What is financial transparency?

by **Richard Murphy**

Recent press reports suggest Cayman is at the eye of a storm. To take an article from the UK's Daily Telegraph of 28 May 2009 as an example[1], it reported:

> ***"Anthony Travers, chairman of the Cayman Islands Financial Services Association and the Cayman Islands' Stock Exchange, says Cayman is a stable, transparent, tax neutral jurisdiction with a secure, British legal system that is used by global financial institutions to access international capital markets."***

In a paragraph that paper, I assume accurately reporting Mr Travers' words, encapsulates the differences of perception that flow around Cayman. Mr Travers projects an opinion, which is no doubt sincerely held by him and many within the Cayman financial community, but which those who criticise Cayman from outside its domain simply do not recognise.

I am one of those critics. Although I am a long standing member of the financial services community, a chartered accountant, former senior partner of a London firm and a past director of numerous companies I am also a founder of the Tax Justice Network. I currently act as an adviser to the TJN and the UK's Trade Union Congress, although I stress the opinions offered here are my own.

Both the TUC and TJN argue for tax justice. In doing so we assume that all people stand equal before the law, and should be treated equally by the law. This is an assumption that we make not only within a jurisdiction, but beyond and between them. This assumption extends to the important role of the state in ensuring that the property rights of people are upheld, but we argue that this in turn requires that those people recognise the right of the state to its claim on their property in the form of taxation. This then involves recognition of the importance of the rule of law being upheld both within and between states and in turn the mutual dependency of states in achieving this goal, not least with regard to tax.

Within this context those who argue for tax justice uphold the right of the individual, for example to privacy when they act within a personal capacity and within the requirements of the law. This is, however, we think a qualified right. The right to privacy is matched by the individual's obligation to the state, firstly to pay tax in accordance with the laws of the place or places where they locate their economic activities (as opposed to where they record them), and second to act responsibly with regard to any privileges granted to them by that state or those states. One such privilege includes the right to use legal structures affording benefit not available to an individual in their own right. These benefits include access to limited liability through use of incorporated structures and the right to use trusts that alter the law of property and the benefits flowing from such rights.

I do not suggest curtailing the use of such structures. I do instead suggest that the privilege these structures bestow carry with them a responsibility to report that the privilege granted by society as a whole acting through a democratic mandate has been responsibly managed. That duty can only be demonstrated to have been fulfilled when evidenced, and the evidence required is that the existence of the entity, the identity of its beneficial ownership, the true identities of those managing it, its constitution and accounts that evidence the activity undertaken must all be placed on public record. That, in the opinion of many critics of Cayman and other secrecy jurisdictions, is the price to be paid for the advantage that these structures undoubtedly provide.

We do not expect this though for purely ethical or legal reasons, important as they are. We expect data on public record because it mitigates the risk of those who trade with limited liability entities. Economic theory makes it clear that the efficient allocation of resources is only possible in very particular circumstances, one of which is the availability of perfect information. That is, of course, impossible to achieve. We know that but we are equally sure that the best approximation to perfect information we can achieve reduces risk in the market place and thereby reduces the cost of capital and consequently gives rise to the greatest efficiency in the allocation of resources for the benefit of all participants. In other words, efficient markets require as much information on the nature and risk inherent in trading entities to be available as possible. This fact strongly reinforces the arguments already made for this disclosure, especially as the majority of trade is by legal entities and not natural persons.

Some, we know, accept this argument but say few offshore companies trade since most act as intermediate investment managers. That may be true, but since we would not know which ones are which without full disclosure the argument makes little sense. In addition, all such companies change property rights. This artificial intervention does in itself require that disclosure be made in the interests of accountability for the benefit provided. Our argument for disclosure holds good even in this case. The consequence is that I and the organisations I work with are calling for sound markets, the rule of law, the safeguarding of people's property from abuse by others through the latter's abuse of legal entities, and a level playing field in information. All of these are predicates of sound markets.

Markets depend on the existence of property rights. We support those rights but think that the person who is relying upon the law has a duty to comply with the spirit of that law as well as its strict letter. As a consequence we hold to the concept of tax compliance which we define as seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

It is readily apparent as a result that we do not condone the recording of a transaction in one location when it actually takes place elsewhere, at least without full disclosure being made in both places. This does though mean that we challenge the whole offshore world, for by definition offshore structures always record transactions in a place where they do not actually occur.

This reality of the offshore world has been the subject of considerable review by us. Although many, Mr Travers included, seem to equate the attractiveness of offshore to taxation we have, after long reflection and research, realised that this has been a very useful diversion when considering what offshore locations have to offer to those who make use of their facilities. The core

offering they make is in fact of secrecy. Without the secrecy that those places, which I have collectively termed secrecy jurisdictions, have to offer then we doubt that many of their other offerings would be of benefit to the clients of the lawyers, accountants and bankers who work from, but in a very real sense not in, these locations. That is why you will now rarely hear the critics of such places refer to them as tax havens. The term 'secrecy jurisdiction' is our description of choice.

I have defined secrecy jurisdictions as places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain with that legislation or regulation being designed to undermine the legislation or regulation of another jurisdiction. In addition, secrecy jurisdictions create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. I and Cayman's many critics believe that Cayman is a secrecy jurisdiction. The term is, of course, used in the Stop Tax Haven Abuse Act promoted by Senator Carl Levin (and in its time by the former Senator Barack Obama).

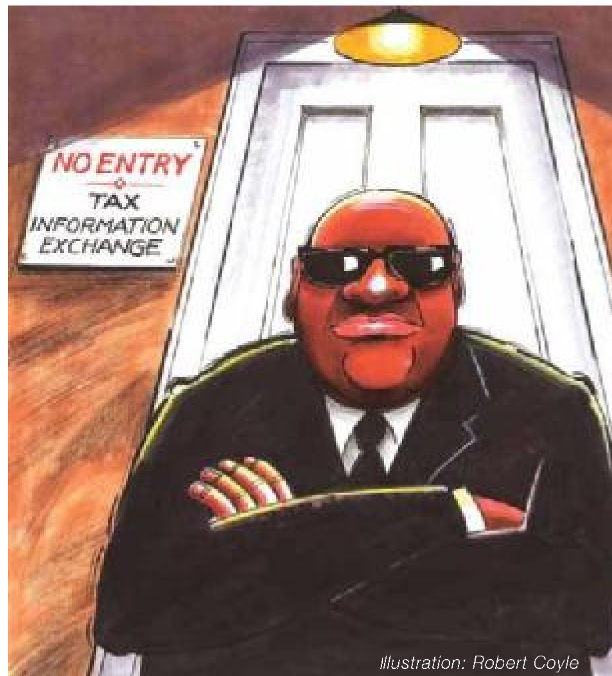


illustration: Robert Coyle

If that is the case then it is very apparent that the claim Mr Travers makes for Cayman does not match the perception of many in the UK, USA, France, Germany and elsewhere, both within government and in civil society who work on the tax haven/secrecy jurisdiction issue.

Using the standards of transparency outlined in this paper, which I readily admit are in ideal not met by any jurisdiction of which I am aware, but which are, despite that, informing public debate, Cayman falls far short of any claim to be transparent. It is not possible, for example, for a member of the public to secure the accounts of a Cayman corporation while the use of nominees is so rampant that all other data placed on public record is assumed by the public to be of little real meaning since it is highly unlikely to provide any real evidence as to the ownership or control of the limited liability entities with which a person may be trading in Cayman. Market inefficiency is the inevitable consequence. By this standard Cayman is not transparent – it is for all practical purposes almost completely opaque.

Cayman's critics hold that the same is true for tax information exchange purposes as well. Of course we acknowledge that it has signed a limited number of Tax Information Exchange Agreements. Most are decidedly recent, the agreement with the USA being the significant exception. And, as I have noted, based on Cayman's budget[2] for 2008-09, the amount of data to be supplied is anticipated to be very low indeed in proportion to the number of transactions likely to be undertaken, just eighty requests are anticipated.

There is good reason for that. As the standard TIEA makes clear[3], a TIEA request must provide or state:

(a) the identity of the person under examination or investigation;
(b) what information is sought;
(c) the tax purpose for which it is sought;
(d) the grounds for believing that the information requested is held within the jurisdiction of which request is made;
(e) to the extent known, the name and address of any person believed to be in possession of the requested information.

The reason for the low number of information requests becomes obvious immediately. There is considerable secrecy within Cayman about trusts of all sorts. Determining from readily available sources the ownership and control of companies is almost impossible in Cayman. Cayman has official banking secrecy. In that case the chance of linking assets owned by a company in turn controlled by a trust of which the person under investigation may or may not be settler and/or beneficiary is remote in the extreme. In consequence the existence of TIEAs is immaterial – the reality is they have no practical value.

I suggest that the similar accusations can be levelled against all of Cayman's claims of transparency, even when, as is clear from Stephen Platt's article[4] in the Second Quarter 2009 edition of this journal, those claims are in reality only made with regard to money laundering matters and not with regard to the much broader issues to which this article relates. As a result we suggest that contrary to Cayman's claims, financial transparency is largely absent within the jurisdiction. Cayman might claim to meet and even lead international standards on this issue. Others, the OECD included, appear not to agree. Explanation of this difference of perception is, I think, possible, I am not so confident the gulf in philosophy that it suggests exists will be so easily dealt with.

There are three core differences evident in the debate on Cayman's financial transparency. The first is that Cayman is relying on the form of legislation to justify its position. It cannot be disputed that on paper Cayman has many of the tools needed to tackle money laundering, financial crime and to information exchange for tax (at least with a limited number of other jurisdictions). The form of being compliant exists. The problem is that critics like me say that the substance of exchange is not happening, as the budgeted number of exchanges and the near impossibility of using TIEAs evidences. We have no interest in the form of compliance: we are interested in the outcome of compliance, and do not have the evidence we need that it is happening.

Secondly, Cayman persists in arguing that this matter relates only to financial crime. In tax it is exceptionally hard to prove what is criminal or not, particularly when the 'smoking gun' that would provide the evidence of abuse of offshore arrangements is hidden behind the veils of secrecy that Cayman provides to the clients of those banks, lawyers and accountants working out of its domain. What might be legal in Cayman may not be in the territory in which the clients of those 'secrecy providers' actually operate, but as Maples and Calder noted[5] in their comments to the US Government Accountability Office in 2008, they consider "that ultimate responsibility for compliance with US tax laws lies with US taxpayers". The implication in the context quoted was that Maples denied responsibility for the US compliance of their clients: this is something that critics suggest offshore financial services firms cannot do. We argue that they are responsible for the supply of the structures many in so called onshore jurisdictions use to avoid and maybe evade taxes. In that case critics think that Cayman (and other secrecy jurisdictions) has a duty to ensure that the tax consequences of the structures it facilitates, which because they are 'offshore' do by definition arise in other jurisdictions, are reported in those locations where those consequences arise to mitigate the risk that financial crime, in-

cluding tax evasion, might occur in that or those places. Until this happens then the definition of financial crime used by Cayman is, in my opinion, far too narrow.

Thirdly, and perhaps most importantly, there remains a fundamental ideological difference in approach between those who work offshore and their critics. Few would argue that even at its best offshore taxation is anything but tax avoidance. This must be the case, again by definition since offshore might be defined as the provision of tax and regulatory privileges to those who do not conduct active business affairs within a jurisdiction. It follows that the main purpose of the Cayman financial services sector is to record transactions whose real economic impact is elsewhere. This suggests that the difference between the substance and form of transactions is absolutely central to all it does. Cayman provides the form of transactions; their substance comes from 'elsewhere'. To a very large degree the critics of Cayman do, as a result, continue to hold the opinion that the place is little more than a 'booking centre', albeit that we accept that Cayman is more than capable of innovation and creativity in the way in which it undertakes the booking of transactions. We also doubt that Cayman takes its responsibility to those places described as 'elsewhere' sufficiently seriously, even if it knows where they might be.

The difficulty for Cayman is that tax and other regulatory avoidance is now seen for what it really is – a process of getting round the law. The argument that 'what is lawful is appropriate' no longer holds true with the public or much political opinion. And the mantra that financial transparency and accountability stops such abuse is not offered idly, the reality is that this does really stop abuse. That does, however, require me to conclude by stating what financial transparency means in this context. Having said which I admit that I have tried to define financial transparency but I have come to the reluctant conclusion that it is in this respect an elephant: capable of description but not of definition. I therefore offer the following description of financial transparency instead:

Financial transparency is a four stage process. Financial transparency requires that:

1. the true identity, ownership and management of any person or entity that might enter into a transaction be known to all who might transact with it. This requires that all natural persons who undertake a trade record that fact on public record and all legal entities and other structures created by law, whether trading or not, must place on freely accessible public record full details of their beneficial ownership, management and constitution;
2. all legal entities and other structures created by law with the legal right to enter into transactions must record their capacity to do so by placing their full and unabridged accounts, prepared in accordance with agreed international standards so that they show the substance as well as the form of the transactions they undertake on freely accessible public record in all jurisdictions in which they transacted during the period to which those accounts relate;
3. the regulatory authorities of any state can secure information on any transaction they believe to have been undertaken within their domain so long as the enquiry they make can be proven to relate to the responsibility they hold and that they shall have the right to expect the assistance of any other state when pursuing such enquires without having to prove that wrong-doing has occurred;
4. exceptions to disclosure shall only be allowed when it can be shown that the security of a natural person would be prejudiced as a consequence of disclosure being made.

This is, of course, a very different interpretation of financial transparency to that offered by Mr Travers on behalf of Cayman. First, the notion of criminality has little to do with it. Secondly, the range of laws to be complied with is wide and relates to civil as well as criminal matters. Third, disclosure of the substance of transactions would necessarily require that disclosure be made in those places where the impact of offshore transactions arises. So, for example, a Cayman company effectively pursuing activity in the UK would be expected to file data with the UK Registrar of Companies.

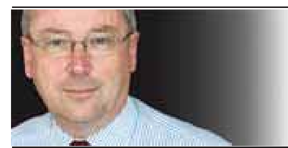
Substance also requires beneficial rather than legal owners to be disclosed whilst 'other structures' extends disclosure requirements to trusts, and it is only natural persons transacting in their own name who have a right to privacy with regard to commercial issues under this definition. In all others cases, including partnerships, the claim of others requires that disclosure be made. None of this, of course, compromises the right of the individual – no one is obliged to use a legal entity, trust, partnership or any other structure. All are choices provided for in law, but none are obligatory. But, in case of real risk arising, an opt out is offered, and I think that appropriate if used exceptionally.

Of course this standard of financial transparency is an ideal. I accept that no state reaches this standard at present but the move in sentiment is clearly in this direction. That is the issue with which Cayman must contend. Whilst it shows little understanding of the concepts inherent in this ideal form, nor recognises the validity of the demand for information of this sort then the language it uses will continue to be misunderstood, as will be those who use it, which is of no benefit to anyone.

Can Cayman embrace this approach? Can it at least engage with and debate this approach constructively and with an open mind? That in itself might be a challenge for inherent in his argument are very different perceptions of the nature of property from those commonplace, I suspect, in Cayman. But if Cayman wants to make progress it might have little choice but do so.

BIO: AT A GLANCE

Richard Murphy is a chartered accountant and graduate economist. He was senior partner of a London firm for many years and is also a serial entrepreneur. Since 2000 Richard has worked mainly on taxation policy. He advises the Tax Justice Network the UK TUC and many other organisations on tax issues. He writes a daily blog at www.taxresearch.org.uk/blog. He is co-author of a forthcoming book on tax havens for Cornell University Press.



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ENDNOTES

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