of Representatives is currently a clear obstacle to transparency reform. Majority staff in the House Financial Services Committee indicated that “nothing will happen in this Congress,” as the Committee has set other priorities for the remainder of the legislature.

\textsuperscript{13} Interview with Pr. Graetz, March 2012
\textsuperscript{14} http://www.opengovpartnership.org/sites/www.opengovpartnership.org/files/country_action_plans/US_National_Action_Plan_Final_2.pdf
3.1.1.3. Banking transparency legislation is unlikely to pass as standalone legislation

Beyond considerations of context, the actual characteristics of proposed legislation are naturally a factor in reform outcome.

First of all, standalone legislation is rarely successful. Transparency measures of the Patriot Act were passed within a broad and far-reaching security initiative. FATCA did not leave committee as a standalone bill in 2009, but it successfully passed as a pay-for in the HIRE bill in 2010. Meanwhile, Sen. Levin’s repeated attempts at reform have not passed as individual initiatives. In fact, an aide to a high-ranking minority member of the House Ways & Means Committee reckons that there is no way to pass meaningful banking transparency reform as a standalone bill: such a usually low-priority issue could not gather the required momentum, unless it is championed at a level well above that of rank-and-file members and even some committee ranking members.\textsuperscript{15} Attaching transparency bills to larger initiatives allows the former to benefit from the latter’s popularity or perceived importance, as seen before. Moreover, it often represents an easier process: the attached clause does not need to pass its own Committee.

This finding is particularly relevant for banking transparency reform because so much of the content of reform legislation centers around direct or indirect amendments to the tax code which, by law, must pass through the Senate Finance Committee. Chaired by Senator Baucus (D-Montana) from 2007-present, the Senate Finance Committee has been largely agnostic (pro-reform lobbyists have characterized the Committee as apathetic) towards transparency reform; in particular, the Stop Tax Haven Abuse Act received little to no traction among leadership and the rank and file. In 2009, however, moved by political pressure to impose stricter regulations on international banking practices due to negative externalities imposed on America’s finances, the Chairman himself co-authored FATCA which not only incorporated several provisions of the Stop Tax Haven Abuse Act, but designed broader, more far reaching reform initiatives (threatening 30% withholding tax on non-compliant banks) than transparency advocates were proposing.

It is clear that advocacy efforts must focus not only on attaching legislation to the readiest vehicle, but, moreover, tailor legislation to the objectives of individuals (e.g. Senator Baucus) with the political capital and legislative purview to amend tax law.

\textsuperscript{15} Interview - aide to a high-ranking minority member of the House Ways & Means Committee, March 2012
3.1.1.4. Intensive, narrowly focused legislation could crowd out transparency provisions

By that logic, one would expect that a large, must-pass, crisis-led banking regulation bill would be an ideal vehicle for transparency reform. However, surprisingly, the Dodd–Frank Wall Street Reform and Consumer Protection Act had no substantial banking transparency clause. One explanation for this seeming idiosyncrasy is that Dodd-Frank was “too large” and “too important” for transparency advocates to be heard. Banks saw the debate around Dodd-Frank as vital to their interests, and devoted extensive resources to it; such a crowded playing field might be difficult for less well-funded actors to navigate. The HIRE Act, by contrast, was a much less expansive and controversial initiative. If our hypothesis is true, this means that the political economy of Congress leads to a “Goldilocks” model of legislation: too small a bill lacks momentum, too large a bill leaves little space to maneuver. The perfect vehicle for transparency reform lies between these two extremes.

3.1.1.5. Banking transparency legislation is unlikely to be added to comprehensive legislation that already imposes a significant cost to those affected by increased transparency

The effect of proposed legislation is likely yet a more important factor in its success. In particular, the distribution of its expected costs and benefits is a crucial determinant. An alternative – though possibly complementary – explanation for the absence of transparency articles in the Dodd-Frank Act is the fact that, as a whole, the bill already represented net costs for the banking industry: additional burden in the form of transparency compliance clauses would have been difficult to impose. According to a Hill staffer, transparency reform is more likely to pass as part of a larger bill that would include measures that are favorable to banks. In political economy terms, this implies that Congress could be analyzed through a “conservative social welfare function” model; it is averse to making any group worse off than it currently is.16

3.1.1.6. Costs imposed on foreigners hinder the passage of banking transparency reform less than costs imposed on Americans

Another hypothesis that emerges from recent reforms suggests that change may be easier to enact if its costs burden foreign interests rather than domestic ones – simply put, foreigners cannot vote, nor make campaign contributions. FATCA’s significant compliance costs only apply to foreign banks; could this help account for the passage of the legislation? While this may be part of the story, this interpretation should not be overstated. A representative of the American Bankers Association pointed out that foreign banking associations are involved in the debate over FATCA, both directly and through the International Banking Federation; moreover, the

16 Max Corden, Trade Policy and Economic Welfare - 1974
State and Commerce Departments are sensitive to other nations’ interests and the U.S.’s international standing. Unilateral imposition of harmful regulation risks attracting retaliation and the risk of “beggar thy neighbor” spirals is likely to impose limits on such policies.

An important caveat to this finding is the fact that many domestic banks tend to rally around legislation which contributes to domestic retention of wealthy customers who, attracted by non-disclosure laws and favorable tax outcomes abroad, store their money elsewhere. For these banks, certain elements of FATCA align with their interests insofar as it allows for domestic firms to regain “lost” revenue as secrecy jurisdictions can no longer provide anonymity to American customers. In this instance transparency advocates could consider the possibility of non-traditional alliances (such as partnering with banking associations) to oversee implementation of FATCA.

3.1.1.7. Legislation can be tailored to Congressional rules to ease its path to passage

Finally, it is worth mentioning that successful reform adapts to the constraints of the legislative process in other ways. Just as advocates “tailor the message” according to opinion concerns, they also adjust reform projects to the mechanics of Congress. For example, the threat of terror is usually an effective justification of transparency reform and the Levin bill makes clear reference to it; however, security issues are entirely absent from the House companion bill introduced by Rep. Maloney. The bill was written this way so that it can be examined in the Financial Services Committee, where transparency advocates are deemed in a more powerful position than in the Homeland Security Committee.

3.1.2. Executive action

The second stage of analyzing banking transparency at the federal level focuses on executive action, which is further divided into rulemaking and enforcement authorities. Rulemaking authority refers to the authority of an institution to create and promulgate regulations pursuant to existing legislation, and enforcement authority refers to the authority of an institution to enforce these regulations. Institutional rulemaking therefore acts as the critical link between legislation and enforcement.

The coincidence of rulemaking authority with ambiguous legislation, however, induces a corresponding period of legal ambiguity that is susceptible to the influence of banking transparency stakeholders. In turn, analysis of legal ambiguity at the executive stage points to the susceptibility of rulemaking to external influences, and to becoming an extended battlefield in the fight for banking transparency. Finally, both political circumstances and material constraints appear to shape executive action at the enforcement stage.
While many banking transparency advocates are present and vocal at the lawmaking stage, we propose that there is a great deal of room for maneuver at the rule-making and enforcement stage which deserves the attention and consideration of advocacy groups as well. That the architecture of implementation and enforcement body indeed reflects the spirit of the law is an important milestone in the timeline of any reform effort and cannot be taken for granted by transparency advocates once a law is passed. Moreover, advocacy groups can also contribute to the forward movement of reform by applying pressure to relevant rule-making and enforcement bodies (discussed below), such that the structure to carry out and oversee reform is identified and erected in a time-sensitive fashion, ensuring that the gains of legislation are not lost due to institutional drag, and every day inertia.

### 3.1.2.1. Rule-making

#### 3.1.2.1.1. Far-reaching reform that would have been politically unviable in the legislative arena can be introduced during rule-making phase reform

The significance of the rule-making phase in transparency reform appears clearly in the case of FATCA, for which Treasury is currently formulating regulation. Although the mode of implementation of reform appears to be relaxed compared to the initial provisions of the law (or even ‘watered down’, as some observers would have it\(^\text{17}\)) and deadlines have been extended for a gradual phase-in between 2014 and 2017, crucially, the Treasury has entered discussions with foreign governments to let them enforce the disclosure requirements and share the relevant information with the US, rather than have all banks report directly to the Treasury. This profound change in the enactment of the law should not only be seen as a way to ease the burden on banks and enable for a smoother execution: it also paves the way for the automatic exchange of information between the U.S. and other states, for which several European countries have expressed support.

It should be noted that proponents of transparency had advocated for such a system for a long time, with limited success: Canada is currently the only country with which the U.S. has a functioning automatic information-sharing scheme. Global Financial Integrity supported FATCA legislative plans in so far as it could lead to the expansion of information-sharing. It is therefore clear that the rule-making phase can be an opportunity to introduce far-reaching reform that would have been politically unviable in the legislative arena. Interest groups realize the potential to influence reform in weighing in on regulation in addition to, or instead of voicing their positions on Capitol Hill. In fact, in certain cases, groups such as the American Bankers Association see more opportunities in maintaining a close relationship with regulators, in particular Treasury, than in legislative lobbying.

\(^{17}\) http://www.moneymarketing.co.uk/investments/us-government-waters-down-fatca-requirements/1045783.article
3.1.2.1.2. The scope of legislation can be contracted in the rule-making phase

The responsibility of the Financial Crimes Enforcement Network (FinCEN) on the one hand to interpret and issue regulation and on the other hand to support and enforce compliance suggests that FinCEN plays a critical role in balancing the needs of the financial system\(^{18}\). For this reason, FinCEN is a lightning rod for anti-banking transparency advocates.

The Patriot Act expanded Anti-Money Laundering requirements pursuant to BSA (Bank Secrecy Act) to all financial institutions, which BSA defines to include “loan or finance company” and “persons involved in real estate closings and settlements” (see Annex for details). Yet on April 29, 2002, and again on November 6, 2002, FinCEN issued a temporary rule exempting both of these categories of financial institutions, citing the need for additional study in accordance with Patriot Act Section 352(c), whereby FinCEN must “consider the extent to which the requirements imposed under [the AML program requirement] are commensurate with the size, location, and activities of the financial institutions to which such regulations apply.” Subsequently, in 2003 FinCEN issued an Advanced Notice of Proposed Rulemaking (ANPRM) with regard to persons involved in real estate closings and settlements, highlighting “increasing concern among regulators, law enforcement and Congress over abusive and fraudulent sales and financing practices in both the primary and secondary residential mortgage markets.”

As part of the 2003 ANPRM, FinCEN stated that real estate transactions could involve multiple “persons” to include real estate businesses and announced the opening of a comment period during which stakeholders were invited to share their views with regard to the proposed rulemaking. Organizations including the American Bar Association, American Land Title Association, Mortgage Bankers Association, and the National Association of Realtors took part in the process of providing feedback to FinCEN. Arguments against the proposed imposition of AML requirements on persons involved in real estate transactions and settlement stemmed mainly from the protection of attorney-client privilege, the high-cost-versus-low-benefit of implementation, and attempts to avoid accountability based on the technical interpretation of BSA requirements. Since the 2003 ANPRM, however, FinCEN has not issued any additional notices with regard to persons involved in real estate closings and settlements, claiming to continue “its research and analysis related to the categories of financial institutions exempted in 2002.”

Meanwhile, FinCEN revisited its initial exemption of loan and finance companies from Patriot Act requirements, publishing two notices that further point to the collaborative exchange of views between regulatory authorities and stakeholders during the rulemaking

\(^{18}\) Since 1990, FinCEN has had rulemaking authority under BSA. FinCEN’s mission is “to enhance the integrity of financial systems by facilitating the detection and deterrence of financial crime,” is responsible for interpreting and issuing regulations authorized by statute as well as supporting and enforcing compliance with those regulations.
process. On July 29, 2009, FinCEN issued an ANPRM to “solicit public comment on a wide range of questions pertaining to the possible application of anti-money laundering (AML) program […] to a specific sub-set of loan and finance companies: Non-bank residential mortgage lenders and originators.” The 2009 ANPRM elicited 12 comments, none of which was submitted by transparency advocacy organizations. At the least, comments generally supported FinCEN’s AML concerns with regard to the real estate industry and FinCEN’s incremental approach, which effectively appears to use the term “loan and finance” companies as a vehicle to incrementally elaborate the term “persons involved in real estate closings and settlements.” At the most, comments suggested disparate views with regard to the timing and scope of AML requirements.

Subsequent to the 2009 ANPRM soliciting comments from stakeholders, on February 14, 2012, FinCEN issued a Final Rule defining “non-bank residential mortgage lenders and originators as loan or finance companies for the purpose of requiring them to establish anti-money laundering programs and report suspicious activities under the Bank Secrecy Act.” FinCEN’s Final Rule in effect overturned the previous exemption of “loan and finance” companies as they relate to the real estate sector, and suggests two important dynamics at play. First, FinCEN consistently exhibits efforts to carefully balance regulatory prerogatives with the needs of the financial system and second, FinCEN’s incremental approach to rulemaking reflects creativity and ingenuity in accommodating stakeholders while meting out regulatory imperatives.

3.1.2.1.3. **Regulation that incrementally builds upon existing regulation is more likely to be successful:**

From a political economy viewpoint, the context of the preceding case study provides insight not only into what or who influences banking transparency at the executive stage but also what may create a window of opportunity within which to influence banking transparency at that stage. Previously, banking transparency analysis at the legislative stage pointed to a clear opportunity to influence legislation by studying and leveraging the so-called political lay-of-the-land. In contrast to the legislative stage, however, the playing field at the executive stage appears to be much narrower, particularly since FinCEN is the premier Financial Intelligence Unit (FIU) concerning AML regulation and terrorist financing in the US.

Additionally, the fact that rulemaking at the executive stage proceeds in consultation with stakeholders highlights the rulemaking process as an opportunity to continue to shape the impact of legislation, if not legislation itself. This is because rulemaking depends in part on interpretation, which any student of constitutional or international law knows may afford executors considerable room for maneuver. Moreover, that rulemaking proceeds collaboratively through various phases ranging from advanced notices to comment periods to binding decisions means that the process is slow. In turn, the length and pace of the process
arguably creates extended windows of opportunity in which banking transparency advocates may directly engage the rulemaking process to influence decision-making processes.

Beyond what may be explained by the slow pace of rulemaking, the timing of the foregoing Final Rule in the wake of the 2008 financial crisis, which was caused in part by the negligent practices of real estate persons, raises the question of FinCEN’s sensitivity to political circumstances. Indeed, when one considers that the real estate sector has been in FinCEN’s sights since 2002 one wonders if there is causality between the 2008 financial crisis and FinCEN’s subsequent ANPRM in 2009. While the answer to this question is presumably complicated and thus unlikely to be shaped exclusively by increased political pressure to combat malpractice within the real estate sector, the countervailing case that the financial crisis had nothing to do with accelerating FinCEN’s treatment of the real estate sector appears equally unlikely. The likelihood that the two events were not entirely unrelated therefore supports the possibility that crises generate opportunities to shape banking transparency not only at the legislative stage but also the executive stage.

Another fundamental lesson that may be drawn from banking transparency analysis at the executive stage is not only to understand the extent to which the executive stage is susceptible to external influence but also to consider the extent to which banking transparency may be enhanced via integration with preexisting, transparency-related legal regimes. Indeed, similar to the point made earlier at the legislative stage that banking transparency seldom passes on face value, at the executive stage the foregoing case reveals that the term “transparency” is nowhere apparent throughout the rulemaking process. Rather, banking transparency-related rulemaking appears to proceed in a language that is conspicuously if not exclusively drawn from the AML lexicon originally found in BSA. Two reasons explain this characteristic of transparency-related rulemaking at the executive level. First, Patriot Act requirements refer to BSA requirements, and hence refer inevitably to BSA terminology. Second, rulemaking as demonstrated by FinCEN appears to avoid innovation, seeking instead to harmonize rulemaking within preexisting legal regimes.

In turn, the fact that transparency-related rulemaking proceeds cumulatively rather than spontaneously confirms additional insight given by a senior Treasury official, who emphasized the utility of leveraging and expanding AML regulations as a vehicle for increased banking transparency. According to this official, the financial system continues to evolve into an increasingly sophisticated and opaque structure at a time when the threat of financial disruption is increasingly potent. Meanwhile, the military option is increasingly costly at a time when financial coercion is an increasingly preferred method of coercion and enforcement in international affairs. Thus, financial integrity is increasingly paramount to national security but the tools to adequately protect the financial system are lacking, while the few that exist stem mainly from AML regulation. From a practitioner viewpoint, therefore, AML regulations may be
said to “operationalize transparency.” From an advocacy viewpoint, this suggests that an opportunity to support AML regulation is in effect an opportunity to support banking transparency.

3.1.2.2. Enforcement

3.1.2.2.1. Law enforcement responds to visual, shocking anecdotes:

The UBS case brought evidence of deliberate tax evasion by a shockingly large number of wealthy Americans with the help of the Swiss Banks (see Annex for details). The immense scale of tax evasion brought to light by the case, shocked and embarrassed the IRS to undertake aggressive administrative and enforcement measures to crackdown on tax evasion. In the recent push for greater fiscal responsibility and controlling America’s debt, Congress could not push for higher taxes or cuts in subsidies for the majority of the American population, unless they first cracked down on tax evasion by the rich. Hence, the presence of substantial evidence provided the political will and the funds to act. It also provided the leverage and political support to the Department of Justice and the IRS, to take action against Swiss banks and other strong players, something which they would not have been able to do in ordinary circumstances.

3.1.2.2.2. Enforcement is constrained by structure and resources

An audit published by Treasury in 2010 “identified Treasury’s role in preventing money laundering and combating terrorist financing as a significant management challenge.” The report furthermore examines the ability of FinCEN, which is not only responsible for creating and promulgating regulations pursuant to BSA but also coordinating enforcement action with other agencies, to collect and analyze Suspicious Activity Reports (SARs). BSA requires domestic financial institutions to file SARs depending on the size and origin of a financial transaction. According to the audit report, however, 59% of 1.1 million SARs audited in 2006 contained omissions or were incorrect or inconsistent with data filing requirements. In turn, “SAR data quality problems diminish the usefulness of the data for FinCEN, law enforcement, and other users.” Thus, the high volume of incoming SARs, coupled with meticulous filing requirements and limited institutional capacity, constrains FinCEN’s ability to coordinate enforcement action with other agencies.

From a systemic point of view, a central question of banking transparency is whether the costs of enhanced scrutiny outweigh the benefits or, conversely, if the benefits of enhanced scrutiny are outweighed by the burden of due diligence that is placed on financial institutions. Earlier insight provided by a senior Treasury official provided compelling evidence that threats to the financial system were not only sufficiently but also increasingly substantial to warrant increased costs. On this point, the official explained that out of a conservative estimate of a
recoverable $500 billion the current AML/transparency regime results in the recovery of a total of $1 billion. This raises the question of whether increased transparency costs are likely to be outweighed by an increasingly large share of recovered funds. What is certain, however, is that the financial system must continue to evolve to meet similarly evolving threats against which AML and transparency regulation is the first line of defense. But more must be done to consolidate the AML and transparency system, which was “built like a human body without a backbone.” Currently, an ANPRM to standardize customer due diligence requirements for financial institutions appears as a step in the right direction.
3.2. State level dynamics – the example of Delaware

The formation, operation and dissolution of U.S. corporations are governed mostly by state law. As a result of the fact the corporate laws in each state have evolved quite differently, there is a lack of uniformity about corporate laws and the actual mechanics of creating a corporation vary from state to state. This difference enabled regulatory arbitrage and the competition among certain states to attract legal entities to their jurisdictions. It is widely argued that this has created a “race to the bottom” and a real money laundering threat.

There has been intense scholarly debate as to whether this competition for incorporations is for good or ill – “race to the bottom” or a “race to the top.” However, there is widespread agreement on the point that Delaware, the second smallest state in the U.S., won this competition to attract companies and has gained predominance in this field. Delaware is one of the leading states within the U.S. for the incorporation of business entities. Today more than 850,000 business entities are legally domiciled in Delaware. More than 50% of all publicly-traded companies in the United States including 63% of the Fortune 500 have chosen Delaware as their legal home. Some prestigious companies such as Facebook, Google, and Amazon are registered in Delaware.

Delaware’s appeal as a home to corporations stems from a variety of factors; key among them, however, are lax regulations, which do not require the disclosure of firms’ beneficial ownership (a detailed study of Delaware’s incorporation policies and their impact on banking secrecy is provided in the Annex). In other words, real owners of Delaware corporations can remain anonymous, and therefore engage in secret banking operations: banking transparency is compromised.

Delaware is therefore often stigmatized a hotbed for money laundering. The Tax Justice Network listed Delaware as the world’s most opaque jurisdiction in their 2009 Financial Secrecy Index, a ranking based on the scale of cross-border financial activity and on “Delaware’s commitment to corporate secrecy, and resolute lack of corporation and compliance with international norms.”

In the Financial Action Task Force (FATF)’s threat assessment published in January 2006, the U.S. authorities have highlighted the risks posed by the incorporation arrangements in states

such as Delaware, Nevada, and Wyoming. This study will focus on the case of Delaware, however, since it is such a dominant player in incorporation.

Considering the impact of state-level incorporation law in banking transparency, it is essential to understand the dynamics at play in relevant state-level legislation. What factors have enabled Delaware to maintain its flexible regime of corporate laws? Who has opposed increased banking transparency in Delaware, and what motivations have driven this opposition?

### 3.2.1. Legislation is driven by the state government’s revenue-maximizing strategy

Delaware has a strong incentive to create corporate friendly laws in order to attract many lucrative corporate charters. This means that Delaware has a strong incentive to resist any movement which might lead to the loss of its attractiveness as a place to register corporations. The roughly $750–800 million which are generated every year through corporate franchise taxes account for approximately one-fourth of the entire Delaware State budget. In fact, general fund revenue collections reached a record high of $859 million in fiscal year (FY) 2011. Incorporations revenue accounted for 24% of the State’s general fund in FY 2011. Given the fact that Delaware does not have major industries which can provide a large portion of tax income, corporate laws are indispensable “products” which produce state revenue through incorporation fees and corporate taxes.

Richard J. Geisenberger, Delaware’s deputy secretary of state and chief of the corporations division noted that revenue from corporation franchise taxes was an important part of the state budget. In other words, corporate registration is definitely an “industry” for Delaware.

The state’s small size and heavy reliance on revenues form incorporation strongly motivated Delaware to be responsive to corporate need. As a result, Delaware has made a great deal of efforts to not only keep corporate-friendly and advanced laws, but also support the implementation of these laws by sophisticating its corporation administrative system. In fact, the Divisions of Corporations employs state-of-the-art computer technology, leading to the reduction of the average licensing process time from weeks to a matter of hours through the internet-based convenient system. As a result, incorporation is routinely possible within 24 hours, and the Divisions of Corporations offers a one-hour service on demand. Additionally, Delaware emphasized international marketing outreach. In 2010, delegations from Delaware

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22 Chancellor William B. Chandler III, Fiduciary Responsibilities of Corporate Board Members Lecture Series at Moritz College of Law, The Ohio State University (Mar, 20, 2009)
24 Interview, March 2012
have visited Brazil, Canada, China, Israel, Japan, the Netherlands and the United Kingdom to market Delaware’s advantages to attract global firms in registering in Delaware.\textsuperscript{25}

Thus, the combination of legislative efforts to optimize Delaware’s business laws and executive efforts to support its smooth and efficient implementation accounts for Delaware’s current situation. In other words, the system, in which both legislature and executive cooperate with each other in order to maximize benefits provided by corporate-friendly laws as a main source of revenue, has been institutionalized in Delaware.

3.2.2. The Delaware State Bar Association plays a leading role in the definition of state legislation

The legislative process ruling over the Delaware General Corporation Law (DGCL) is effectively dominated by a single professional organization: the Delaware State Bar Association (DSBA). The members of the Delaware General Assembly have not taken on any significant role in initiating or drafting changes to the DGCL. It is the DSBA that carries out the function of identifying and crafting legislative initiatives in the field of corporate law.\textsuperscript{26} In particular, the governing body of the Corporation Law Section—its Council—develops such initiatives.\textsuperscript{27} The Council currently consists of twenty-one members, formally elected annually by the members of the Corporate Law Section. A number of informal traditions guide the selection of nominees to the Council. As a matter of practice, seven of the large commercial law firms in Wilmington have nominated two members each; the other members practice in smaller firms, all in Wilmington. Any in-house lawyers, any non-Delaware lawyers, and with one exception, any lawyers from firms not principally based in Delaware are notably absent from the Council. Therefore, the legislative process of the DGCL is virtually dominated by Delaware lawyers.\textsuperscript{28}

Council members suggest potential amendments, and such suggestions are considered by the full Council to determine whether they merit further exploration. In this regard, the work of the Council proceeds in private.\textsuperscript{29} Additionally, Council members rarely receive suggestions for change from clients or co-counsel outside of Delaware and Council members’ suggestions are often prompted by problems or issues they have observed in their dealing with clients and co-counsel.\textsuperscript{30}

\begin{itemize}
\item \textsuperscript{26} The Delaware State Bar Association is a non-unified organization of members of the Delaware Bar. See generally Del. State Bar Ass’n, Profile(2012) at http://dsba.org/index.php/about-the-dsba/profile.html
\item \textsuperscript{27} Hamermesh 1754-55
\item \textsuperscript{28} Hamermesh 1755-56
\item \textsuperscript{29} Hamermesh 1756
\item \textsuperscript{30} Hamermesh 1756-57
\end{itemize}
Delaware’s legislature then typically adopts the proposed amendments. Neither a legislative committee nor the legislature as a body changes the proposal or debates its merits, and the vote on the proposed amendments tends to be unanimous.\textsuperscript{31} In other words, the Delaware General Assembly almost automatically approves the proposed amendments if they are supported by the DSBA.

Thus, the DSBA virtually dominates the legislative process of the DGCL. Given this fact, we can hypothesize that the DSBA has an incentive to maximize its members’ benefits by creating corporate-friendly laws since concentration of corporate charters in Delaware has created high demand of legal service and a decrease in corporate charters will lose lawyer’s benefits.

The Council members are about evenly distributed between those whose practices concentrate on litigation and those whose practices gravitate toward transactional counseling.\textsuperscript{32} Corporate-friendly laws are effective in terms of expanding benefits for these two categories of lawyers, since they will create high demand for legal services. In fact, according to Lawrence A. Hamermesh,\textsuperscript{33} a professor of corporate and business law of Widener University School of Law in Delaware, there are a lot of lucrative litigation activities in Delaware including corporation litigation, bankruptcy litigation, and intellectual property litigation. Delaware law firms that specialize in business law are large local employers, generating employment and tax revenue. As a result, this impact is bigger than franchise tax.\textsuperscript{34} Thus, it can be presumed that the DSBA has a strong incentive to keep Delaware the nation’s favored state of incorporation through its leading role in the legislative process of the DGCL. Accordingly, the DSBA has a strong incentive to resist any movement which might lead to the decrease in demand of legal services.

On the other hand, the fact that the DSBA virtually dominates the legislative process of its corporate laws is favorable for the Delaware state government in terms of minimizing lawmaking cost. Because of the DSBA’s leading role, the Delaware legislature, in exercising its legislative function, is able to utilize the expertise of the lawyers. This means that the Delaware legislature faces no cost in researching and drafting the amendments to the DGCL. In general, lawmaking might involve including hearing from various interest groups, research and estimation about impact evaluation, and drafting new provisions, which requires human resource with legal expertise and sufficient budget. The Delaware legislature does not need to incur these costs as it leaves the DSBA in charge of these activities. In practice, Delaware

\textsuperscript{31} Marel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 VAND.L.REV. 1573, 1600(2005)
\textsuperscript{32} Hamermesh 1755-56
\textsuperscript{33} Since 1995, Professor Hamermesh has been a member of the Corporation Law Council of the Corporation Law Section of the Delaware State Bar Association and was Chair of the Council from 2002-2004.
\textsuperscript{34} Interview – Hamermesh

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lawyers, in-house lawyers, and company managers conduct lobbying activities about the amendments of the DGCL not toward the Delaware General Assembly, but toward the Council. In other words, Delaware is able to create the most attractive legislative ‘product’ at minimal cost. It is worth noting that this unique feature of Delaware’s legislative process is favorable not only for the DSBA but also for the Delaware legislature.

3.2.3. The interactions between the state and the federal government are characterized by pragmatic assessments of the costs and benefits of transparency reform rather than ideological or legal states’ rights arguments

There is little constitutional doubt that, if federal legislature wished to enact a national corporate law that would take over state corporate law, it could do so pursuant to its power under the Commerce Clause. The federal government currently leaves incorporation law matters to states based on prudential considerations and respect for historical backgrounds and conventions. As Mark Roe explained, the federal government has intervened in the domain of state laws according to its needs several times. Since Delaware has faced the threat that federal regulation of corporations could undermine the advantage of its corporate laws, we can hypothesize that Delaware has an incentive to avoid federal intervention in the domain of state laws. Therefore, assuming that the relationship between federal and state governments is confrontational, Delaware may try to avoid federal attention by limiting controversial legislation and maintaining flexible, ambiguous laws.

That assumption needs further examination, however. Hamermesh pointed out that Delaware carefully updated statutes of its corporate laws on an annual basis in order to deal with and correct uncertainties that interfere with capital formation, rather than avoiding legislating on important issues. The Delaware players often want to avoid federal action in corporate law, because they think federal authorities will be likely to over-correct the local problem. Therefore, Delaware, fearful of national over-reaction, has a motivation to actively fix Delaware problems before they reach the national agenda.

For instance, the example of the 2003 amendment to the DGDL can be interpreted as an attempt from Delaware to avoid federal intervention through compromising amendment.

36 Kahan and Rock 1578  
37 Kahan and Rock 1585-86  
39 Interview – Hamermesh  
2003, Delaware amended the DGCL to expressly prohibit bearer shares, which guarantee a high level of anonymity.\textsuperscript{41} FinCEN highly evaluated this amendment, saying that positive experiences with Delaware on the issue of bearer shares lead to believe that some states could be motivated to take steps to remedy transparency compliance weaknesses.\textsuperscript{42} However, from Delaware’s perspective, that legislation was not reform at all and Delaware never permitted bearer shares. Hamermesh, who served as Chair of the Council of the DSBA in 2003, said that the legislation was simply designed to clarify that point for the benefit of the federal government and international reviewers who seemed unable to accept that this was always the law.\textsuperscript{43} This example showed that Delaware responded to the federal government’s pressure to amend its domestic legislation and compromised on a matter which would not substantially impact its corporate laws.

Federal-state interaction has played an important role in shaping Delaware’s corporate laws, as well as the state-oriented features that have been discussed above (the state’s dependence on franchise tax and the lawyer’s interests). In other words, federal-state interplay is closely associated with how to achieve a proper balance between federal control and state autonomy, centralization and decentralization. In this regard, Financial Crimes Enforcement Network (FinCEN) recognizes that the federal government has no authority to force the states to amend their domestic legislation, and must, therefore, rely on their goodwill.\textsuperscript{44} Thus, it can be presumed that the Delaware corporate system has evolved through the relationship between the federal and the state which has been moderate, cooperative, and compromising, rather than confrontational. In other words, the federal and state governments have achieved a practical balance through this relationship. In this regard, a more recent approach promoted by Marcel Kahan and Edward Rock suggests that the Delaware system evolves through a symbiotic relationship with the federal government.\textsuperscript{45} Both the federal government and Delaware benefit from this relationship.

However, for Delaware, the Levin Bill requiring all states to obtain beneficial ownership information in corporation formation can be a threatening attempt on the part of federal authorities to harmonize corporation transparency across states. In other words, Delaware sees this bill as an unfavorable federal action to over-correct state problems under the pretext of combating money-laundering, despite the fact that Delaware has strived to fix its problems to avoid federal intervention. We can say that a tense and confrontational relationship, instead of

\textsuperscript{41} Bearer shares are negotiable instruments that accord ownership of a company to the person who possesses the share certificate. Such share certificates do not contain the name of the shareholder and are not registered, with the possible exception of their serial numbers.

\textsuperscript{42} Financial Crimes Enforcement Network

\textsuperscript{43} Interview – Hamermesh

\textsuperscript{44} Financial Action Task Force 236

\textsuperscript{45} Kahan and Rock 1595-96
cooperative or symbiotic, between Washington (and especially law enforcement agencies), and states, especially Delaware, has come to the surface. In fact, Geisenberger claims that federal authorities try to put the responsibility of combating money-laundering onto states and denounces the economic inefficiencies and high costs that the Levin Bill would entail, while the federal government claims that states should take the responsibility to improve incorporation transparency and rejects the cost argument as an excuse.

This current tension between federal and state (Delaware) governments does not stem from the conflict between federal control and state autonomy, but lies in different assessments with regards to the balance between economic efficiency and crime prevention. In fact, states’ arguments against transparency reform point to the economic costs of reform much more frequently than to principle issues of states’ rights.

3.2.4. Discussion and the orientation of reform

This analysis of three hypotheses offered a profound insight into the dynamics in Delaware among various factors including intra-state forces and federal-state interplay. The following chart shows the dynamics regarding Delaware’s incorporation system among various actors. Several conclusions can be drawn from this analysis.

Delaware’s dynamics

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46 Interview – Geisenberger

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First, the fundamental factor that makes Delaware a walk link in U.S. banking transparency is its unique incorporation system that has evolved through the interactions among various actors in a way that they had rational incentives to keep this system attractive. The Delaware government strongly supported its business-friendly corporate laws in order to maximize state income. The Division of Corporations strongly supported their smooth implementation through a streamlined and efficient administration and active marketing. The Delaware State Bar Association’s leading role in legislative process of corporate laws made it possible to update them in favor of lawyers’ benefit. Fixing corporate problems promptly is helpful to avoid federal intervention. The judiciary also contributed to Delaware’s preeminence thorough its sophistication and predictability of litigation. All actors worked in close cooperation, which created a unique and robust incorporation system. This system has been embedded and institutionalized into Delaware politics, society, and economy.

Second, it is important to note that a lack of incorporation transparency in Delaware is just a secondary effect of the system. In order to attract corporate charters, Delaware’s corporate system has evolved not by expanding secrecy, but by pursuing more advanced, well-balanced, flexible, and stable laws. A lack of requirement for beneficial ownership constitutes an indispensable part of Delaware’s corporate system as a whole ensuring the efficiency of company formation. Thus, reforming the lax beneficial ownership reporting requirements can have a negative impact on the overall incorporation system. In other words, Delaware might lose the advantages and attractiveness: this makes Delaware wary of the current federal attempt to intervene in state incorporation law.

Third, it should be noted that Delaware’s preeminence has strong repercussions in lives of many of its citizens. Conversely, if Delaware loses its preeminence in incorporation, it will have dramatic impacts on state budget and employment. As long as there is even a slight possibility that any action toward incorporation transparency might undermine Delaware’s preeminence, it is inevitable that this type of action will directly clash with Delaware’s vital interests. The incorporation system has been deeply embedded in Delaware’s society.

We should realize that improving incorporation transparency in Delaware is practically equivalent to reforming this complex and resilient structure. It may appear as a daunting task. However, given that the primary concern of Delaware is the risk of losing many of its registered companies, alleviating this concern may be the key to the solution. Specifically, the federal regulation needs to be redesigned to be more flexible so that some problems of implementation can be fixed promptly and appropriately through review process on a regular basis after the implementation. This can bridge the gap of values between federal authorities and Delaware regarding how to achieve a proper balance between incorporation efficiency and crime prevention.
4. Conclusion

4.1. Main findings

The political economy of U.S. banking transparency is characterized by the political environment of banking transparency reform and interplay of stakeholders whose capacity to exact or prevent change varies from context to context, and is effected by both federal political dynamics – legislative and regulatory – and state level factors. In summary we present the following findings.

At the federal level during the law-making stage, times of crisis are particularly conducive to advancing banking reform insofar as they often generate must pass legislation which can create opportunities for log-rolling, as evidenced by banking transparency clauses incorporated into the Patriot Act and FATCA, framed in the crisis context of enhancing security and providing financial support for economic stimulus, respectively.

Faced with a playing field for banking transparency legislation and enforcement so packed with players rallying against reform, we note that a crisis context does not always generate the means to advance banking reform. In particular, the absence of ground breaking legislation in banking transparency within Dodd-Frank in the aftermath of 2008 highlights the fact that, even during crisis, anti-transparency, pro bank lobbies who view legislation as vital to their interests, can out play their less well funded and less agile counterparts. Transparency advocates’ success in advancing reform via the Patriot Act, where increased scrutiny was couched in terms of enhancing security and vocal banking lobbies were largely absent, provides a potent counterexample to the limitations of Dodd-Frank. As such, the need to target a “Goldilocks Vehicle” – adjacent to banking lobbies’ primary interests but neither big ticket nor small-fry (standalone), is a key finding of our report.

It is equally important to note that, at the legislative stage, banking transparency is largely a partisan issue as Republicans view (or at least purport to view) banking in anonymity as concomitant with the right to privacy, and receive significant financial and political support from anti-reform lobbies. By contrast, Democrats take the position that the negative externalities imposed by opaque banking practices allow individuals to skirt their obligation to pay taxes, threaten national security, and privilege the benefits to the individual or corporation over the benefits to society at large. In this regard, banking reformers have been largely stymied by conservative congresses, specific legislators, and bank lobbies.

Finally, reform may be easier to achieve if its costs burden foreign interests rather than domestic actors as foreigners cannot vote, nor make campaign contributions. Potential international retaliation, however, limits the appeal of this avenue.
Our research has also sought to draw relevant lessons from the rulemaking/enforcement stage in advancing transparency reform. In contrast to the legislative stage, the playing field at the rulemaking stage appears to be more sparsely populated, and typically proceeds in consultation with stakeholders. The rulemaking stage should not be viewed as, necessarily, a second-rate platform for change or a less potent channel for reform than its more rumble-tumble legislative counterpart.

Rather, our research shows that banking transparency can be defined and redefined at the rulemaking stage (either degrading or enhancing banking transparency legislation); insofar as the product of rulemaking is a function of interpretation, this stage provides ample opportunity for maneuver. Moreover, whereas must pass legislation is often approved in the blink of an eye, the slower, more measured pace of the enforcement stage means the window of opportunity lasts longer, thereby compounding the potential for having a say in reform.

Finally, at the federal level we note the power of high profile tax evasion cases to generate the political will to increase scrutiny on banking transparency reform. Since a central question of banking transparency is whether the costs of enhanced scrutiny outweigh the benefits or, conversely, if the benefits of enhanced scrutiny are outweighed by the burden of due diligence that is placed on financial institutions, well-publicized instances of egregious malfeasance on the part of financial institutions are sometimes the best means of generating the political will to move forward with banking transparency reform at both the lawmaking and rulemaking stages.

At the state level, our case study shows that a commitment to revenue raising, and a tightly controlled system of writing and amending banking transparency laws with neither checks-and-balances nor vocal pro-transparency advocates means that flexible state-level incorporation laws from which many local stakeholders benefit are very difficult to overturn. As such, our research shows that the simple and efficient incorporation process views the blight on transparency – whatever the risk to state and/or national security and the negative externalities imposed on national revenue – as nominal.

4.2. Recommendations

Based on these findings we make the following recommendations.

1. Adapt the message of banking transparency reform to plug into must-pass legislation stemming from windows of opportunity now so as not to miss the Goldilocks vehicle when such an opportunity arises.

2. Prepare a case for change in Congressional leadership or apply pressure on key figures such that they have no choice but to either write their own legislation (e.g. 2009
Baucus-Rangel FATCA) or incorporate elements of Senator Levin’s Stop Tax Haven Abuse Act.

3. Attempt to defray U.S. based costs of pro transparency legislation by imposing costs on foreign actors such to appease local lobbies.

4. In the face of the current legislative impasse and unfavorable odds of improvement in the coming election, reorient advocacy efforts towards rule-writing and or enforcement stage where there is already ample activity and fewer actors.

5. Publicize (and whistleblow, to the extent possible) high profile cases of tax evasion – especially international - such that American enforcement entities like DOJ and IRS are endowed with the political capital to exact international information sharing agreements without incurring a retaliatory spiral.

Because the political economy of banking transparency at the state level is heavily freighted toward preserving the status quo, we propose two distinct recommendations for advancing banking transparency reform at the state-level:

6. Attempt to disrupt the state model either by:
   a. Publicizing the negative externalities imposed on America’s security and financial opportunities to whip up support in the electorate and congress;
   b. Lobbying the federal government to invoke its regulatory power under the Commerce Clause citing the fact that Shell corporations are not neutral entities, and opaque incorporation practices transcend state level politics.

7. Attempt to support the state model by redesigning proposed legislation such that burden is somehow defrayed from their balance sheets or offset via other provisions:
   a. Investigate new ways to offset opportunity costs from loss of revenue generated by reduction in incorporation fees assuming there is a drop-off in registration numbers ex post;
   b. Involve states in redesigning banking transparency and incorporation laws such that new legislation permits states’ banking laws to retain the qualities that give states like Delaware comparative advantage (flexibility, ease of incorporation), while tightening “know your customer” stipulations.

4.3. Further Research

This study has investigated banking transparency in the United States in an attempt to draw lessons on the political economy of banking transparency that can be applied to banking transparency efforts and tax haven abuse worldwide. However, insofar as financial flows, banking practices, incorporation laws and tax havens are, in 2012, an international phenomenon, this report can only begin to shed light on the political economy of banking
transparency reform. In particular, while Switzerland, one of the most high profile secrecy jurisdictions, signals readiness to work with the DOJ, IRS, and SEC in the wake of the UBS Case and similar scandals, it is clear that the legacy of secrecy jurisdictions and opaque banking laws have entrenched a culture of banking practice which privileges the tradition of tax-havens over reform, and anonymity over “know-your-customer” requirements such that the integrity of the global financial system hangs in the balance. We can only surmise that further study of other offshore financial centers – Isle of Man, Ireland, British Virgin Islands, Cayman Islands – will enrich our understanding of the political economy of banking transparency and provide insights as to whether banking transparency efforts on an international scale show signs of movement towards reform or, rather, a “race to the bottom”.

In the future, students and practitioners of banking transparency reform efforts should build on the recommendations and insights highlighted in this report by continuing to explore successes and failures of banking transparency reform in international locales, by identifying stakeholder dynamics within and between offshore and global financial centers. While it appears that banking transparency reformers in the United States Congress and independent lobbyists like GFI are the vanguard of banking transparency reform, we hope that further research will explore how the political economy of banking transparency in the United States compares with that of other jurisdictions as well as whether initial attempts at reform in the United States are, as we hypothesize, a leading indicator of the trajectory of reform efforts or, by contrast, are unique to the U.S. We look forward to reading and contributing to further research in the compelling study and practice of banking transparency reform in this more international context.
5. Annex

5.1. Key steps of banking transparency reform in the past-war period

5.1.1. Historical overview

The Bank Record and Foreign Transactions Act, better known as the Bank Secrecy Act, was passed and signed into law 1970 and comprises one of twelve separate legislative actions, which include the 1986 Anti-Money Laundering Act and the 2001 Patriot Act. [http://www.aba.com/Compliance/CCBSA.htm] The central purpose of this act was to target the use of unregulated foreign accounts as a vehicle for organized crime. The legislation targeted domestic banks, whose lax recordkeeping practices impeded criminal prosecutions of illicit use of bank accounts, and bank accounts in foreign countries with strict secrecy laws which had also impeded the ability of U.S. law enforcement agencies to prosecute against criminal activity financed by funds kept in such jurisdictions. In the two decades since the BSA was enacted, its constitutionally has been questioned and held to be constitutional in three instances in 1974, 1986, and 1990.\(^{47}\) Subsequent legislation included the Crime Control Act of 1990, the Annunzio-Wylie Anti-Money Laundering Act of 1992 as well as the 1994 merger of the Treasury’s Office of Financial Enforcement with FinCEN, which has attempted to implement BSA’s provisions while ensuring that oversight and regulatory agencies coordinate efforts and share resources.

Since September 11, 2001, the United States has also established tools to address the threat to the U.S. financial system of money laundering and terrorist financing. One such tool is Section 311 of the USA PATRIOT Act of 2001, which authorizes the Treasury to prohibit U.S. financial institutions from maintaining certain accounts for foreign banks if they involve foreign jurisdictions or institutions found to be of primary money laundering concern.

Another banking transparency enforcement mechanism at the disposal of U.S. policy makers are known as Offshore Voluntary Compliance Initiatives – the first of which was enacted by the IRS in 2003 – whereby U.S. taxpayers using offshore accounts to avoid taxes can avoid criminal prosecutions if they present themselves to the IRS within a set window. In 2009, a second compliance initiative known as the Offshore Voluntary Disclosure Program again provided erstwhile tax evaders clemency under criminal proceedings if they declared themselves during a certain window. These initiatives not only serve as a means of collecting lost tax revenue but, arguably, provide the IRS a means of forensic analysis, increasing the IRS’ understanding of the mechanisms and schemes by which U.S. taxpayers use foreign banks to evade and avoid taxes.

\(^{47}\) [http://fincen.gov/statutes_regs/bsa/bsa_timeline.html](http://fincen.gov/statutes_regs/bsa/bsa_timeline.html)


5.1.2. Focus on key cases

5.1.2.1. Public Law 107-56: the Patriot Act

In the wake of the 9/11 terrorist attacks against the U.S., Congress passed and President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, commonly known as the Patriot Act, which greatly expanded the authority of law enforcement agencies to combat international terrorism. Title III of the Patriot Act, known as the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, specifically addresses the nexus between illicit financial flows and terrorism and contains provisions that closely relate to banking transparency. Thus, on the one hand the Patriot act was “arguably the single most significant AML law that Congress has passed since the BSA itself.”48 On the other hand, however, the Patriot Act failed to provide specific guidance with regard to a growing class of increasingly powerful financial actors such as hedge funds and real estate mortgage lenders.

Title III of the Patriot Act expanded the preexisting anti-money laundering regime that was established by the BSA to include general due diligence requirements, restrictions, and prohibitions related to financial transactions. For example, Section 312 requires that all financial institutions have “appropriate, specific and, where necessary, enhanced due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering through those accounts;” Section 313 “bars covered financial institutions from establishing, maintaining, administering or managing correspondent accounts in the United States for foreign shell banks;” and Section 326(a) requires that the “Treasury prescribe, by regulation, minimum standards that financial institutions must follow to verify the identity of customers, both foreign and domestic, when a customer opens an account.”

The Patriot Act not only expanded but also amended BSA to require every financial institution to establish an anti-money laundering program that includes, at a minimum, the development of internal policies, procedures, and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. On the one hand, therefore, reference to BSA in the Patriot Act reflects an attempt to develop a coherent anti-money laundering regime that evolves to meet similarly evolving threats. On the other hand, however, legislative lacunae between BSA and Patriot Act perpetuate systemic vulnerabilities. For example, ambiguity surrounding the term “financial institution,” which the BSA defines to include real estate personnel and Patriot Act defines as categorically subject to anti-money laundering regulations, resulted in a ruling that temporarily exempted real estate mortgage lenders from anti-money laundering regulations. In this regard,

uneven application of Patriot Act raises important questions that may be answered from a political economy viewpoint.

5.1.2.2. FATCA (passed as part of Public Law 111-147, the HIRE Act of 2010)

The Foreign Account Tax Compliance Act requires foreign banks to report to the Treasury on the balances, receipts and withdrawals of US taxpayers. Banks that would fail to do so face significant penalties in the form of a 30% withholding tax on their US proceeds,\(^{49}\) effectively challenging the viability of their US operations. By imposing strict reporting constraints on foreign institutions, the Act is a notable instance of extraterritorial authority on the part of the US government.\(^{50}\)

FATCA was initially introduced in Congress in 2009 as a stand-alone bill in the Senate Committee on Finance and the House Committee on Ways and Means, but it was never put to a vote.\(^{51}\) In 2010, however, FATCA was attached to a jobs initiative, the Hiring Incentives to Restore Employment (HIRE) bill, part of the Administration’s stimulus effort. FATCA was introduced in the bill as a pay-for: by allowing the Treasury to track US assets more effectively, FATCA was meant to limit the scope of tax evasion and therefore increase US tax revenue. FATCA was thus passed as part of the HIRE Act in 2010, with 217 votes in the House and 68 in the Senate.\(^{52}\)

FATCA initially entailed a direct reporting line from foreign banks to the US Treasury, starting in January 2013. However, since the passage of the law, debates over its application modalities (under the aegis of the Treasury) have led to significant inflections. While rule-making is still in progress, it should be noted that deadlines have been relaxed: the law will only come into force in January 2014, or later for certain clauses. Moreover, major European countries (UK, Spain, France, Italy and Germany) have issued a joint statement suggesting that their national banks report to their own governments rather than the US Treasury: automatic exchange of information at government level would complete the reporting system.\(^{53}\)

5.1.2.3. Stop Tax Haven Abuse Act of 2011 and bills in prior congresses

Senator Carl Levin (D-MI) has, since 2005, introduced bills targeting tax loopholes used by corporations.

\(^{49}\) http://citywire.co.uk/wealth-manager/fatca-costs-of-compliance-may-be-less-than-expected/a565060
\(^{50}\) Interview with GFI staff
\(^{52}\) http://thomas.loc.gov/cgi-bin/bdquery/z?d111:SN01934:@@@X
Senator Levin first became Ranking Member of the United States Senate Homeland Security Permanent Subcommittee on Investigations in 1999. The subcommittee was created in 1952 as part of what was then called the Committee on Government Operations. Senator Levin became Chairman in 2001, when Democrats gained control of the Senate. Senator Levin became ranking member again in 2003, before finally regaining the chairmanship in 2007, holding it to this day.

In the current Congress, his bill is called the Stop Tax Haven Abuse Act. Its provisions include increased disclosure requirements and requiring those involved in incorporating businesses and unregistered investment companies such as hedge funds to establish anti-money laundering programs and submit suspicious activity reports.54

Representative Lloyd Doggett, a member of the United States House Committee on Ways and Means, introduced companion legislation. It also closes two tax loopholes by changing the treatment of payments made as part of credit default swaps and foreign subsidiary deposits.

As of 13 April 2012, the bill has seven co-sponsors, which is the highest total of all versions. Although some provisions of past bills have been included in other legislation that has passed, no standalone version of Senator Levin's Stop Tax Haven Abuse Act has seen either a hearing or a markup in the United States Senate Committee on Finance – the committee of jurisdiction – let alone a vote in the full Senate.

5.1.2.4. The UBS bank case and the crackdown on Swiss Banks:

Under the Swiss principle of banking secrecy, codified under the Swiss Banking Act of 1934, privacy is statutorily enforced, with Swiss law strictly limiting any information shared with third parties, including tax authorities, foreign governments or even Swiss authorities, except when requested by a Swiss judge's subpoena.

In 2007, a whistleblower, then a senior UBS banker, provided information to the IRS showing that UBS had systematically helped wealthy American hide taxes on assets worth $20 billion. In response, the IRS started criminal investigations against UBS and 11 other Swiss banks, including Credit Suisse – the other of the two largest Swiss banks by capitalization. In 2009, the IRS and Swiss authorities reached a deal whereby UBS had to pay a $780 million fine and transfer details of around 4,450 U.S. clients. In response, the IRS agreed to drop the criminal investigation against UBS.

In February 2011, the U.S. indicted Wegelin bank, the oldest Swiss private bank, on charges that it enabled wealthy Americans to evade taxes on at least $1.2 billion hidden in offshore bank accounts. This was the first time an overseas bank has been indicted by the U.S. for

54 http://thomas.loc.gov/cgi-bin/bdquery/z?d112:s.01346:
enabling tax fraud by U.S. taxpayers. Under the indictment, the U.S. government seized more than $16 million from Wegelin’s correspondent bank in the U.S.

The Swiss authorities are frantically trying to negotiate a deal with the Americans, whereby criminal investigations into Swiss banks are dropped in exchange for fines and limited transfer of information. However, the Americans want something resembling an automatic information exchange between the countries’ fiscal authorities, which would mean the end of Swiss banking secrecy. The Swiss are concerned that any changes in the secrecy laws would have a devastating impact on the health of their financial sector and the economy and are determined to protect the secrecy laws at all costs. In the meanwhile, the Swiss finance ministry has handed U.S. authorities encrypted data on bank employees who served U.S. clients suspected of dodging taxes, and has said it would only provide the key to decipher the data once an agreement is reached.

Switzerland is seeking a global solution for its entire banking industry, not just the 11 banks under criminal scrutiny. It has come under increasing pressure from European countries facing steep budgetary constraints in the present Euro-area debt crises. Switzerland has signed withholding tax agreements with a number of countries, including Germany and the United Kingdom, whereby Switzerland collects taxes on accounts on behalf of these countries and transfers them over to their financial authorities. However, these agreements protect Swiss banking secrecy provisions.

Switzerland has also agreed to a clause for providing information on request. This will allow German and British authorities to submit a request for administrative assistance to Switzerland in which the name of the client is stated, but not necessarily the name of the bank. However, the number of requests for assistance will be subject to an annual limit. In all cases, applications for assistance must be backed by reasonable grounds.

Switzerland has also agreed to revise its double taxation treaty with the United States. The revised double-taxation accord allows for administrative assistance to be provided to the US in matters involving grouped requests for information, based on a suspicious pattern of behavior”55 by people or financial institutions for example when they create off-shore companies to avoid paying tax. US tax authorities will not have to provide names or addresses of suspects in order to receive assistance. This treaty has been approved by the Swiss Parliament. However, in January 2012, the treaty was blocked by Senator Rand Paul (R-KY), in the U.S. Senate, citing privacy concerns.

After the UBS whistleblower surfaced, the IRS and Department of Justice (DOJ) have adopted increasingly aggressive administrative and enforcement measures to crack down on

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tax evasion. Some measures include three Voluntary disclosure programs by the IRS, John Doe summons to the Swiss authorities by the DOJ and Title 31 Subpoenas issued directly to US citizens holding large amounts of undeclared assets in foreign accounts.

The UBS case has proven to be the catalyst for bringing in greater global banking transparency. However, almost all the measures which have been introduced or are under negotiation have primarily focused on foreign banks. American banking transparency laws have been spared the scrutiny.
5.2. Evidence of the negative consequences of a lack of banking transparency

5.2.1. The cost to developing countries:

Global Financial Integrity estimated that developing countries lost between $859 billion and $1.06 trillion in 2006 illicit flows of money. The size of the illicit outflows increased to approximately $1.44 trillion in 2008. Taken on average, developing countries lost between $725 billion to $810 billion per year over the nine-year period 2000 to 2008.

In current dollar terms, this illicit flow increased by 18.0 percent per annum from $369.3 billion at the start of the decade to $1.26 trillion in 2008. When adjusted for inflation, the real growth of such outflows was 12.7 percent. Broken down by region, real growth over the nine years is as follows: Middle East and North Africa at 24.3 percent, developing Europe at 23.1 percent, Africa at 21.9 percent, Asia at 7.85 percent, and developing nations within the western hemisphere at 5.18 percent.

Asia accounted for 44.4 percent of total illicit flows from the developing world followed by the Middle East and North Africa at 17.9 percent, developing Europe at 17.8 percent, developing nations within the western hemisphere at 15.4 percent, and Africa at 4.5 percent.

In the developing world, the largest ten countries’ cumulative illicit outflows during 2000 to 2008 in declining order of magnitude are China at $2.18 trillion, Russia at $427 billion, Mexico at $416 billion, Saudi Arabia at $302 billion, Malaysia at $291 billion, United Arab Emirates at $276 billion, Kuwait at $242 billion, Venezuela at $157 billion, Qatar at $138 billion, and Nigeria at $130 billion. On average, these ten countries account for 70 percent of the illicit outflows from all developing countries over the period from 2000 to 2008.\(^56\)

5.2.2. As a facilitator of the drug trade:

After an investigation of a plane that landed in Ciudad del Carmen, Mexico, on April 10, 2006, it was revealed that the Sinaloa drug cartel purchased the plane with money laundered through Wachovia, now part of Wells Fargo. The investigation was led by agents from the U.S. Drug Enforcement Administration, and the Internal Revenue Service. Mexican police forces also found 5.7 tons of cocaine valued at $100 million.\(^57\) Authorities uncovered billions of dollars in wire transfers, traveler’s checks, and cash shipments through Mexican exchanges into Wachovia accounts. It was also discovered that $13 billion were ultimately channeled through correspondent bank accounts at Wachovia to purchase airplanes for the use of drug trafficking in Mexico.

\(^{57}\) http://www.guardian.co.uk/world/2011/apr/03/us-bank-mexico-drug-gangs
Following these discoveries, Wachovia was put under immediate investigation for failing to maintain an anti-money laundering program. This investigation led to criminal proceedings against Wachovia, which were settled out of court under the U.S. Bank Secrecy Act (BSA) in March 2010. Wachovia ultimately paid federal authorities $110 million in forfeiture, a $50 million fine to the treasury for failing to monitor cash flow, and a sanction because it never applied the proper anti-money laundering structures to a transfer of $378.4 billion.\(^5\) This amount is equivalent to approximately 40% of Mexico’s gross domestic product.

Jeffrey Sloman, the federal prosecutor on the case, pointed out that Wachovia’s “blatant disregard” for banking laws only incurred a fine less than 2% of the bank’s $12.3 billion profit in 2009. Antonio Maria Costa, head of the U.N. office on drugs and crime in 2008, stated that there was evidence to suggest that proceeds from drugs and crime were seen as “liquid investment capital” that were only available to those banks who were in trouble of collapsing. He also said that interbank loans were funded by money from the drug trade, which saved a number of banks during the 2008 banking crisis.\(^5\)

Wachovia is also accused of proceeding with their business despite knowing the illicit nature of its activity. Jose Luis Marmolejo, a prosecutor for the case, said that the bank handled all of the transfers, but never filed any Suspicious Activity Reports (SARs). Wachovia also ignored numerous complaints brought by whistleblower Martin Woods, a senior anti-money laundering officer who joined the bank in 2005. He discussed the concerns arising from Wachovia’s suspicious ties to Mexico with the bank’s head of global anti-money laundering for correspondent banking and then filed a series of SARs. The response from the Wachovia Bank in Miami, which served as the center for Latin American business, was not supportive, according to Woods. Increasing pressure and attention from the U.S. attorney’s office in 2007, however, led Wachovia to eventually cut ties with some of its casas de cambio or currency exchange locations, with whom it did business in Mexico. Woods eventually found a representative from the Drug Enforcement Agency to take up and investigate the case, which resulted in the 2010 settlement.

5.2.3. A potential threat to national security

Inadequate banking transparency does not only facilitate organized crime and the drug trade; it also raises security concerns at the national defense level. This was evident in 2009, when it was revealed that shell companies in New York were used by Iran to purchase military equipment illegally, some of it potentially used in the build-up of a nuclear arsenal. As Manhattan District Attorney Robert Morgenthau stated, “despite sanctions, Li Fang Wei [a

\(^5\) http://www.justice.gov/dea/pubs/pressrel/pr031710.html
rogue provider of metal alloys and minerals to the global market] and Limmt [the company he managed] used aliases and shell companies to deceive banks into processing payments related to the shipment of banned missile, nuclear and so-called ‘dual use’ materials to subsidiary organizations of the Iranian Defense Industries Organization.”

This example is a stark illustration of how banking secrecy can undermine US security policy. Sanctions can be rendered essentially void if lacking banking regulation offers loopholes which complex networks of front companies can exploit. In effect, banks – both in the US and in Europe – were readily used by Iranian interests to circumvent sanctions and carry out the procurement of equipment which the US has repeatedly identified as a key threat to Middle-Eastern stability as well as US security interests.

60 http://gfintegrity.org/content/view/257/74/
5.3. Banking transparency in Delaware

5.3.1. The source of Delaware’s appeal as the US incorporation capital

What are the actual problems regarding banking secrecy caused by Delaware’s corporate laws? In order to identify them, it is crucial to overview what factors made Delaware so appealing to corporations.

Why is Delaware so attractive for corporations? There is no one answer, but many. There are six primary reasons commonly given for Delaware’s popularity. First, Delaware’s laws governing corporations are among the most advanced and flexible laws in the nation. The statute itself is an enabling statute intended to permit corporations and their shareholders maximum flexibility in ordering their affairs. There has been a strong tendency in Delaware corporate law making to broaden that room for private ordering.61 Compared to other corporation laws, the Delaware statute has a spare, almost open quality. Every effort is made to simplify drafting and to avoid complexity.62 Second, jurisdiction over most questions arising under Delaware’s corporations is vested in the Delaware Court of Chancery, which has developed over 200 years of legal precedent in corporation and business law, and is noted for its sophistication and its balance between the rights of investors and managers.63 Delaware’s court system plays the leading role in determining the legality of actions taken in the midst of battles for corporate control.64 Third, The Delaware legislature seeks routinely on an annual basis to update its laws, while maintaining a stable core. Fourth, Delaware’s corporate and legal services community has unparalleled expertise in the application of Delaware corporate laws. Fifth, the Delaware Division of Corporations provides prompt, friendly, and professional service to its customers and strives to continually improve upon that service based on customer’s opinions and complaints. Finally, Delaware has a built-in reputation, in other words, a network externality because Delaware has kept its predominance in competition for corporate charters for almost 100 years. Thus, these six factors contribute to Delaware’s preeminence.

5.3.2. Problems regarding banking secrecy

Delaware’s corporate laws are attractive not only to legitimate companies but also organized crime. The primary reason is a lack of transparency of beneficial ownership. This can

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62 Lewis S. Black, Jr. Why Corporations Choose Delaware, Delaware Department of State, Divisions of Corporations, 2007, p2
be a desirable characteristic for some legitimate uses of shell corporations, but it is also a serious vulnerability that can make some shell corporations ideal vehicles for money laundering and other illicit financial activity.

The term “shell corporation” generally refers to limited liability companies (LLC) and other business entities with no significant assets or ongoing business activities. Shell corporations typically have no physical presence other than a mailing address, employ no one, and produce little to no independent economic value. Shell corporations are often formed for legitimate purposes, such as domestic and cross-border currency and asset transfers, corporate mergers and reorganizations, while they can be used for illicit purposes. Moreover, shell corporations are easily formed with minimal information in Delaware. Incorporation is routinely possible within 24 hours, and the Divisions of Corporations offers a one-hour service on demand.

All information held on the corporate registry is available to the public. However, there is no obligation to file the name or any shareholder or beneficial owner when establishing either a corporation or an LLC in Delaware. Now the Delaware General Corporation Law (DGCL) requires that anyone from out of state wishing to establish a Delaware corporation must use the services of a registered agent to provide the appropriate address. Even though the registered agent must maintain an address in the state, be open during normal business hours, and act as the liaison between a company and the Delaware’s corporations’ division, no obligations are imposed on registered agents with respect to customer identification or record-keeping. Thus, there is a lack of incorporation transparency in Delaware.

This leads to a lack of banking transparency. Shell corporations can provide an essentially anonymous legal entity with which to open domestic and foreign bank accounts and, in the case of U.S. shells, carry an air of legitimacy. Criminals trade on this air of legitimacy by sending illicit money through shell corporations’ bank accounts fraudulently disguised as legitimate economic trade. In other words, criminals often layer shell corporations with one owning another and so on, to make it harder for law enforcement to trace the money movement. As a result, the criminal source, destination, and true ownership of the money are protected from law enforcement scrutiny by Delaware laws that do not require disclosure of beneficial

65 U.S. SEC states that shell companies have “no or nominal operations and either no or nominal assets or assets consisting of any amount of cash and cash equivalents and nominal other assets
67 Financial Action Task Force 231
68 Financial Action Task Force 232
ownership. These corporations gained access to the U.S. financial system via banking relationships with U.S. financial institutions.69

The abuse of U.S. shell corporations in Delaware has facilitated money laundering or terrorist financing. The Wall Street Journal reported that law enforcement agencies in Russia and 13 other countries made more than 100 requests to obtain subpoenas on Delaware companies in a four-year period ending in September 2004.70 German prosecutors have reportedly complained that the secrecy inherent in Delaware’s regime for legal entities has hindered investigations into suspicious financial activity.71 A U.S. government watchdog, General Accounting Office, warned in 2000 that criminal groups and corrupt politicians in Russia had established thousands of companies in Delaware that could be used for transnational money laundering and other financial crime.72

In addition to a lack of disclosure requirement, Delaware also offers lax tax regulations. Delaware corporations can be used to hold assets in the U.S. with an effective tax rate of zero, as long as the majority of directors are non-U.S. persons. This makes the state of Delaware a de-facto tax haven on U.S. soil.73

The FATF and the International Monetary Fund (IMF) describe a weakness in the US anti-money laundering regime that relates to beneficial ownership information of companies: “In the case of the states whose procedures were reviewed in the course of this evaluation (Delaware and Nevada), the company formation procedures and reporting requirements are such that the information on beneficial ownership may not, in most instances, be adequate, accurate or available on a timely basis. This is vulnerability for the U.S. AML/CFT system.”74

In short, Delaware’s problem is that the simplicity and efficiency of the incorporation process came at the expense of transparency, and has brought about the abuse of shell corporations for the purpose of criminal activities.

70 Simpson, Glenn R., Laundering queries focus on Delaware, Wall Street Journal, September 30, 2004
74 Financial Action Task Force, Summary of the third mutual evaluation report on anti-money laundering and combating the financing of terrorism, June 23, 2009
5.3.3. Delaware’s position regarding banking secrecy:

Delaware has long been criticized for an incorporation process that leaves it vulnerable to criminal activity. Richard J. Geisenberger, Delaware’s deputy secretary of state and chief of the corporations division, declared that Delaware has been aware of this problem and showed its willingness to provide more transparency. However, there is widespread recognition that the problem is not the existence of shell corporations in itself, but the misuse of shell corporations for nefarious purposes, that is, the movement of money through shell corporations.75 In short, a lack of incorporation transparency is different from a lack of banking transparency. From Delaware’s perspective, prevention of money laundering is most usefully accomplished through federal regulation of bank transfers and tax registration, instead of incorporation reform (the Levin Bill). According to Lawrence A. Hamermesh,76 who is a professor of corporate and business law of Widener University School of Law in Delaware, trying to use corporate formation and beneficial ownership reporting, as Senator Levin’s proposed legislation does, creates serious economic and administrative inefficiencies and will not work any event.77

Thus, Delaware resists the current movements toward banking transparency, such as the Levin Bill, because these movements might undermine its advantages over other states in attracting corporations. In other words, Delaware wants to preserve its business-friendly corporate laws and efficient corporation formation system.

76 Since 1995, Professor Hamermesh has been a member of the Corporation Law Council of the Corporation Law Section of the Delaware State Bar Association and was Chair of the Council from 2002-2004.
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