

IN THE DARK

Who is behind Luxembourg's 4.5 trillion-euro investment funds industry?

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In the Dark: Who is behind Luxembourg's 4.5 trillion-euro investment funds industry?

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EXECUTIVE SUMMARY

Who is behind Luxembourg's 4.5 trillion-euro investment funds industry? A new investigation by Transparency International and the Anti-Corruption Data Collective shows that Luxembourg-based investment funds largely operate in an opaque manner.

Anonymity and the ability to rapidly move large sums across borders make shell companies one of the vehicles of choice for the corrupt and criminal. There are, however, other legal entities that offer similar "benefits" but face considerably less scrutiny from regulators. Such are, first and foremost, private investment funds, including hedge, private equity, venture capital and other types of pooled funds.

A new investigation by Transparency International and the Anti-Corruption Data Collective has found investment funds in Luxembourg largely operate in an opaque manner. With more than 4.5 trillion euros in assets under management, Luxembourg is home to the largest number of investment funds in Europe and the second largest in the world after the United States (US). Yet, despite recent anti-money laundering reforms, we know very little about who the real end-investors are and whether the funds they invest are of legitimate sources.

Using OpenLux, a database created by *Le Monde* by scraping the data of the newly released Luxembourg Register of Beneficial Owner (RBO) from November 2019 to December 2020, we have found that approximately 80 per cent of private investment funds did not declare their beneficial owners. In most cases, this is likely because they could not identify any beneficial owner following the definition provided in Luxembourg's legislation.

We then compared data from the RBO registry with the reports that a smaller number of Luxembourg funds had to submit with the US government in order to do business there. Our analysis reveals that

over 15 per cent of the funds from our sample submitted conflicting information to the US and Luxembourg authorities. Taken together, a significant number of Luxembourg-based funds appear to have failed to identify their owners as required by law.

About OpenLux

OpenLux is a collaborative international investigation on the hidden side of the Luxembourg offshore industry. Around four million documents and records were obtained by *Le Monde* from the Luxembourg online business register platforms. They include corporate documents, financial statements and beneficial ownership declarations from more than 260,000 companies, covering a period from 1955 to December 2020. To analyse the data, *Le Monde* collaborated with other media organisations, including the Organized Crime and Corruption Reporting Project (OCCRP), *Le Soir*, *Miami Herald*, *Woxx* and *Süddeutsche Zeitung*.

Our findings highlight significant shortcomings in both how beneficial ownership is defined as well as the verification mechanisms in place to ensure the accuracy of the information recorded in the register.

To effectively close the loopholes that continue to enable corruption and money laundering, we call on the authorities in Luxembourg and the European Commission to review and amend the current beneficial ownership definition. Investment funds

must be required to disclose all individuals (end-investors) who financially benefit from the fund; not only those individuals owning a certain percentage of shares or who control the fund.

Luxembourg should review the current register and sanction legal entities that fail to comply with the rules or provided false information. Authorities should also ensure that a mechanism to independently verify the data provided by companies is in place. Accuracy and quality of the data cross European Union member states should also be a priority for the European Commission as part of EU anti-money laundering reforms in 2021.

What are investment funds?

An investment fund is a pool of capital from different investors that is used to purchase a variety of assets, such as stocks, bonds and real estate. Hedge funds, private equity and mutual funds are among the most common types of such pooled investment funds. These funds are usually registered as legal entities and controlled by a fund manager, who decides which assets to buy or sell, when and how. Investors simply own their individual shares and benefit from them.

The Financial Action Task Force (FATF) has classified the sector as high-risk for money laundering.¹ The international nature and volume of transactions, anonymity, number of intermediaries involved are some of the features that make the industry attractive for criminals wanting to disguise ill-gotten gains. More recently, a leaked May 2020 report of the Federal Bureau of Investigation reportedly stated “with high confidence” that these financial vehicles are being used by bad actors to launder funds and evade sanctions.²

Previous corruption schemes, such as Malaysia's 1MDB case, also show how investment funds are prone to abuse. Small investment funds in Curaçao were used to launder dirty money embezzled from the Malaysian fund. The funds in question, which had other customers and held investments unrelated to 1MDB, created segregated portfolios for individuals involved in the 1MDB scheme that invested solely in a shell company created by those same individuals.³

In another instance, a major US law firm is suspected in laundering close to US\$400 million through a series of private equity funds located in the Cayman Islands and the Republic of Ireland. These ill-gotten gains arose from the massive OneCoin cryptocurrency pyramid scheme, described as one of the largest scams in history.⁴

MONEY LAUNDERING RISKS IN LUXEMBOURG

Luxembourg is home to more than 15,000 investment funds that hold more than 4.5 trillion euros in assets. It has been estimated that 67 per cent of the world's cross-border funds are domiciled in Luxembourg.⁵ The country's investment fund industry is second only to the US in size and significance.

Different types of pooled funding vehicles that can be established in Luxembourg include, among others: venture capital funds, Undertakings for Collective Investment in Transferable Securities (UCITS), Undertakings for Collective Investment (UCI), Investment Company in Risk Capital (SICAR), Specialised Investment Fund (SIF). These funds are subject to different regulatory and supervisory requirements – and while their exposure to money laundering also varies, authorities in Luxembourg rate the overall risk to money laundering across the industry as very high.⁶

To mitigate money laundering risks, there are two main measures in place:

1. Anti-money laundering checks. Investment fund managers/advisers are subject to anti-money laundering requirements. They must understand the main risks they face considering their portfolio, region of operation, profile of customers and establish appropriate customer due diligence checks. They are required to collect information on the beneficial owner, the real individuals who are their corporate investors, and perform enhanced due diligence, including on the source of funds in cases considered as high-risk. They are also obliged to report suspicious transactions to competent authorities. There are significant challenges to the effective implementation of these measures, from the incentive structure for fund managers to reject customers in a very competitive

environment, to the number of intermediaries involved as often fund managers deal with banks, rather than directly with the end-investors. These challenges are not the objective of this analysis, but some of them have been recently highlighted in a paper by the Tax Justice Network.⁷

2. Public beneficial ownership registers. The 5th EU Anti-Money Laundering Directive (AMLD) required EU member states to establish public beneficial ownership registers to allow greater scrutiny of the real owners of legal entities by competent authorities, civil society, journalists and businesses. In Luxembourg, the law establishing the register was approved in January 2019. According to the rules, all investment funds operating in the country are subject to reporting obligations and must disclose their beneficial owners to the Register of Beneficial Owner (RBO) managed by the Luxembourg Businesses Registers.

According to Luxembourg's anti-money laundering law, a beneficial owner is any natural person who ultimately owns or controls the entity through direct or indirect ownership of more than 25 per cent of shares or voting rights, or control through other means. If no beneficial owner can be identified following the rules above, information has to be provided with respect to the natural person(s) who hold the senior management positions. The

definition is in line with the 5th EU AMLD, although the directive encourages member states to consider a lower threshold depending on the level of risk legal vehicles pose.

The RBO represents significant progress towards greater transparency in company ownership. Within months of its establishment, journalists have already been able to uncover that the former head of the Central Bank of Lebanon was the true owner of several companies registered in Luxembourg.⁸ However, important gaps emerge with regards to legal entities' compliance with the requirements, data accuracy and verification of the information in the register, and the treatment of investment funds, all of which threaten the effective use of the register as a tool to prevent and detect money laundering and other crimes.

The power of public beneficial ownership registers

Knowing the beneficial owner of companies is key for law enforcement, tax and other authorities tasked with investigating corruption, tax evasion and other criminal activities. Officials in several countries have often highlighted the challenges they face in investigating criminal activities when anonymous companies are used.⁹

A review of countries' compliance with the FATF recommendations on beneficial ownership undertaken by Transparency International in 2019, shows that competent authorities are more likely to have timely access to beneficial ownership data in countries where this information is easily accessible through a beneficial ownership register.¹⁰

However, the extent to which easy access to a register can support the detection of potential wrongdoing and further investigation depends on the adequacy of rules and on the quality of the information recorded. A public beneficial ownership register allows for more scrutiny of the data and to point out potential loopholes and weaknesses to be addressed.

This report, and the stories published as part of the Open Lux project, shine a light on some of the issues that should be taken into account by authorities in Luxembourg and across the EU if the register is to achieve the stated purpose of the EU Anti-Money Laundering Directive.

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INVESTIGATION FINDINGS

Transparency International and the Anti-Corruption Data Collective analysed data on investment funds recorded in Luxembourg's RBO to find that the industry, and its trillions of dollars in assets under management, continues to operate as a black box.

The Anti-Corruption Data Collective and Transparency International analysed data recorded in Luxembourg's RBO to identify 16,777 investment funds out of 140,000 active companies. These include different types of regulated investment funds in Luxembourg (for a full list, see the methodology section).

We found that 81 per cent of these funds did not declare any beneficial owners, according to the definition laid out by the Luxembourg authorities. This means that for the vast majority of funds, in spite of Luxembourg's steps to shine a line on corporate ownership, the real beneficiaries remain unknown. The industry, with the trillions of euros in assets under its management, continues to operate as a black box.

Moreover, our research reveals that many funds potentially violated the law by not identifying any beneficial owners.

To illustrate this, we matched Luxembourg investment funds with their entries in the Investment Advisor Public Disclosure System run by the US Securities and Exchange Commission (SEC).¹¹ The SEC requires that any cross-border funds that have business in the US must file annual reports describing their operations.¹² Importantly, while the names of beneficial owners are not disclosed, all funds must report the approximate number of beneficial owners of the fund.¹³

We were able to identify 719 funds (out of 16,776 total) that were registered in both the RBO

(Luxembourg) and the SEC (United States). Collectively these funds manage over US\$300 billion in assets.

Our investigation uncovered significant discrepancies between the way firms filed reports in the two government databases. By construction, if a fund has less than three owners, then there is at least one individual owner that owns more than 25 per cent of the total fund, and hence should be considered the beneficial owner according to Luxembourg's law.

We found 112 funds that reported between one and three beneficial owners to the US government. But only 17 of those funds (16 per cent) reported the names of any beneficial owners to the Luxembourg authorities.

This discrepancy suggests that either the funds are misrepresenting their ownership structure to the SEC, or failing to abide by the rules laid out in the Luxembourg RBO. Either scenario carries potential penalties and illustrates the need for stronger verification mechanisms and enforcement of beneficial ownership regulations. When asked for comment on the discrepancies, an official from the Luxembourg Commission de Surveillance du Secteur Financier claimed that because of the differences in definitions and purposes, the two registries cannot be compared.

Even among those that did declare beneficial owners in the Luxembourg RBO, the information does not always seem to be accurate. Managers and trustees still appear, in some cases, as the ultimate beneficial owners.

For example, in the RBO, private equity fund ESO Fund VII S.C.Sp. SICAV RAIF¹⁴ listed a single beneficial owner that held 100 per cent of its shares – a British lawyer at ESO Capital which administers the fund. Yet, the fund's registration with the SEC listed three beneficial owners and US\$51.9 million in assets as of 13 December 2020.¹⁵

Take another case of the fund Ares European Property Enhancement Partners III, which listed one

beneficial owner in the RBO owning 98 per cent of the US\$667 million fund. That owner was a lawyer and partner at Ares Management LLC which operates the fund. However, records show the fund has a 100 million-euro investment from the Illinois Municipal Retirement Fund, a public pension fund based in Oak Brook, Illinois.¹⁶

In both these instances, the funds appear to have submitted the name of the administrator or trustee rather than the true beneficial owners. This problem undermines the intent of the registry in providing accurate data for both regulators and investigators to ensure the integrity of the source of funds being invested.

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LOOPHOLES IN THE TRANSPARENCY FRAMEWORK

With more scrutiny over other types of legal vehicles, such as shell companies, there is a risk that investment funds will become even more attractive to criminals going forward. Closing the loopholes allowing investors to remain anonymous should be a priority.

The findings of our investigation reveal two main loopholes in Luxembourg's – and the EU's – current corporate transparency framework: inadequate definition of who qualifies as a beneficial owner and lack of verification mechanisms to ensure the quality and accuracy of the data in the registry.

INADEQUATE DEFINITION

In the context of investment funds, the current definition of a 'beneficial owner' is unlikely to help identify the real beneficiaries of funds.

The very concept of an investment fund provides that the individuals investing in the fund and financially benefiting from it are not the same as those controlling the fund and making decisions on the types of investments, among others. Moreover, one purpose of pooling an investor's resources into an investment fund is to diversify assets and spread the risk; therefore, most investors often hold smaller shares, falling below the 25% + 1 reporting threshold used in the definition.

The main money laundering risk is that the corrupt and other criminals are able to layer or integrate the proceeds of crime by investing dirty money across different investment funds, while remaining anonymous as long as their investment is below the reporting threshold. With more scrutiny over other

types of legal vehicles, such as shell companies, there is a risk that investment funds will become even more attractive to criminals going forward.

Understanding who the real individuals investing in a fund are and the ability to scrutinise their source of funds will require a reform in how beneficial owners are defined. For investment funds in particular, law enforcement, tax and other competent authorities should be able to identify all individuals who benefit financially from the fund (such as by earning interest or dividends) and not only those taking decisions (in control). Luxembourg authorities and the European Commission should require all natural persons that are end-investors of a fund to be identified and reported to beneficial ownership registers.

LACK OF VERIFICATION MECHANISMS

With the first public beneficial ownership registers came the recognition that the quality of the data collected varies significantly. This is not a problem that affects only public registers. Private registers, too, are likely to have inaccurate data as registry authorities across the globe rarely have the mandate to independently verify the information provided by companies. Public registers helped to expose these problems and led to reforms in many countries.

This was the case in the United Kingdom (UK). In July 2018, Global Witness reviewed the Persons of Significant Control (PSC) Register hosted by Companies House to find that, at the time, more than 9,000 companies were controlled by beneficial owners who each controlled over 100 companies – an indication that the beneficial ownership information of these registered companies could be false. Additionally, more than 10,000 companies declared a foreign company as their beneficial owner, which is unlikely to meet government requirements. Of these, 73 per cent were linked to secrecy jurisdictions.¹⁷ In 2020, the UK government announced reforms to Companies House to clamp down on fraud and money laundering, which

included the adoption of several steps to verify the information provided by legal entities upon registration.¹⁸

This is now the case in Luxembourg. The ability to scrutinise the data also serves to identify and highlight loopholes and weaknesses that need to be addressed. Our findings point to potential instances where legal entities are failing to adequately disclose their beneficial owner – not reporting any or providing inaccurate information. Trust and confidence in the register will depend to a great extent on how the government deals with these cases, and on the measures that are put in place to improve the data.

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RECOMMENDATIONS

A beneficial ownership register is only as good and valuable as the information recorded. To effectively close the loopholes that continue to enable corruption and money laundering, Luxembourg and the EU should assess the main weaknesses of the current approach.

In particular, we call on the authorities in Luxembourg to:

- + Take steps to review the definition of a 'beneficial owner' to ensure that all beneficiaries of investment funds – the real natural persons who are the end-investors – are accurately identified, disclosed and recorded in the RBO
- + Undertake a review of the data currently in RBO to assess if legal entities are complying with the rules. Cases of non-compliance and / or false information should be sanctioned in a timely manner
- + Adopt a mechanism to verify and validate the information provided by legal entities. This can be done, for example, by cross-checking information in the register against other government databases or by making use of advanced analytics. The parameters for verification should be well specified and in accordance with security and confidentiality provisions.

We call on the European Commission to review and amend the current beneficial ownership definition in the Anti-Money Laundering Directive and mandate member states to independently verify the information recorded in their beneficial ownership registers. In its Anti-Money Laundering Action Plan published in 2020, the European Commission highlighted the need for further harmonising the EU anti-money laundering framework and make it less subject to diverging implementation by member states.

To that end, the Commission is expected to deliver a single rulebook for anti-money laundering to harmonise provisions related to beneficial ownership registers, among others. Top priority should be given to ensuring member states adequately define beneficial ownership according to the nature and risks posed by a legal vehicle, and establish robust mechanisms to verify the accuracy of the information reported by legal entities to the register. This is key if beneficial ownership registers are to serve their purpose.

METHODOLOGY

To be counted as an investment fund, a company in the RBO had to at least one of the following three criteria:

- + The company's name had to contain a fund-related keyword such as SICAF, SICAV, SCSP, LP, etc.
- + The company had report as belonging to one of the following NACE industry codes:
 - 64.304 Venture Capital Fund (VCF)
 - 64.302 Open-End Investment Company (OEIC)
 - 64.303 Closed-End Investment Company (CEIC)
 - 64.301 Mutual Fund
 - 64.305 Private Asset Management Company
 - 64.309 Trusts, funds and similar financial entities n.e.c.
- + The company's RCS number started with the letter "K". In 2016, Luxembourg authorities required that common funds (fonds communs de placement, "FCP") register begin filing their own reports and thus receive identification numbers in the Trade and Companies Register starting with the letter "K".

Using these criteria, we were able to identify 16,777 investment funds. We used explicit fields from the registry to calculate that 81 per cent did not report any real beneficial owners, as compared to trustees or administrators.

We then collected data on 1,357 Luxembourg funds registered in the Investment Advisor Public Disclosure System run by the United States Securities and Exchange Commission (SEC). We merged the RBO and SEC records using a fuzzy matching algorithm, manually checking matches to ensure accuracy. 719 funds appeared in both the SEC and RBO databases, collectively managing US\$315 billion in assets. We then used a field in the SEC data to count the number of beneficial owners, and isolate all funds that reported three or fewer to the US government.

While we believe our approach took into account the vast majority of data discrepancies, no set of automated or manual tools can clean all data perfectly.

ENDNOTES

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- ¹² All investment advisors with over US\$150 million in assets under management and business in the US are required to register in the US, no matter where the funds are domiciled.
- ¹³ The number of owners is asked in Question 13 in Section 7.B.(1) of SEC IAPD Form ADV, which does not set a minimum percentage of shares that each owner must hold to qualify as a beneficial owner.
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