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Due Diligence to Protect National Ship Registries from UN Sanctions Violations

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The Challenge

Recommendation 24 of the Financial Actions Task Force (FATF) posits the due diligence challenge of establishing reliable beneficial ownership for all ship registries unequivocally: "Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities".

The key challenge is how to secure information about both, the beneficial ownership and control. The meaning of these dual requirements is spelled out in considerable details in interpretative notes and a 2018 study "Concealment of Beneficial Ownership.

> ***FATF Recommendation 24***
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> ***Countries should take measures to prevent the misuse of legal persons for money laundering or terrorist financing. Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities. In particular, countries that have legal persons that are able to issue bearer shares or bearer share warrants, or which allow nominee shareholders or nominee directors, should take effective measures to ensure that they are not misused for money laundering or terrorist financing. Countries should consider measures to facilitate access to beneficial ownership and control information by financial institutions and DNFBPs undertaking the requirements set out in Recommendations 10 and 22.***

If the FATF's recommendations stake out objectives and voluntary anti-money laundering practices on a global scale, UN sanctions are binding international law focused on resolving specific conflict drivers.

Sanctions measures that affect national ship registries are primarily part of the UN response to North Korea's proliferation of weapons of mass destruction and related

destabilizing actions. Like all UN sanctions measures, they are adopted under Chapter VII of the UN Charter and thus, are binding to member states. By extension, all government branches of the members are obliged to fully implement and comply with these Security Council decisions, including national ship registries. They reinforce long-standing International Maritime Organization (IMO) rules for registries being in fact considered responsible for obtaining and maintaining a repository of "accurate and current information" on a ship's ownership structure.

These approaches are reflected in many jurisdictions, such as in the EU's Anti-Money-Laundering Directive, AMLD4, that incorporates the recommendations from FATF. It introduced new obligations concerning beneficial ownership, in particular the necessity of obtaining and maintaining a repository of "accurate and current information" (central register) on beneficial ownership, such as the company name and address and proof of incorporation and legal ownership, "that could be accessed by any person or organization with the ability to demonstrate a legitimate interest." Notably, this also includes the requirement for trustees to disclose their status and to make beneficial ownership information available.[1]

Beneficial Owner

FATF defines the beneficial owner as: "the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement."

As a result, the term Ultimate Beneficial Owner or UBO has been coined and is now widely used by compliance specialists.

The latest version of the EU's Anti-Money-Laundering Directive under AMLD5 further tightens the language be demanding "effective, proportionate and dissuasive measures or sanctions" for those failing to comply with UBO-related requirements.

The problem with these regulations is that they still leave room for arguments as no political consensus exists outside FATF to demand unambiguously the identity of "the natural person(s) who ultimately owns of controls…"

[1] The UK and AMLD 5 in their beneficial ownership definitions include those individuals who have more than 25 per cent of the voting rights or the right to appoint or remove the majority of the board of directors.

UN sanctions on North Korea

While FATF recommendation 24 frames the due diligence norms by referring to "beneficial ownership and control", UN sanctions measures on North Korea leave no room for arguments against conducting due diligence on a ship's ownership. The following are specific sanctions measures that directly pertain to ship registries:

1. All Member States are required to de-register any vessel that is owned or operated by the Democratic People's Republic of Korea (DPRK) and not to register any such vessel that is de-registered by another Member State.
2. All Member States are prohibited from owning, leasing, operating, chartering, or providing vessel classification, certification or associated service and insurance or re-insurance, to any DPRK-flagged, owned, controlled, or operated vessel.
3. All Member States are required to deny port entry if they have information that provides reasonable grounds that the vessel is owned, controlled, directly or indirectly, by a designated individual and/or entity.
4. All Member States are required to seize, inspect, and freeze (impound) any vessel in their ports, and may do so with any vessel subject to their jurisdiction in their territorial waters if they have reasonable grounds to believe that the vessel was involved in activities, or the transport of items, prohibited by the relevant resolutions.
5. All Member States are required to freeze the assets, funds, and economic resources of the entities of the Government of the DPRK and Korean Workers' Party, that the State determines are associated with the prohibited activities, including designated persons and entities, as well as any persons or entities acting on behalf of or at their direction, or those owned or controlled by them. These assets include tangible, intangible, movable, immovable, actual or potential, which may be used to obtain funds, goods or services, such as vessels, including maritime vessels.
6. Designated vessels are subject to assets freeze by Member States.

It is self-evident that these six implementation and compliance requirements cannot be successfully met by a ship registry unless the ultimate owner of every ship that sails under its flag is disclosed. The implications of UN sanctions measures also requires verification of the identity of the operator of a ship *before* it's registration is approved by the new flag state, since ship owners intending to conceal their identity are able to

do so by creating front or shell companies as *registered owners*.

Unfortunately, as is so often the case, FATF recommendations and its interpretive notes do not specifically mention maritime assets. However, paragraph 12 of resolution 2270 of 2016, aligns with FATF, where "maritime vessels" are included as "economic resources," and therefore could be seized as such. States who like to exploit any potential ambiguity, may therefore feel empowered to argue over precisely what due diligence regarding ownership is appropriate. While these arguments obviously intend to obfuscate the issues, this paper will explain nevertheless the most pertinent logic for the unambiguous establishment of the ownership of all ships operating under national flags.

Onshore versus offshore jurisdiction – does it matter?

The due diligence discussion is often overshadowed by the highly politicized criticism that is heaped on tax havens or offshore banking centers. Every imaginable illicit financial action is attributed to them, and by implication onshore banking appears to be legitimate. In reality, political and economic competition confuse the fact that offshore financial activities are simply those that serve non-residents. The potential for illicit activities has to do with the tolerance for poor transparency for example of the beneficial ownership of corporations.

Many other aspects that can make an offshore jurisdiction attractive for corporate headquarters. They include regulations that exempt or minimize the taxation of corporate profits, open currency exchanges with liberal capital controls, generally favorable regulations (usually this means very little regulations) such as the protection of intellectual property, or regulations that are custom-tailored to attract specific industries. The Bermudas have for example created an inviting environment for insurance and re-insurance companies, Luxembourg has attractive regulations for investment fonds, or Switzerland has traditionally cornered the precious metal refining industries and is now building regulations for the Fintech industry (crypto-assets).

Whatever their offshore strategies are, they all have in common that their jurisdictions attract corporate headquarters or significant assets that have previously been located elsewhere. No wonder, that they have become targets, to various degrees, of the wrath of high-income states that are allied under the Organization for Economic Cooperation and Development (OECD) who champions the fight against

offshore tax evasion.

During the late 1990s, the OECD defined the following principles representing model taxation relevant transparency and exchange of information practices between countries:

1. Exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of a treaty partner.
2. No restrictions on exchange caused by bank secrecy or domestic tax interest requirements.
3. Availability of reliable information, particularly accounting, bank and ownership information and powers to obtain it.
4. Respect for taxpayers' rights.
5. Strict confidentiality of information exchanged.

Starting in 2000, OECD blacklisted out of about 40 jurisdictions that did not meet some of these criteria Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru, Vanuatu as "Uncooperative Tax Havens". These countries have since relented under the international pressure and committed to the OECD standards of transparency and effective exchange of information.

The OECD's push against breeding grounds of tax cheats has created unexpected consequences. One of the premier organizations that emerged from the OECD's effort is the Tax Justice Network, based in the United Kingdom and often at the forefront in major tax haven revelation scandals such as the Panama Papers. It is now a highly respected organization whose Financial Flows Vulnerability Tracker is used by journalists, academics, or politicians to measure and write about illicit financial flows, the illicit origin of capital or nature of related transactions.

The network is aggregating its incident data collections to issue country profiles, named Financial Secrecy Index [2] (Table 1).

Table 1: Top-secret jurisdictions for 2020.

1. Cayman Islands
2. United States
3. Switzerland

[2] The Financial Secrecy Index is a composite of 20 points of indicators that also include the level of transparency of recorded and publicly accessible beneficial and legal ownership of companies and limited partnerships, excluding however investment entities. Top scores go to countries that provide ownership data via internet to the public.

4. *Hong Kong*
5. *Singapore*
6. Luxembourg
7. *Japan*
8. Netherlands
9. British Virgin Islands
10. United Arab Emirates
11. Guernsey
12. United Kingdom
13. Taiwan
14. Germany
15. *Panama*
16. Jersey
17. Thailand
18. *Malta*
19. Canada
20. Qatar
21. South Korea
22. *Bahamas*
23. Algeria
24. Kenya
25. *China*

It is perhaps counterintuitive that among the 25 most secret jurisdictions rank only six of the top ten ship registries (measured by gross tonnage). It is even more counterintuitive that the list contains both on- and off-shore jurisdictions.

Another surprise is that among the 25 most secretive jurisdictions, also happens to feature some but not all top ten ship registries (measured by tonnage of registered ships)

Table 2: Top ship registry nations

1. *Panama*
2. Liberia
3. Marshall Islands
4. *Hong Kong*
5. *Singapore*
6. *Malta*
7. *Bahamas*
8. *China*
9. Greece
10. *Japan*

In other words, those who seek guidance for reliable due diligence standards will probably not find answers in the arguments lined up around the legitimacy of on- and off-shore jurisdictions.

Looking more broadly at international legal opinion, the courts of Australia and New Zealand, have established that proprietary rights, rather than the registration itself, will determine *who* (the entity or person) owns a ship. However, importantly, the

party who is registered as the *owner* of the ship will then have the burden of proving that it is *not* the beneficial owner.

Methods to conceal the beneficial ownership of a vessel

Parallel to the mostly rhetorical hyperbole over tax havens, much more technical insights and typology data has been developed around beneficial ownership concealment strategies for all asset classes that get entangled in criminal and related money-laundering activities. The use of off-shore jurisdictions has no priority because plenty on-shore jurisdictions offer secrecy too as the list of the 25 most secret jurisdictions demonstrate (see table 1).

Camouflaging the beneficial ownership of assets is not a skill taught in universities, but has built among a secretive group of lawyers, fiduciaries, and legal experts, or lobbyists for tax reduction policies. Accordingly, the masters of this expertise have built secretive international infrastructures with ever more complex methods of hiding money while keeping it invested in profitable assets.

These specialists typically demand and receive high compensations. After all, their guidance will enable asset holders to l benefit from obscure legal loopholes in select jurisdictions that facilitate activities that in other countries is considered money laundering, and other infractions of laws and regulations – while enjoying usually full anonymity and impunity.

It may well be the case that evading full transparency can be justified in the rare circumstance where, for example, a kleptocratic regime attacks an honest individual's asset. These exceptional conditions do not apply with maritime vessels that are subject to UN sanctions. North Korean ship owners and operators are without fail part of the illegal effort to circumvent nonproliferation sanctions.

They succeed because ship registries wittingly or not, practice lenient due diligence standards and tolerate inadequate disclosures about the true ownership of the registrant. In all cases this means that one or several legal persons, form a company and register it either as a partnership, proprietorship, or corporation, using one or several of the following methods to conceal their beneficial ownership:

- Personal intermediaries – which could be a member of the registrant's family, trusted friend, or someone who is deeply indebted or otherwise indentured –

who will front publicly as owner on behalf of the actual ultimate beneficial owner.

- Professional intermediaries, such as a lawyer, fiduciary, agent, consultant, or any other individual or company whose subservient role on behalf of the registrant remains undisclosed. In the case of a lawyer serving as intermediary, a registrant may even claim to have legal privilege and protection when challenged by investigators or prosecutors. Any of these professionals can sell their services to "front" publicly as owner on behalf of the actual ultimate beneficial owner.
- Shell company registered in a jurisdiction with low transparency rules - by definition they have no assets or functions by themselves. Depending on the jurisdictions' laws, they can be very effective shields against intrusive inquiries about the ultimate beneficial owner.
- Even without the use of a shell company, any entity, including trusts, legally established in jurisdictions whose laws require little or no public disclosures about the actual shareholder provides effective protections against intrusive inquiries, including in cases of suspected sanctions violations.
- Shadow banking offering asset securitization services or the use of "special purpose vehicles" that all assist in hiding the beneficial ownership while enabling transactions of the underlying assets.
- Virtual asset trusts or fonds – a new form of ultimate beneficial ownership concealment has emerged with the ubiquitous acceptance of cryptocurrencies or other virtual assets. Where such asset holders create investments pools, the individual owners are very likely going to enjoy a high degree of secrecy.

In the day-to-day practices, lawyers and fiduciaries will often combine several approaches to create a seemingly impenetrable jumble of data behind which registrants can hide their identity. The complexity can include multiple companies, registered in multiple jurisdictions, using layers of intermediaries that in a formal inquiry will consume enormous resources and time before the true ultimate beneficial ownership can be established.

What is the due diligence answer?

At the outset of considerations for ship registries to optimize due diligence, it should be understood that the question cannot be asked by those seriously interested in complying with UN maritime sanctions. They are either confused or attempt to confuse the issue because UN sanctions resolutions set a clear benchmark: Member

States are required to prevent vessels from being owned or operated by North Korean interests. How states, specifically their ship registries, accomplish this task is irrelevant. Should it turn out that a suspicious vessel is owned or operated by North Koreans, the registering state, its registry and registrars risk becoming subject of secondary sanctions. National flag registries who also operate company registries should have an even higher incentive to mitigate this risk.

An interesting test case is a closed ship registry of a jurisdiction that maintains high secrecy levels for its corporate registries. In other words, disclosures about the ultimate beneficial ownership of a registered company is not a legal requirement, and therefore the register will often only know the company's local representatives, lawyers or fiduciaries who are under legal obligations not to disclose the identity of the owner of the registered entity. The company's registering agent may be under legal obligations to keep this information on file and will divulge it only in the gravest of all circumstances. They usually are that one state that authorizes inquiries by its prosecutors or by its financial intelligence units. A corporate registry will in most jurisdictions not likely disclose ultimate beneficial shareholder data to its country's ship registry. In other words, the closed ship registry has perhaps an elegant bureaucratic justification to shortcut its due diligence in the full knowledge that it doesn't really meet the UN sanctions requirements.

One underlying principle that should come to light in any due diligence concerning the beneficial ownership of a maritime vessel is that the ultimate owner can never be a company. It has to be either an individual or a government. A checklist designed to assist policy makers with for Beneficial Ownership registration has been developed by The Tax Justice Network is helpful in this regard.[3]

After extensive consultations with ship registries from around the world, so far only one seems to have stepped up - that has a clearly formulated policy of requiring disclosure of the ultimate beneficial ownership of a vessel registrant. The Office of Maritime Affairs and Maritime Personnel, the open international ship registry of the Commonwealth of Dominica Maritime Administration has adopted this policy since 2019 in an effort to better facilitate sanctions compliance. According to its Draft Policy Memorandum, it did so at the behest of the U. S. Department of Treasury that had the authority to request this measure because the Dominica Maritime Registry Inc. (DMR) is

[3] See https://taxjustice.net/wp-content/uploads/2017/04/TJN2017_BO-Registry-ChecklistGuidelines-Apr.pdf

registered in the U.S. State of Delaware. The DMR recognizes that identifying ultimate beneficial ownership is required because a basic beneficial ownership requirement is not sufficient to identify some criminal actors.

According to the Memorandum, the DMR will register a vessel once the following information requests are satisfied:

- Identification of the current owner, and in case a change of ownership is intended the identity of any intended owner.
- Identification of the operating company, and in case a change of operating company is intended, the identity of any intended operator or third-party operator. Another corporation as a beneficial owner is only accepted if the corporation discloses its individual shareholders.
- Identification of any other entity or individual associated with the vessel such as a passport or similar national ID verification to confirm the identities of all individual shareholders.
- Confirmation that the vessel is not an asset of a sanctioned or criminal network prior to any registration, either provisional or permanent. Articles of Incorporation must also be vetted against the SDN list.
- Details of the vessel's P&I cover note to verify if the beneficiary of the insurance policy is someone other than the owner then their information must also be checked.

Additional information requirements include:

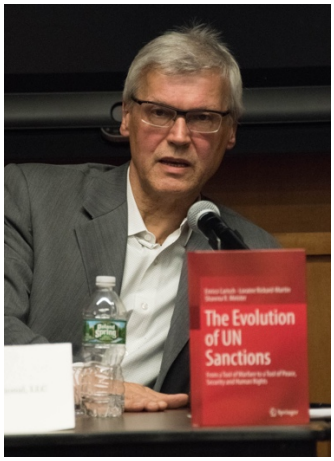
A review of the vessel's recent movements and AIS sightings, in particular whether the vessel had traded in sanctioned countries or high-risk areas as this may point to the extent of the owner's adherence and compliance to sanctions measures.

All of the identities will of course be vetted with UN lists of designated individuals, companies and entities, as well as the sanctions list of other jurisdictions, specifically the list of the Office of Foreign Assets Control of the U.S Treasury Department. Since implementing these requirements, the DMA has denied numerous vessels on the basis that they were either associated with individuals on the U.S. Treasury Department's Specially Designated Nationals (SDN) list or posed a high likelihood of being part of a sanction evasion network. In some instances, requests for corporate ownership documentation and further due diligence have resulted in a denial

of service.

It remains of course a sovereign priviledge of any state to chose between the DMA due diligence approach or any other method to insulate the international maritime industry against negative actors such as the North Koreans. But the claim to sovereignty does not, according to the UN Charter's Article 2 (7), "prejudice the application of enforcement measures under Chapter VII." Secondary sanctions for states or ship registry ignoring this principel is a very real possibiloity.

About the Author



Enrico Carisch is a co-founder of Compliance and Capacity International, LLC (CCI) (http://www.ccsi.global) has served with and led over 8 years UN Sanctions Monitoring Expert Panels, conducting numerous field investigations against violators of UN sanctions all over the world. His specialization are the financial and economic aspects of UN sanctions, and during his previous career as an investigative financial journalist, he covered extensively emerging corporate social responsibilities and how the global capital markets are adjusting to new due diligence and compliance obligations.

As a co-founder of CCI, Enrico Carisch has initiated the High-Level Review on UN Sanctions (see: http://www.HLR-UNSanctions.org), a UN-wide reform of its sanctions system, that is supported financially by Australia, Germany, Sweden, Finland and Greece. The UN senior leadership and dozens of States are active participants in order to make UN sanctions more effective and fair.

Carisch is conducting sanctions training programs on sanctions implementation skills for delegations of member States, international organizations, and

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