Solers Inc.

ON: THE IMPACT OF S. 569 INCORPORATION TRANSPARENCY AND LAW ENFORCEMENT ASSISTANCE ACT.

TO: THE UNITED STATES SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

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About Solers

Solers is a client-focused business staffed primarily by engineers and scientists. The Solers staff members are problem solvers who derive job satisfaction by listening and finding practical and innovative solutions to client requirements. Solers' staff is its principal asset. By providing a flexible and supportive work environment coupled with well-structured incentives, Solers has consistently attracted and retained high quality staff. Solers' successful staff performance and retention has led directly to numerous long-term client relationships built upon delivering on our commitments. Solers' two lines of business are Net-Centric Systems and Mission Support Services.

Testimony before the Senate Committee on Homeland Security and Governmental Affairs
Thursday, November 5, 2009

Statement of David H. Kellogg
President and CEO of Solers Inc.

INTRODUCTION

Thank you Chairman Lieberman, Ranking Member Collins and members of the Committee on Homeland Security and Governmental Affairs, for the opportunity to testify today on the impact to business if S.569, the *Incorporation Transparency and Law Enforcement Assistance Act*, were to pass and be enacted. Solers believes strong corporate governance and capital formation are vital part of any vibrant economy. We also agree with the priority of combating terrorism and money laundering. However, I must express my serious concerns with S.569 because it does not appear to combat money laundering and places additional burdens on American businesses during the worst economic downturn in 75 years. While I agree with the stated goal of your legislation, I have significant concerns with your implementation.

Founded in 1999, the Solers employee owners are proud to be a part of the effort to make our Nation safer through our primary lines of business -- Net-Centric Systems and Mission Support Services. We have a strong working relationship with the Department of Defense and Intelligence Community and our mission at Solers is to find practical and innovative solutions to meet the challenges they face in fulfilling their vital missions.

To achieve this critical mission for our Nations defense, Solers relies on our principal asset – our talented staff, which is comprised primarily of engineers and scientists. We currently have 200 employees and hope to grow our workforce in the coming years. By providing a flexible and supportive work environment coupled with well-structured incentives, Solers has consistently attracted and retained high quality staff. Solers' successful staff performance and retention has led directly to numerous long-term client relationships built upon delivering on our commitments.

An important component to attracting and retaining our high performing team is that our employees have an opportunity to own a piece of Solers. After being employed by Solers for about one year, employees are eligible to become shareholders. Therefore, Solers is privately held by its employees, former employees and directors and is a Virginia "C" corporation

with about 140 stockholders. We anticipate that we will grow to approximately 180 stockholders by early next year. The majority of Solers staff think of themselves as owners at Solers and we have found that our employee owners greatly value this benefit. With our employees owning stock in the company, they satisfy the definition of "beneficial owners" under S. 569.

CONCERNS

Upon review of S. 569, I was struck by several issues that I believe would both impede the effectiveness of the legislation, such that it would not be an effective deterrent to illegal activity and at the same time penalize legitimate, law abiding businesses and their workers.

NO CLEAR DEFINITION OF BENEFICIAL OWNER

First, I would like to speak to the difficulty of determining beneficial ownership under S. 569. The bill lacks a clear-cut definition of beneficial owner that can be understood and applied by lawyers, let alone by the common business person like me. The definition derives from Treasury regulations related to the identification of beneficial owners of accounts. Furthermore, the definition is overly broad in its breadth and scope to the extent that it may be impossible for a business to comply with a standard that can be subjectively interpreted.

For example, as the bill is now written, any shareholder, family member of a shareholder, an individual who has the power of attorney for financial purposes of a shareholder, an accountant employed or retained by the business, lien holder, bondholder of the company, credit card company or financial institution extending credit to the business and any other individual who may have a legal interest in or entitlement to the company and its assets will be required to be reported as a beneficial owner. Any change in the relationship between any of these entities and the business will require new documents to be compiled and filed with the appropriate legal authorities.

For instance the change in the familial status of a shareholder could change the status of beneficial owner under the bill. With such an overbroad definition, the company would be required to track and file information that is beyond its control. The vagueness and lack of precision in a standard that requires an assessment of when as "practical matter" a person exercises control is particularly troubling in a law that carries criminal penalties.

The ambiguous nature of S. 569's beneficial owner definition is unworkable even when considering more practical and mundane business

arrangements, such as when entities are owned by other entities. S. 569 require corporations and limited liability companies to trace ownership to an individual. This means, for instance, that if a record owner of a corporation is another entity, such as a corporation, limited liability company, partnership or trust, then the corporation would need to know the identity of all of the shareholders, members, partners and beneficiaries of the record owner entity. And if that record owner entity is owned by another entity, and if that entity is owned by another entity, and so on, the corporation would be required to trace ownership and control all the way up the chain until it reaches individuals. This would very difficult and nearly impossible to do.

Also, S. 569 requires keeping track of and reporting any changes in beneficial ownership ongoing complexity and potential liability to businesses. Take the example where one of our employee stockholders decided to own her Solers shares in a trust or family limited partnership, which are often used estate planning tools. For a number of reasons over time, the beneficiaries of the trust or the limited partners may change – hardly an unusual occurrence. Unless the employee had the presence of mind to inform the company, they would have no way of knowing about these changes and could potentially violate the law.

This hidden trap in S. 569 applies equally to other common occurrences in business. For instance, the sale of shares by a shareholder of Corporation X that owns shares of Corporation Y would probably never be known to Corporation Y without being notified of the sale by Corporation X. In all of these examples, the stockholder on corporation Y's records never changed.

Unquestionably, preventing money laundering, tax evasion and other illegal activities are laudable goals, but S. 569's indiscernible requirement to disclose beneficial owners based on the uncommon and vague definition used in this bill fails to advance these goals. Criminals will simply ignore S. 569's requirements and legitimate companies will be unable to understand or comply with them. Criminals who desire the benefits of limited liability associated with forming corporations or LLCs will simply lie in their disclosures. They can also select different forms of business entities other than the two regulated by this bill to conduct their illicit activities.

This bill will place burdens upon law abiding companies, cause a chilling effect upon potential avenues of investment for small businesses, creating an economic disadvantage for anyone who were to choose a corporation model. It should be remembered that companies such as Microsoft, Wal-Mart and Ford

have all started as small corporations and grown into large ones. Faced with the expensive, time consuming and virtually impossible task of determining beneficial owners, my prediction is that if S. 569 is passed, some law abiding entrepreneurs creating or running corporations subject to this law will forego the corporate model and employee ownership, and the benefits it gives workers, rather than risk the potential of up to three years imprisonment.

OWNER PRIVACY

Second, I would like to speak to the privacy rights and safety of investors, business owners and in Solers case, our employees. S. 569 would require states to amend their incorporation law practices to comply with new federally mandated standards. This would include providing and documenting the detailed personal information, including home address, of all the beneficial owners of a non-public corporation or limited liability company and further place the burden on business to have it updated in the event of any change.

According to the National Association of Secretaries of State, at least 38 states would require compliance with their own internal "Right to Know Laws" and other regulations. Once the states collect this data it is immediately made public, at which point many trade journals actually issue reports with this information. Needless to say, this private information is now in the public domain.

I fear that the "beneficial owner" list of Solers employee owners will be used by recruiters and competitors to solicit my staff. Like any professional services firm, my staff is my most valuable asset and providing a list, complete with home addresses, to professional recruiters and competitors puts Solers at a distinct disadvantage relative to the numerous public companies that are my competitors. In short, without a privacy protection treating Solers beneficial ownership information as sensitive financial data, S. 569 will put Solers at a disadvantage to my public company competitors. We urge you to consider a privacy provision for the beneficial ownership information to prevent its use by competitors, recruiters and other parties or activist groups who would use it for their own purposes.

CORPORATE COMPETITIVENESS

When operating in the competitive environment, businesses make decisions and purchases and seek to conceal them from their competitors. It is a perfectly legitimate business practice to protect trade secrets. This is true for my company or any business to ensure that the business entity can receive the first movers' advantage, as we seek to develop markets.

These companies are not interested in breaking the law; they are interested in being a competitive, effective force in their industry. By passing S. 569, small companies will be placed at a competitive disadvantage in relation to large public companies, partnerships, sole proprietorships and even foreign competitors. Further, all U.S. companies would operate at a competitive disadvantage to the international community, because international competitors could use this signaling information to block or bid up legitimate investment.

Venture capital firms invest in new product lines and small companies and form a vital cog in the formation of capital for small businesses. However, this financial backing, sometimes known as angel financing, is undisclosed so as to prevent market signaling. Nevertheless, these financing vehicles would now have to be publically disclosed, potentially cutting off start up financing for small businesses that account for 80% of the job growth in the United States.

Competitors could also use this information to intimidate investors out of investing in a particular company. If this private information is publically disclosed, what is to stop competition from filing lawsuits against particular beneficial owners? This could also be done through the work of activists groups devoted to intimidating legitimate capital formation.

Furthermore, it is unclear how S.569, by targeting only nonpublic and limited liability corporations, would stem money laundering or terrorist financing. Bad actors will not hesitate to exploit that large loophole and simply form business entities not covered by S. 569, leaving only legitimate businesses with an unreasonable burden and possible criminal penalties for non compliance. In that regard, we are punishing the whole class, because of one student's bad behavior.

HOMELAND SECURITY

S. 569 could also create other unintended consequences including new and onerous recordkeeping requirements on states. While estimates vary by state, the National Association of Secretaries of State estimates that the cost of implementing S. 569 in California could be as high as $17.5 million dollars.

As the legislation is currently written, the funding for the program would be siphoned from homeland security grant funding to the states. As a private citizen, I would like to express hesitation on this point, because I do not believe that funding for this program should be taken from fire fighters and first responders and other important homeland security functions of the states. If

the mandate is important, then Congress should fund it fully and further provide incentives for business compliance rather than punishments. Legitimate businesses are not looking to skirt legal requirements, but it will be these same legitimate businesses that are penalized for non-compliance while illegal actors find other ways around the law.

FOREIGN INCORPORATION PRACTICE AND FATF

I think it is also important to consider S. 569's requirements in relation to what other countries require. At least one European Union country, the United Kingdom, considered a beneficial ownership disclosure system similar to that being mandated by S. 569 with an almost identical definition of beneficial owner.[1] According to FATF's evaluation, the United Kingdom engaged consultants in 2002 to produce a report on the proposed system and then subjected it to public consultation.[2] The conclusion of this process with respect to this strikingly similar proposed beneficial ownership disclosure system was "that there were significant disadvantages and no clear benefits, particularly when taking into account the costs of introducing such measures. Reasons included:

1. disclosure of beneficial ownership would add no information of benefit…Those engaged in criminal activities would not provide true information about the beneficial owners;

2. disclosure would result in misleading information being included on the register. Because beneficial ownership is, as a matter of law, impossible to define precisely, any information requirement designed to require by law disclosure would have to be complex and detailed. Many ordinary, innocent shareholders would be unable to understand it or comply with it;[3]

3. according to FATF, the United Kingdom authorities concluded that their current entity formation regime, which does not require beneficial ownership disclosure, provided investigators with as much as any disclosure regime could, and that attempting to add a beneficial

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[1] See Financial Action Task Force, *Third Mutual Evaluation Report Anti-Money Laundering and Combating the Financing of Terrorism The United Kingdom of Great Britain and Northern Ireland*, Section 1132 at page 234 (June 29, 2007), available at http://www.fatf-gafi.org/dataoecd/55/29/39064399.pdf.
[2] *Id.*
[3] *Id.*

ownership disclosure requirement "would be harmful to investigations through the resulting misleading information provided by both criminal and innocent shareholders."[4]

FEDERALIZATION OF STATE INCORPORATION LAWS

Lastly, corporate law, within the United States, has been the domain of the states for over 150 years. This system has allowed for differing corporate and management structures that have created the foundation of the free enterprise system. S.569 would effectively place federal mandates on corporate law and create a one size fits all approach. This federalization could hamper capital formation and discourage entrepreneurialism in the current economic downturn and beyond.

CLOSING

I appreciate the opportunity to speak to you regarding this important issue. Again, while we share the goals of protecting this country, we do have disagreement with the methods being employed. I seek to make sure that this legislation actually accomplishes its goal, without hurting legitimate businesses in the process. Thank you and I look forward to your questions.

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[4] *Id.* Section 1133 at page 234