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Invited Testimony

United States Senate
Committee on Homeland Security and Governmental Affairs
Permanent Subcommittee on Investigations

The Honorable Norm Coleman, Chairman
The Honorable Carl Levin, Ranking Minority Member

November 14, 2006

Mr. Chairman and Members of the Subcommittee:

Thank you for this opportunity to address the Subcommittee and to provide testimony on behalf of the State of Delaware in response to the Subcommittee's letter of November 1, 2006 and to share our observations and comments on the Government Accountability Office (GAO) report entitled *Company Formations: Minimal Ownership Information Is Collected and Available* (the "GAO report") as well as Chapter 8 of the December 2005 *U.S. Money Laundering Threat Assessment* (the "MLTA report"), and Section 5.1 of the *Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America* (the "FATF report") (together the "Reports").

My name is Rick Geisenberger, and I am Delaware's Assistant Secretary of State as well as the Director of the Delaware Division of Corporations. I have served in this position for the past six years. I wish to thank the numerous corporate and alternative entity law attorneys in Delaware who have assisted the State in preparing this testimony.

Our testimony specifically responds to the eight matters raised in the Subcommittee's letter as follows:

(1) The approximate number of non-publicly traded corporations and limited liability corporations (hereinafter "corporations") formed in Delaware each year; the procedures typically used to form corporations in Delaware, including the role of on-line procedures and registered agents; the typical amount of time required by Delaware authorities to form a corporation; and the typical fees charged.

Under the federal system in the United States, each state and the District of Columbia has the authority to charter corporations and other business entities. As noted in the GAO report, along with Florida, California, and New York, Delaware is one of the largest filing offices in the United States. Just over half of all publicly traded companies in the United States are incorporated in Delaware including 61% of Fortune 500 companies. Last year, 119 initial public offerings (IPO's) or 73% of all IPO's on U.S. exchanges were incorporated in Delaware.

Delaware officials including our Governor and Congressional Delegation have traveled the world telling the Delaware story to corporate attorneys, venture capitalists, large institutional investors and others that advise businesses on where to incorporate. The Delaware story is a compelling one -- -- modern and flexible laws that are updated annually to enable businesses to structure their internal affairs in ways that meet changing business conditions, a highly regarded judiciary that has written much of the modern case law on fiduciary duties, a well-developed corporate and legal services industry in our State that is expert in the application of Delaware corporate law and active in its development, unparalleled service and responsiveness from the Delaware Division of Corporations which handles complex documents efficiently and effectively, and an elected leadership in Delaware with an enduring commitment to ensuring the continued success of our corporate laws.

Due to these strengths, in 2005, more than 133,000 new, non-publicly traded corporations, limited liability companies, limited partnerships, general partnerships and statutory trusts made Delaware their legal domicile. As of November 4, 2006 there were 753,684 active domestic business entities and 9,397 active foreign entities (that is, having their legal domicile in a jurisdiction other than Delaware) on the State's corporate record. The legal entities incorporated in Delaware and other States represent every segment of the nation's economy including the for-profit, religious, governmental and charitable sectors.

At one end of the spectrum are large, well-capitalized public and privately held companies. Delaware is the legal home of thousands of publicly traded companies such as General Motors, Google and the New York Stock Exchange. Delaware is also home to many large privately held firms. Some of these firms, such as Cargill and Cox Enterprises, have millions of authorized shares held by thousands of beneficial owners. Some of the largest closely held corporations in America such as Mars Incorporated are Delaware business entities. A significant percentage of the legal entities formed in Delaware are subsidiaries or affiliates of such large firms, and are created for the purpose of arranging the financings, asset-backed securitizations, mergers and acquisitions, roll-ups, investment vehicles and strategic alliances in which those large businesses engage.

At the other end of the spectrum are small Mom & Pop businesses, private investment and real estate vehicles as well as religious, charitable and civic organizations. Due to the wide diversity of types of businesses formed in Delaware and the importance of speed and efficiency to large multi-national corporations, the Delaware Division of Corporations has developed a variety of innovative services to meet the business needs of such companies. For example, while some documents filed via paper might take a week or more to be approved by the State, the typical document is processed within 24 hours of receipt. It is not uncommon for large corporations to pay for expedited service options enabling documents to be processed in under an hour. The typical formation fee paid to the State is $90 plus a $30 fee for a certified copy of the formation document. Expedited service fees range from $40 to $1,000 depending on the level of expedited service requested.

(2) The extent of beneficial ownership information typically obtained by Delaware authorities during the incorporation process, including initial incorporation and period reporting requirements; why corporations but not limited liability corporations are required to file annual reports in Delaware; and Delaware policy on establishing corporations that issue bearer shares.

As noted in the Reports, neither Delaware nor other states' filing offices obtain beneficial ownership information, either at the time of formation or through periodic reports. It should be noted that the purpose of a public filing by a company has never been to ascertain beneficial owners. Rather the purpose of the public filing is to create a public record of the existence of a legal entity, the state or country of its legal domicile, and its address for service of process.

Like many corporation laws in other states, the Delaware General Corporation Law ("DGCL") does require that corporations file with the Delaware Secretary of State an annual report that includes the names and addresses of all of the corporation's directors, one officer and the number and description of authorized shares of stock. For several reasons outlined below, these reporting requirements do not readily fit the legal structure of Delaware limited liability companies.

First, from its inception, the Delaware Limited Liability Company Act ("DLLCA") has been a contract-oriented statute, modeled largely on Delaware's successful partnership laws. It was not modeled on the DGCL and as a result, the DGCL's annual report requirement was not replicated in the DLLCA.

Second, while Delaware corporations have a predictable form of governance, there are limitless options available for managing a Delaware limited liability company. Except in the rarest of situations, Delaware corporations are managed by a board of directors, and the DGCL contains numerous provisions regarding the manner in which such boards function and govern the corporation. By contrast, the DLLCA does not require any particular form for the management of a Delaware limited liability company, but rather leaves that to determination of the parties ("members" in limited liability company parlance). The DLLCA does provide a default rule for management by the members in the event the contract among the members does not otherwise provide.

Third, the DGCL contemplates an annual election of directors and it often follows that there is a change in officers at the same time. The annual report provides a useful means of making such annual changes in the composition of the board of directors and senior management a matter of public record. Unlike the DGCL, there is no analogous mandate for periodic elections under the DLLCA. Indeed, in many instances, management does not change in a predictable timeframe and sometimes not at all during the life of a Delaware limited liability company. Because a limited liability company is a creature of contract, the parties are generally already aware of the identity of the party or parties managing the limited liability company. To the extent parties desire to provide for a

notice requirement similar to the information rights afforded by the annual report of a Delaware corporation, they may do so by way of the agreement among them.

Fourth, in contrast to the DGCL, the DLLCA reflects an almost completely contract-oriented approach to intra-entity relationships. Whereas the DGCL provides stockholders with access to information (e.g., the name and addresses of directors) by way of a statutory mandate, the DLLCA allows parties to the contract governing a Delaware limited liability company to provide similar information rights by way of that agreement, if desired. Thus, the absence of an annual report analogous to the requirement under the DGCL illustrates this principle that Delaware limited liability companies are creatures of contract.

With respect to bearer shares, the DGCL Section 158 was amended in 2002 to clarify what had previously been generally understood: "A corporation shall not have power to issue a certificate in bearer form." For limited liability companies, bearer shares, or bearer limited liability company interests, are neither specifically permitted nor specifically prohibited under the DLLCA. Based on the experiences of a number of leading Delaware lawyers who practice in the field, bearer limited liability company interests are not used. While theoretically it might be possible for the contract governing a limited liability company to be drafted to permit bearer shares, the DLLCA is not structured to facilitate this. On the contrary, the default rules of the DLLCA contemplate that all members of a limited liability company generally be known by the limited liability company, just like all partners of a partnership are generally known by the partnership.

(3) The role and legal responsibilities of third party agents paid to assist in the formation of Delaware corporations, including whether they are required to obtain and verify beneficial ownership information; and Delaware procedures for overseeing the actions of such company formation agents;

Businesses typically form legal entities with the assistance of a third party such as an attorney, an accountant or a company formation agent. Some companies submit formation documents without the assistance of a third party. Some company formation businesses in Delaware have requested and been granted "online access" to the Delaware Corporation Information System (DCIS) by the Division of Corporations. This access permits such businesses to view certain public information in the State's database and enables "imaging" agents to scan and automatically transmit images of corporate documents to State officials. This system dramatically improves the State's efficiency and timeliness in the processing of complex corporate filings.

In exchange for such access, each of the State's 54 authorized online agents sign a contract with the State agreeing to comply with a variety of policies set by the Division. The contract is broadly drafted to permit the State to deny, revoke, or suspend online access to an agent or its officers, directors, partners, owners or key employees that 1) do not satisfy the minimum statutory qualifications to serve as a registered agent in Delaware; 2) have a criminal background or are known to associate with persons of

nefarious backgrounds or disreputable characters; 3) demonstrate financial irresponsibility in dealings with the Secretary of State; 4) demonstrate a pattern of submitting documents which contain inaccuracies or false statements; 5) fail to be responsive in addressing questions and concerns of the Secretary of State; 6) fail to comply with the laws and regulations of federal, state or local governments; or 7) have information coming before the Secretary of State related to the agent's competency, financial capability, honesty, integrity, reputation, habits or associations. The State does deny online access to company formation agents that fail to meet these standards.

Many company formation businesses in the State also offer registered agent services to their customers. Every company in the State is required to have a registered agent in the State to accept service of process. The registered agent may be the company itself, an individual resident of the State, or another legal entity. Registered agents are required under Delaware law to maintain a business office in the State which is generally open, or if an individual, they are required to be generally present at a designated location in the State at sufficiently frequent times to accept service of process and forward State correspondence to the entities they represent. There are more than 32,000 registered agents in the State of Delaware. The vast majority of registered agents in Delaware (more than 96%) represent three or fewer business entities.

We, of course, share the concern of federal law enforcement officials that business entities ought not to be formed for illicit purposes. In June 2006, the State adopted legislation designed to ensure that law enforcement will have better access to information that identifies a person who is acting as a representative of a Delaware business entity. Under this new legislation that takes effect on January 1, 2007, every Delaware business entity will be required to provide to their registered agent and to update from time to time the name, business address and business telephone number of a natural person who is an officer, director, employee or designated agent of the business entity who is authorized to receive communications from the registered agent. Every registered agent will be required to retain such information in paper or electronic form for every entity they represent.

Delaware has also become the first state in the nation to adopt legislation responding to concerns expressed by law enforcement regarding illicit practices of registered agents. Delaware has approached this issue from two angles. First, Delaware is making a conscious effort to ensure that the State gathers more information on companies engaged in the registered agent business. Effective January 1, 2007, 237 registered agents in Delaware -- those representing directly or through affiliates 50 or more business entities -- will be required to meet additional qualifications as "Commercial Registered Agents". Commercial Registered Agents in Delaware will be required to maintain a Delaware business license, have generally present in their office an officer, director or managing agent, and provide to the State such information identifying and enabling communication with the Commercial Registered Agent as the Secretary of State shall require. For the first time, the Secretary of State will be explicitly authorized to refuse to file documents on behalf of any registered agent that fails to meet the qualifications for being a registered agent. In addition, the new legislation creates a mechanism allowing the

Delaware Court of Chancery to enjoin any person or entity from serving as a registered agent for failure to meet the qualifications to be a registered agent; for conviction of a felony or crimes involving dishonesty, fraud or moral turpitude; or, for being engaged in conduct in connection with acting as a registered agent that is intended or likely to deceive or defraud the public. We believe that these new provisions of Delaware law will have the desired deterrent effect while continuing to enable legitimate business entities to conduct their affairs quickly, at minimum cost and without deterring economic activity and business investment by impinging on privacy.

(4) The extent to which Delaware permits the use of nominee shareholders, directors, and officers for corporations formed in the United States, and the justifications for the use of such nominees in the United States.

Directors: DGCL Section 141(b) establishes that directors must be natural persons ("The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person").

By default rule under the DLLCA, the members of a Delaware limited liability company share authority to manage the affairs of the entity. By contractual arrangement, however, the DLLCA permits the use of other management structures, including ones where the parties with managerial control are acting in a representative capacity on behalf of the members or other interested parties. The flexibility in the DLLCA in this regard responds to the personal, tax and business needs of contracting parties and is consistent with the overall contractual nature of limited liability companies. A party acting in such a representative capacity (i.e., a "nominee") need not be a natural person and may be another entity. For example, an individual (e.g., a parent) acting as trustee on behalf of beneficiaries (e.g., her children) may in her trustee capacity legally become a member of a Delaware limited liability company and as such manage the Delaware limited liability company; an investor in a Delaware limited liability company may be entitled to nominate a firm (e.g., a financial services firm) to manage some aspect of the Delaware limited liability company's business (e.g., formulating and executing its investment strategy) and that "nominee" manager legally may do so. Contracting parties demand flexibility to achieve legitimate tax, business and other goals, and the foregoing are just several examples of the limitless options available in structuring the management of a limited liability company.

Officers: The DGCL no longer explicitly establishes that officers must be natural persons. Until 1998, however, the statute governing the selection of corporate officers (Section 142(b)) implicitly recognized that officers must be natural persons, providing that "[e]ach officer shall hold *his* office until *his* successor is elected and qualified or until *his* earlier resignation or removal." (emphasis added). In 1998, in the interest of removing gender distinctions throughout the DGCL, the words "his" were eliminated in favor of the term "such officer's." This amendment was not intended, however, to expand Section 142 to permit non-natural persons to serve as corporate officers. To our knowledge, moreover, it remains universal practice that officers of Delaware corporations are natural persons.

The DLLCA does not require that a Delaware limited liability company have any officers. By contractual arrangement, however, a Delaware limited liability company may have one or more "officers." Under the DLLCA, a person who is an officer of a Delaware limited liability company need not be a natural person and may be an entity. As discussed with respect to directors, the management of a Delaware limited liability company may be structured in a manner that such an officer is acting in a representative capacity. As noted above, the DLLCA's flexibility in these respects furthers legitimate interests.

Stockholders: Like the Model Business Corporation Act,[1] the DGCL and the DLLCA permit persons to hold formal or nominal title to shares or other equity interests in the name of other persons as beneficial owners. Taking advantage of that flexibility, the large majority of equity securities traded on the national securities exchanges and national securities markets are held in "street name," by depository nominees for the benefit of banks and brokers who, in turn, hold such securities for the benefit of clients as beneficial owners. The identities of the beneficial owners are largely unknown to the corporations or other entities that issue such securities. The Depository Trust Company, a principal securities clearinghouse, reports that it "retain[s] custody of almost 2.5 million securities issues worth about $28.3 trillion, including securities issued in the United States and more than 100 other countries."[2] It is therefore no understatement to say that without business entity laws permitting such nominee ownership, the equity capital markets in the United States would collapse as unmanageable.

In addition, flexibility as to the manner of ownership of stock and limited liability company interests fosters investment and capital formation (by securing for investors the limited liability that accompanies the use of a separate legal entity as the investment vehicle) and promotes efficiency (by enabling investment at the entity level). For example, an institutional investor (e.g., an insurance company or a pension plan) or a private investment firm may purchase interests in an investment fund created in the form of a Delaware limited liability company; two corporations may invest in a separate joint venture corporation or Delaware limited liability company in order to pursue a strategic alliance, and that investment vehicle in turn may make investments in other business entities for purposes of carrying out the strategic alliance; an individual (e.g., a parent) acting as trustee on behalf of beneficiaries (e.g., his children) legally may hold in his trustee capacity an economic interest in a Delaware limited liability company created to own real estate or other investment property.

(5) The approximate number of requests made over the last five years by law enforcement for beneficial ownership information related to Delaware shell corporations, and the extent to which the state was able to provide that information.

All documents filed with the Delaware Secretary of State are public information. The Secretary of State responds to hundreds of thousands of requests annually for copies of

[1] See Model Business Corporation Act §7.23 ("Shares Held by Nominees")
[2] http://www.dtcc.com/AboutUs/affiliates.htm?shell=false.

such documents and certificates of good standing. Delaware does not track the number of requests made for beneficial ownership information. We field daily requests for beneficial ownership information from citizens and/or members of the media that may, for example, be interested in researching the ownership of a particular privately-held investment or real estate venture. However, since federal, state and local law enforcement officials are already well aware that states do not track such information, we seldom receives such requests from law enforcement. We do, however, field frequent requests from law enforcement for annual reports, registered agent information and copies of company filings. Sometimes these requests come in the form of a subpoena although it is the position of the Division that requests for public information do not require a subpoena. The Division occasionally receives subpoenas requesting non-public information such as ad-hoc reports prepared by the State or information on depository accounts maintained at the State on behalf of customers of the Division. The State of Delaware fully cooperates with law enforcement and tax authorities in all such matters.

(6) Any information the state may have on the extent to which the lack of beneficial corporate ownership information in state records can impede or has impeded domestic and international law enforcement investigations.

The State has no specific knowledge of the extent to which the lack of beneficial ownership information by federal, state and local government records impedes or has impeded domestic and international law enforcement investigations.

(7) Delaware's views of: (a) the GAO report; (b) Chapter 8 of the December 2005 report, U.S. Money Laundering Threat Assessment, issued jointly by the Departments of Justice, Treasury, Homeland Security and others; and (c) section 5.1 of the 2006 Financial Action Task Force report, Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism: United States of America, each of which addresses the issue that the United States does not obtain beneficial ownership information for shell corporations formed within U.S. borders.

The stated concern of the Reports is money-laundering, that is, the use of corporations and other business entities, the owners of which are anonymous, to facilitate illegal transactions. The ostensible solution offered by these Reports appears to be having each of the 51 jurisdictions in the United States impose a mandatory rule that would require companies to identify who their beneficial owners are, and then make that information available to the State and, perhaps, to the public.

In summary, it is the view of Delaware that (i) a beneficial ownership reporting system that included public companies would be a logistical and costly nightmare for corporations; (ii) even a self-reporting system that exempted public companies and their "affiliates" would have immense verification costs and definitional administrative problems;[3] and (iii) as applied to non-public companies, such a system would impose

[3] First, it will be difficult for the State to determine who would qualify as an "affiliate" under such an exemption. Second, since it is a self-reporting system, there is little doubt

costs on legitimate private businesses that seem vast in relation to benefits that are at best uncertain.

Part A of this portion of our testimony sets the stage for our comments on the GAO, MLTA and FATF reports by providing a brief summary of the concepts of record and beneficial ownership under Delaware law, as well as the current record-keeping requirements imposed on corporations governed by the DGCL. Part B of this portion of our testimony provides specific responses to the Delaware corporation law issues raised in the Reports.

A. Delaware State Law Concepts of Record and Beneficial Ownership

A "stockholder" under the Delaware General Corporation Law (the "DGCL") has historically been considered to be the "holder of record," and not the "beneficial owner" of a company's shares. The same is true in those states that have adopted the Model Business Corporation Act (the "Model Act").[4] In part, the law-- both in Delaware and elsewhere-- has developed this way for practical reasons. For example, Delaware corporations rely on a list of record holders in order to determine which of their stockholders are entitled to notice of a stockholder meeting. In contrast, corporations are not required to send notice of stockholder meetings to beneficial owners. This is because such a requirement would impose an unfair responsibility on the corporation to uncover all persons who hold a beneficial interest in its stock. Indeed, sorting through the various layers behind beneficial ownership would result in a logistical nightmare for the corporation (private companies included). It would also compromise the efficiency and certainty that reliance on a list of record holders provides to corporations.

Under the DGCL, record holders are considered the "stockholders" of a company. Delaware corporate law has traditionally limited the rights of stockholders to stockholders of record,[5] and has long recognized the "rule that a corporation may rely on its stock ledger in determining which stockholders are eligible to vote or exercise the important rights of a stockholder."[6] In fact, a corporation satisfies its obligations to its stockholders by communicating with record holders and is not required under Delaware

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that potential money-launderers will report that they are eligible affiliates of a public company and, the State, for all intents and purposes, could not easily determine their status.

[4] Model Business Corporation Act §7.23, Official Comment ("Traditionally, a corporation recognizes only the registered owner as the owner of shares.").

[5] For decades the Delaware Supreme court has consistently defined the term "stockholder" as a holder of record. *See In re Giant Portland Cement Co.*, 26 Del. Ch. 32 (Del. Ch. 1941); *Salt Dome Oil Corp. v. Schenck*, Del. Supr., 28 Del. Ch. 433, 41 A.2d 583, 589 (1945); *Carl M. Loeb, Rhoades & Co. v. Hilton Hotels Corp.*, Del. Supr., 43 Del. Ch. 206, 222 A.2d 789 (1966); *ENSTAR Corp. v. Senouf*, Del. Supr., 535 A.2d 1351, 1354 (1987); *Shaw v. Agri-Mark, Inc.*, 663 A.2d 464, 469 (Del. 1995); *Haft v. Dart Group Corp.*, 1997 Del. Ch. LEXIS 46 (Del. Ch. 1997).

[6] *See Shaw*, 663 A.2d at 469.

law to identify and disclose all of its beneficial owners. For example, Delaware law does not require corporations to send notice of stockholder meetings to beneficial owners or accept demand for appraisals from beneficial owners.[7]

This is so because corporations must have a practical means by which they can ascertain the names of the individuals with whom they need to communicate in regard to corporate transactions, or other significant corporate events.[8] Using the list of record holders provides "order and certainty," by allowing corporations to deal freely with the registered holders without having to investigate the beneficial ownership of its stock.[9] According to the Supreme Court of Delaware:

> The corporation ought not to be involved in possible misunderstandings or clashes of opinion between the non-registered and registered holder of shares. It may rightfully look to the corporate books as the sole evidence of membership.[10]

A contrary rule, such as the rule contemplated by the Reports, would amount to an unreasonable burden on corporations. It would also compromise the certainty and expediency that relying on a list of record holders provides to corporations. Corporations would be faced with the near impossible task of uncovering, on a continuous basis, all persons who hold an interest in their stock, whether through a business entity, trust, or some other form of ownership.

Indeed, to comply with such a rule, public corporations would have to sift through various levels of the holders of stock, including the brokerage houses, banks, depositories and other nominees, to discover the identity of their beneficial owners (who had chosen to have those entities register their respective shares). Such a task would be incredibly time-consuming and costly. This is especially true for large private companies that have a number of shareholders who spread out their ownership and hold shares in multiple trusts, or some other business entity.

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[7] *See Gilliland v. Motorola, Inc.*, 859 A.2d 80, 85 (Del. Ch. 2004) (holding that the corporation satisfies its notice obligation under section 262 by sending notice to the brokers or fiduciaries, and is not required to send notice to the beneficial owners.); *see also Edgerly v. Hechinger*, 1998 Del. Ch. LEXIS 177 (Del. Ch. 1998) (holding that only a holder of record can demand an appraisal); *Bandell v. TC/GP, Inc.*, 1996 Del. LEXIS 23, Del. Supr., No. 247, 1995, Berger, J. (Jan. 26, 1996) (ORDER) (holding that an appraisal action must be filed by the record owner).

[8] *See In re Northeastern Water Co.*, 28 Del. Ch. 139, 150-151 (Del. Ch. 1944) (holding that "failure to have shares registered so as to indicate an interest in others than the registered holder may reasonably be deemed a manifestation of intent that the corporation should deal freely with the registered holder as the true owner without investigating his authority.").

[9] *Salt Dome Oil Corp.*, at 441 A.2d at 589.

[10] *Id.*

Apart from concern about the impact on corporations, there are nearly countless situations in which disclosure of beneficial ownership information of privately held firms would run counter to legitimate personal or business interests of equity owners:

(1) An investment fund, sponsored by an investment management firm, may take the form of a Delaware limited liability company. A listing of the investors in that Delaware limited liability company might effectively constitute the client list of the sponsor, which clients have been identified and cultivated by the sponsor at considerable effort and expense. Disclosure of the investors' identities in that case would permit a competing investment management firm to obtain and potentially trade unfairly on the sponsor's proprietary client list. Indeed, because investment management firms commonly invest in each other's investment vehicles, there are compelling competitive reasons not to reveal to the limited liability company investment vehicle the information as to the beneficial ownership of its various investors.

(2) A joint venture between two large companies, created for the purpose of developing a new manufacturing process, may take the form of a Delaware corporation. The mere existence of this joint venture relationship may be a sensitive business matter. Disclosure of the alliance could unfairly advantage rival firms by providing insight into their competitors' business initiatives and strategies.

(3) A Delaware limited liability company may be used as a personal estate planning vehicle. Many non-public Delaware limited liability companies hold significant "family" investments or other family assets or serve as a private mutual fund permitting family members to participate in a controlled investment structure. Disclosure of the beneficial ownership of the Delaware limited liability company in that circumstance could intrude on a family's realistic expectation that such sensitive matters will remain private. Moreover, disclosure of the beneficial owners could expose the family members to harassment by persons seeking to invade the family assets or expose a family member to actual physical danger.

B. Responses To Delaware Corporation Law Issues Raised In The Reports.

1. The GAO Report - The GAO Report is generally balanced and factually accurate in describing the types of information collected by States, such as Delaware, in connection with the formation of corporations. However, because the GAO Report was completed in April, 2006, it does not take into account the changes Delaware made this summer to its statutes as described in Section 3 of this testimony.

The GAO Report is important in that it highlights some of the practical problems and administrative challenges that requiring collection of beneficial ownership information in connection with the formation and maintenance of corporations would create. For example, many states, including Delaware, do not have the physical capacity, either in

staffing or technology, to assemble and maintain this information themselves. Indeed, in Delaware, such a requirement would require legislative action to mandate the provision of such information to the State or to registered agents.

Even if such a system were imposed, verifying information about beneficial owners at formation would be difficult, if not impossible, given the reasons for and timing of the formation of corporations. For example, a law firm may be instructed to form an investment vehicle for a client before the ownership of the entity is even determined. In addition, beneficial ownership information may (and frequently does) change following formation, and it would not be practical to require Delaware or registered agents to enforce reporting requirements regarding such changes. Moreover, many persons forming new corporations are themselves entities, such as public corporations and investment professionals, who are taking advantage of the benefits of the corporate form for legitimate business reasons, such as limiting liability exposure or facilitating more affordable borrowing rates through the use of so-called "bankruptcy remote" entities.

Finally, we share the concern expressed in the GAO Report that the experience of other jurisdictions could be repeated in Delaware and other states if this type of inquiry is mandated. It is hard not to envision a drop in the number of entities formed in the United States and a corresponding flight of capital if the beneficial ownership reporting requirements contemplated by the GAO Report are imposed.

2. MLTA Report - Chapter 8 of the MLTA Report ("Shell Companies and Trusts") is flawed in several important respects.

First, the specific reference in Chapter 8 to a "handful of U.S. states," and its identification and study of Delaware, Nevada and Wyoming, create the incorrect impression that Delaware offers what the report describes as "cloaking features" that are distinct and more protective of privacy than what most if not all other states also offer. This is not the case. The Model Act – the template for the majority of corporate statutes outside of Delaware – allows for nominee ownership (see §13.03, "Assertion of Rights by Nominees and Beneficial Owners"); the Model Act vests in the board of directors the discretion to dispense with share certificates (§6.26); unlike the Delaware General Corporation Law as recently amended, the Model Act makes no provision for closing down commercial registered agents for fraud or the like (see Model Act §§5.01-5.04); like Delaware law, the Model Act contains no limitation on share ownership by a national of any jurisdiction, regardless of place of residence, and permits the corporation to operate worldwide (see, e.g., §3.02(10) (corporate power to "conduct its business … within or without this state"); and like Delaware law, the Model Act requires no annual reporting of assets (§16.21). It is misleading to single out Delaware as if it were unusually hospitable to business participants seeking privacy for illegitimate purposes.

Second, Chapter 8 is flawed by an incomplete and cursory assessment of the importance of legitimate uses of so-called "cloaking features." For example, it asserts that "allowance of nominee shareholders undermines the usefulness of the shareholder register … because the shareholder may not be the ultimate beneficial owner." The

suggestion is that this feature of Delaware corporate law is a "cloaking feature" conducive to money laundering, but there is no recognition that the ability to hold shares in nominee name is central to the operation of U.S. securities markets, among many other important legitimate business purposes. Likewise, as an example of a claimed "race to the bottom" that creates "a real money laundering threat," Chapter 8 notes that "a Delaware-registered company may be owned by a national of any jurisdiction, regardless of his or her place of residence," and that "the company can be operated and managed worldwide …." What is missing is an acknowledgement that the ability to attract ownership from all over the world, and the ability to operate in any area of the world, is a necessary underpinning of all capital investment in U.S.-chartered entities, and is a necessary underpinning of the ability of such entities to conduct business overseas as well as domestically, to the great benefit of U.S. investors, taxing authorities and citizens generally.

To be fair, Chapter 8 does acknowledge that shell companies and trusts "are used globally for legitimate business purposes." On the other hand, while it acknowledges that shell companies legitimately "serve as a holding company for intellectual property rights," Chapter 8 omits a wide variety of other uses of shell companies in real estate and other legitimate investment transactions. Similarly, while Chapter 8 acknowledges that trusts "are useful when assets are given to minors or individuals who are incapacitated," it fails to acknowledge the important role of trusts as estate planning devices for families of even relatively modest means.

Third, the "Side by Side Comparison of Wyoming and Nevada and Delaware" at the end of Chapter 8 is factually and legally erroneous in quite a few respects. As previously noted, Delaware law, just like the Model Act, does allow nominee shareholders and permit corporations to dispense with share certificates. The "Side by Side Comparison" fails to note either of these points. Likewise, it fails to note that, like the Model Business Corporation Act (§§8.50-8.59), Delaware law provides for indemnification of directors and officers of corporations. What this has to do with money laundering threats is not disclosed in Chapter 8, but the matter is another in which the "Side by Side Comparison" is erroneous in an obvious way.

Finally, it should be noted that much of the content of Chapter 8 was not the independent work product of the team that compiled the Threat Assessment. For example, much of the text merely rehashes the content of a GAO report that dated from October 2000. The "Side by Side Comparison" was copied verbatim from the website of a company formation business in Wyoming with no attempt at independent verification. Had Delaware officials been consulted regarding this chart and Chapter 8 in general, we could have corrected any erroneous information. While we may not agree with the GAO and FATF reports in their entirely, both the GAO and FATF, to their credit, took the time and effort to visit Delaware and seek input and comment from knowledgeable officials. No such effort was made by the authors of the Threat Assessment. This failure of communication and consultation by the authors of the Threat Assessment might account for its many flaws. In sum, it is our view that Chapter 8 is too cursory, unbalanced and inaccurate to be taken as a reliable basis for regulatory judgment in the area it addresses.

3. FATF Report - The general premise of Section 5.1 of the FATF Report is correct -- Delaware does not require corporations to track beneficial ownership nor does it require Delaware corporations to report such information to the registered agent or the Secretary of State so that such information is a matter of public record. However, the FATF Report is incomplete in a number of respects, and fails to take into account the costs and logistical problems associated with a policy of beneficial ownership disclosure, as well as the limited benefits to be gained by such a reporting requirement.

First, the FATF Report makes a somewhat illusory statement when it claims that "there is no obligation to file the name of any shareholder or beneficial owner when establishing either a corporation or an LLC" in Delaware. The report fails to mention that corporations do not ordinarily have beneficial or record shareholders at the moment of incorporation. Specifically, pursuant to Delaware General Corporation Law, the following sequence of events occurs in forming a corporation:

(1) The certificate of incorporation is filed with the Secretary of State. (Section 101).
(2) The certificate of incorporation contains, among other things, the name and address of the incorporators or the initial directors. (Section 102)
(3) An organizational meeting is held where the corporation adopts bylaws and elects directors and officers. (Section 108)
(4) The directors issue stock in the corporation, and the recipients of the shares become stockholders of the company after payment for the stock.

Accordingly, at the formation stage when the certificate is filed, the company has not yet issued stock in the corporation. Therefore, it would be inapt to require corporations to disclose beneficial ownership at the moment of incorporation.

Moreover, even if detailed disclosure of stock ownership (once shares are issued) were required, it would not provide information about the individuals responsible for the daily controls of the corporation. Under Section 141 of Delaware law, the business and affairs of a corporation are managed under the direction of the board of directors. The stockholders of a corporation are generally not authorized to direct the business of the corporation. For example, in the case of a shell corporation with a single shareholder, the stockholder generally is not permitted to open bank accounts, sign contracts, or take any action to bind the company without specific authorization by the board of directors. Therefore, disclosing the identities of beneficial stock holders of such shell companies would not necessarily address the concerns of the FATF.

Second, the collection of beneficial ownership information contemplated by the FATF Report goes well beyond the current requirements imposed on Delaware corporations. As noted in the FATF Report, the DGCL requires a corporation to maintain information about the record ownership of its shares, but does not require corporations to maintain lists of its beneficial owners. As explained more fully in Part A of this section, *supra*, under Delaware law, the stockholders of record are recognized as the "official

stockholders" of a company. This is because the rights associated with being a stockholder of a company are, for the most part, granted to the stockholders of record. It is the stockholders of record that are required to provide the corporation with information concerning the transfer of stock ownership. In fact, if a stockholder transfers record ownership of its shares to another person or entity, and fails to inform the corporation of this transaction, the corporation may refuse to permit the transferee to vote the shares or otherwise exercise the rights associated with record ownership.

The proposal contemplated by the FATF Report, which would require corporations to disclose changes in beneficial ownership and report such changes to the Secretary of State on a continuous basis, would be unduly burdensome and costly, requiring corporations and the State to employ a significant amount of resources. Moreover, even if the resources were available, such a reporting system would depend on the cooperation of the beneficial stockholders. As a self-reporting system, the beneficial stockholders would have to be willing to disclose the information to the company and the State. Furthermore, even if the beneficial owner disclosed his or her identity, the company and the State would have to expend additional resources verifying whether the information submitted by beneficial owners was current and accurate.

Finally, the FATF report fails to consider that many beneficial owners choose to remain anonymous for legitimate reasons. For example, many start-up companies get financing from so-called "angel investors" who do not want to disclose their identity, because they may have other investments in competing businesses, they value the privacy of their investment strategy, or they recognize that there is a potential for misuse of this information. In addition, many private companies choose to be private because they do not want ownership information publicly disclosed. Take, for example, a private company with many employees and competitors. Assume that the company has been owned of record and beneficially by its founder from its formation. As its founder ages, the founder might, for planning purposes, want to transfer shares of the corporation to various family members or faithful employees. The founder would not want that information available to competitors (potential purchasers of the shares) or to its other employees.

In sum, the FATF Report unfairly characterizes the Delaware system as one that encourages "secrecy" in the formation and ownership of companies. The report fails to take into account that there are numerous lawful and practical reasons why anonymity is valued in the realm of investments and business dealings. Furthermore, the report's suggestion that Delaware's (and other state's) policies are driven by a "powerful lobby" of "company formation agents" who want to maintain the status quo is untrue. The laws enacted under the DGCL and the policies of the Secretary of State are the result of the combined efforts and input of local practitioners, practitioners across the United States, and Delaware's legislature, and reflect the balanced interests of companies, investors, law enforcement, practitioners, and various government agencies.

(8) Recent steps taken by Delaware to address this issue, any recommendations for additional reforms, and any comments on ways to solve this problem.

Delaware has taken a number of recent steps addressing these issues, specifically enactment of a statute in June 2006 that establishes minimum qualifications for Commercial Registered Agents, creates procedures for enjoining a “rogue” registered agent or its principals from doing business in the State, and requires all Delaware business entities to provide a communications contact to its registered agent. We recommend that other states adopt similar measures to ensure reasonable oversight of registered agents and to assure that basic customer contact information is being gathered and retained and is available to law enforcement officials through normal investigatory and judicial procedures.

We also recommend that the federal government study whether existing federal laws should be augmented to address the concerns identified in the Reports. It is our belief that the mere act of forming a business entity is never an act of money laundering. Rather, money laundering occurs when illicit funds are moved through the United States and international financial systems. The United States has in force a number of homeland security, tax and banking laws that require financial institutions to obtain information from their customers that could be augmented through stronger enforcement, new regulations or amendments.

To this end, the most comprehensive federal law is the USA PATRIOT ACT. Section 326 of the USA PATRIOT ACT requires the Secretary of the Treasury, jointly with other agencies, to prescribe regulations that require financial institutions to implement reasonable procedures to (i) verify the identity of any person seeking to open an account, (ii) maintain records used to verify such person's identity, including name, address and other identifying information, and (iii) determine whether any such person appears on any list of known or suspected terrorists or terrorist organizations provided to financial institutions by any government agency. Section 326 of the USA PATRIOT ACT applies to all "financial institutions," which is very broadly defined to include a large range of types of financial institutions, including, without limitation, banks, trust companies, thrifts, credit unions, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, other money service businesses, and casinos. Under the regulations implementing Section 326 of the USA PATRIOT ACT, financial institutions are required, at a minimum, to obtain the following information for a customer prior to opening an account: (i) name, (ii) date of birth, if an individual, (iii) an address, and (iv) an identification number. Based on a risk assessment, a financial institution may also obtain information with respect to the beneficial owners of an entity opening an account, or information with respect to any person with authority over an account.

As to the requirement relating to the tax identification number, for U.S. persons, this will be such person's tax identification number. If the customer is an individual, the individual’s social security number will be used as the individual’s tax identification number. If the customer is not an individual, but is an entity (such as a corporation, limited liability company, partnership or statutory trust), pursuant to IRC § 6109(c), the entity must file a Form SS-4 with the Internal Revenue Service in order to obtain a tax

identification number. The applicant is required to sign the form SS-4 under penalties of perjury. The tax identification number will be issued by the Internal Revenue Service if the information requested on the Form SS-4 is supplied. The information required to be supplied by the entity on the Form SS-4, includes among other things the name of the principal officer, general partner, owner, grantor or trustor of the entity and the taxpayer identification number of such principal officer, general partner, owner, grantor or trustor of the entity.

Although the information provided on Form SS-4 is confidential, pursuant to IRC Section 6103(d), (e), (f), (h) and (i), upon request the information can be disclosed to persons having a material interest, federal, state and local law enforcement agencies and committees of Congress. If necessary, Congress could choose to expand the information requested on Form SS-4 to include beneficial ownership information. However, in the same way that beneficial ownership disclosure at the State level would create a massive State bureaucracy, such a system of beneficial disclosure through federal tax forms would likely create a massive and costly federal bureaucracy. While Delaware does not advocate this approach, it certainly is an option for federal policymakers to consider and one that would avoid a patchwork quilt of 51 different requirements in the states and District of Columbia.

The Bank Secrecy Act also requires financial institutions to comply with recordkeeping and reporting requirements involving certain financial transactions, including certain funds transfer and currency transactions, as well as transactions that are suspicious in nature, and provides law enforcement agencies with the means to trace the flow of illegal funds through the financial system. In order to comply with these recordkeeping and reporting requirements, financial institutions must obtain and retain certain customer identifying information

Revisions to the above-mentioned federal banking or tax laws (or any similar federal laws) may offer the best means for addressing the concerns about illegal activities identified in the Reports.

If there were to be a mandate to collect beneficial ownership information at the state level, we are concerned about the increased cost of collecting and assembling such data. Forms would need to be modified, computer systems reprogrammed, fees adjusted to handle increased labor costs associated with reviewing documents for compliance, increased costs for storage and retention of documents and increased demand for information retrieval and reporting. If such information were required to be maintained by lawyers, accountants, company formation businesses and/or registered agents, the costs would simply be passed on to private industry which would recover the costs in the form of possibly substantially higher representation fees. Also, policy makers would have to consider whether such a mandate would need to be accompanied by a prohibition on self-representation – since it would be impossible to verify whether such beneficial ownership records were being maintained by self-represented entities.

We are also deeply concerned about privacy and disclosure issues. If such a mandate were to place personal identifying information of tens or perhaps hundreds of millions of equity holders on the public record, it would create a huge risk of identity theft. Similar security issues would be raised if such information were not on the public record, but required to be maintained in the files or databases held by lawyers, accountants and company formation agents. Traditionally the owners of private businesses engage in entrepreneurial and investment activity with the expectation of complete privacy. Even SEC regulations permit shareholders to accumulate positions in large publicly traded organizations without disclosure up to a certain percentage. If the ownership of every investment in the United States is entered into massive databases, it certainly presents countless public policy concerns and issues with respect to privacy, security, and insider trading to name a few.

But perhaps the single greatest concern for the State of Delaware is the likelihood that the role of Delaware and, indeed the United States, would shift from that of providing an attractive investment environment for domestic and international capital to one of having regulatory or investigative oversight of equity holders of legal entities. In light of the various challenges and tremendous costs – both financial and economic – that would be associated with attempting to track beneficial ownership of more than 15 million legal entities registered in the nation's 51 jurisdictions, it is unlikely that the State of Delaware would support legislation requiring full beneficial ownership disclosure.

Instead, we believe that any additional reforms at the federal or State level are best focused on enhancing the ability of federal and state officials to "follow the money" through the financial services system, providing law enforcement with the resources to investigate alleged illicit activities and seeking to deter such activity in the first place. This is why we believe Delaware's recent amendments establishing more demanding requirements for Commercial Registered Agents are a step in the right direction and deserve the consideration of other jurisdictions.

The State of Delaware is keenly aware that we are but one of many stakeholders in this issue. In fact, the persons most affected by any reforms are businesses both here and abroad. We believe that any discussion of beneficial ownership disclosure requires input and comment from the persons who will be most affected by such regulations – namely large, medium and small businesses and investors. Perhaps hundreds of millions of individuals in the United States are beneficial holders of public and privately held for-profit and charitable organizations and would be affected by beneficial ownership disclosure. It is critically important to ensure that their voices are heard regarding the costs and benefits of such a system.

On behalf of the State of Delaware, I thank you for this opportunity to share our comments and I look forward to responding to any questions you may have.