TESTIMONY

Testimony
of
Robert M. Morgenthau
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Mr. Chairman, members of the Committee, I am grateful for the opportunity to testify on a subject that has long been of interest to me and is becoming more important every day.

Increasingly, off-shore tax havens are serving as powerful magnets for U.S.dollars. Deposits of U.S. dollars in the Cayman Islands have been increasing by about $120 billion a year; according to the Federal Reserve Bank of New York, there are now more than $800 billion U.S. dollars on deposit in Grand Cayman. That is more than twice the amount on deposit in all the banks in New York City and the equivalent of nearly 20% of all the dollar deposits in the United States. It amounts to almost $3000 for every man, woman and child counted in the last U.S. census. It is about what the federal government now spends on Social Security, Medicare and Medicaid combined in a year.

It also amounts to approximately $20 million for every resident of the Cayman Islands. Obviously, this huge cache of U.S. money does not reflect any real economic activity in the Caymans. In fact, of the nearly 600 banks and trust

companies licensed in the Caymans -- which include 47 of the world's largest 50 banks -- only 100 or so have a physical presence there. According to the website of the Cayman Islands Monetary Authority, only 31 banks are currently licensed to do business with Cayman residents. Similarly, there are some 45,000 companies registered in the Caymans whose only business is outside the country. Notably, Long Term Capital, the giant hedge fund that almost collapsed 3 years ago, was chartered in the Caymans, but managed out of offices in Greenwich, Connecticut.

Though the Caymans have proven particularly attractive to U.S. residents, they do not stand alone as an off-shore haven for U.S. dollars. There are countless others: Antigua, the British Virgin Islands, the Cook Islands, Nassau, Belize, Cyprus, to name just a few. And the list is growing all the time.

What is all this money doing off-shore? It is not there because of the sunshine and the beaches. To be blunt, it is there because those who put it there want a free ride -- depositors, investors, banks and businessmen want to avoid or evade laws, regulations and taxes in their home countries, including the U.S. Some of this avoidance is legal under present law, but much of it is not. And whether legal or not, the presence of $800 billion in a single off-shore jurisdiction -- hidden from the scrutiny of bank supervisors, securities regulators, tax collectors and law enforcement -- is a huge problem.

A few examples from the cases prosecuted by the Manhattan District Attorney's Office illustrate just how attractive tax havens and off-shore jurisdictions offering strict bank and corporate secrecy have become for tax cheats and other white-collar criminals. When you consider that we only come across a small fraction of the illegal activities in these jurisdictions and are successful in prosecuting only a small number of the crimes we discover, the dimensions of the problem may become clearer.

It is becoming increasingly commonplace to find an off-shore connection to security frauds and other major sophisticated white-collar crimes. For example, in 1997 and 1998, my office convicted A.R. Baron & Co. and 13 of its former officers and employees for running an organized criminal enterprise. Baron was what is commonly known as a "boiler room" or "bucket shop," pushing questionable stocks and specializing in market manipulation, unauthorized trading in customers accounts and countless other methods of taking advantage of innocent investors. Baron's illegal activities over 5 years cost investors more than $75 million.

The lead defendant in the Baron case used Liberian shell companies and accounts in the Isle of Jersey to trade in the stock the firm was underwriting, a violation of U.S. securities laws. He also sheltered his illegal profits -- from tax authorities, creditors and the Bankruptcy Court -- in a Cook Islands trust. The Cook Islands are a New Zealand protectorate in the South Pacific.

A New York lawyer drew up the papers for Mid-Ocean Trust Co. in Rarotonga, the Cook Islands, to act as the trustee. The affairs of the trust were, however, managed here in New York by the so-called "protector" of the trust, the lead defendant's father. Mid-Ocean Trust did business in New York through one of the largest banks in Australia, which had branches in Rarotonga and New York, and which refused to honor a New York subpoena on the grounds that to do so would violate Cook Islands bank secrecy laws.

In another securities fraud case, which is still ongoing, we have thus far convicted the company, Meyers Pollock, and 37 individual defendants for enterprise corruption and securities fraud. In this case, we again came across shell companies and off-shore bank accounts. Promoters used these off-shore vehicles to trade illegally in their own stocks, to "paint the tape" -- that is to generate fictitious trades to drive up prices -- and, of course, to cheat on their taxes.

Securities fraud is not the only area where we have found tax havens used for criminal purposes. In 1996, my office concluded a case involving the bribery of bank officers in U.S. and foreign banks in connection with sales of emerging markets debt, transactions which earned millions for the corrupt bankers and their co-conspirators. In this case, a private debt trader in Westchester County, New York, formerly a vice president of a major U.S. bank, set up shell companies in Antigua with the help of one of the "big five" accounting firms; employees of the

accounting firm served as nominee managers and directors.

The payments arranged by the accounting firm on behalf of the crooked debt trader included bribes paid to a New York banker in the name of a British Virgin Islands company, into a Swiss bank account; bribes to two bankers in Florida in the name of another British Virgin Islands corporation; and bribes to a banker in Amsterdam into a numbered Swiss account. Because nearly all the profits in this scheme were realized in the name of the off-shore corporations or off-shore accounts, almost no taxes were paid.

A year ago, in a very different sort of case, a Manhattan jury convicted Sante and Kenneth Kimes, a mother-son team of so-called "grifters," for murdering an elderly Manhattan widow to gain control of her expensive townhouse. In our investigation of the case, we found that to arrange for the payment of filing fees and taxes on a forged deed to the townhouse, the pair drew on funds held in a brokerage account in Bermuda in the name of The Atlantis Group, a shell company. The money, which was part of the proceeds of a separate fraud committed in Las Vegas, came to Bermuda by way of an account established by the defendants at Swiss American Bank in Antigua. It was Swiss American (a bank that was neither Swiss nor American) that helped the Kimes' set up the Atlantis Group shell company in Antigua.

For the defendants in these cases, the principal attraction of doing business in off-shore havens was not the low or non-existent tax rates. They sought to take advantage of other benefits that are almost invariably provided in tax haven jurisdictions: strict bank and corporate secrecy, lack of transparency in financial dealings and the lack of any meaningful law enforcement or supervision in the financial area. For white-collar criminals, the lack of transparency and the code of strict secrecy is particularly useful because it prevents law enforcement from "following the money;" it breaks the trail of dirty money, often leaving investigators at a dead end.

The obstacles created for law enforcement take many forms. In some cases the laws in off-shore jurisdictions do not require adequate records, as when the ownership of an off-shore corporation is evidenced only by bearer shares or off-shore trust documents reveal the identity of the trustee or the protector, but not the beneficial owners.

Secrecy laws and the culture of secrecy may be impediments to disclosure even where legal mechanisms ostensibly permit disclosure to responsible authorities abroad. In the case of the Bank of Credit and Commerce International (BCCI), which was involved with drug money laundering, the illegal shipment of arms, and bribery of government officials, the majority of money transfers went through BCCI Overseas, chartered in Grand Cayman. When my office sought to subpoena BCCI bank records from the Caymans, we met a stone wall. A BCCI official in New York to whom

a grand jury subpoena was issued refused to produce any records, claiming Cayman bank secrecy.

We were told we had to invoke the Mutual Law Enforcement Assistance treaty between the U.S. and Grand Cayman. We did just that and were then told by the Caymans Attorney General that the records would be produced to the Department of Justice but only on the condition that they not be made available by the U.S. government to state and local prosecutors -- including, of course, the New York County District Attorney's Office, which had sought them in the first place. I note that more than 98% of all criminal prosecutions in the United States are brought by state and local prosecutors.

In the end, we did make some headway, after our relations with the British Serious Frauds Office improved, and the Attorney General of Grand Cayman, a lawyer from the Midlands in England, appointed by Her Majesty's Government, came to my office in New York. As a result of this personal diplomacy, we got some, but not all, of the records we sought.

Sometimes the problems continue even after U.S. authorities get their hands on the evidence. In 1996, the U.S. Department of Justice came into possession of a tape containing computerized records of a defunct Caymans bank, Guardian Bank and Trust Company. The bank was set up by an American and used to launder money for its depositors, 95% of whom were U.S. residents. The official Cayman liquidators of the bank -- two partners in another

major world-wide accounting firm -- brought suit in U.S. District Court in New Jersey seeking the return of the computer tape to the Caymans. In their brief, the liquidators argued that disclosure of the contents of the records to, among others, the U.S. Internal Revenue Service would:

> **Have a significant negative impact on the integrity, confidentiality, and stability of the financial services industry of the Cayman Islands. ... The confidence of the offshore financial community in the privacy afforded to legitimate account holders of Cayman Islands offshore banks is at the heart of the Territory's financial services industry and economy, as a whole. ... Thus, not only would the Bank be irreparably injured by the government's retention of the Tape, but the international bank and Eurocurrency industries**
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> **of the Cayman Islands (and, indeed, the economy of the Territory), could suffer irreparable injury as well.**

After decoding the tape -- without the help of the Caymans government -- authorities discovered that the Guardian Bank's U.S. depositors had $300 million offshore, hidden from tax authorities,

litigants and creditors.

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Access to off-shore accounts, shell companies and even private banks in tax haven jurisdictions is no longer limited to a small number of sophisticated professional criminals. John Mathewson, who set up Guardian Bank in the Caymans, started out in the construction and home remodeling business in Illinois. Years after opening a numbered Swiss bank account while vacationing in the Caymans, he was persuaded by a Caymans banker to open his own bank. According to Mathewson, his application for a bank license asked for little more than his name, address and previous work history.

In another investigation, my office obtained indictments earlier this year charging a British solicitor and magistrate and a Canadian lawyer, a Queen's Counsel, with establishing a network of shell corporations and bank accounts in bank-secrecy jurisdictions, including Liberia and Belize, to assist their clients in violating securities, banking and tax laws in the jurisdictions where they lived. The defendants paid a Liberian diplomat, among others, to serve as nominal owners of the companies and to sign blank documents used in the fraud. Among the clients of this enterprise was a New York plastic surgeon, who, when one of his patients died on the operating table, decided to put his assets off-shore to render himself judgment-proof.

In the debt trading case I spoke about, we found there was a virtual cottage industry in New York and elsewhere in the United

States of accountants and lawyers willing to assist in setting up companies in tax haven and secrecy jurisdictions, and willing to serve as agents for the companies or to provide references where required. Similar services are also available through an assortment of financial advisers and financial services companies that advertise in airline magazines and the International Herald Tribune and the Financial Times.

A popular paperback guide by a leading trusts and estates lawyer on how to "die richer" touts the advantages of off-shore Asset Protection Trusts. According to the book, APTs, as they are known, are structured to permit a foreign trustee to ignore U.S. court orders and to simply transfer the trust to another jurisdiction in the face of legal action threatening the trust's assets.

Countless internet sites solicit applications to open bank accounts, purchase shell companies or even establish personal banks off-shore; many take applications by e-mail. According to one web page, a personal bank may be formed in Montenegro "by any natural person or company worldwide with no tiresome background checks." With the bank, the site promises a correspondent account at the Bank of Montenegro and access to the Bank of Montenegro's correspondent network, including Citibank, Commerzbank and Union Bank of Switzerland. While this website may be in need of updating, it illustrates how easy it is today to take advantage of off-shore venues.

Sadly, Mutual Law Enforcement Assistance Treaties (MLATs), where they exist, have not proved to be an answer to the problems associated with off-shore tax and secrecy havens.

As in the BCCI case, countries sometimes withhold meaningful compliance despite the existence of a treaty. In some cases, the existence of an MLAT is even used as a shield to obstruct normal cooperation with law enforcement. In one recent case a financial institution with offices in New York and Switzerland transferred accounts from New York to Switzerland, to conceal the distribution of funds. When we issued a subpoena for the records, the institution insisted that we proceed by way of Treaty.

Where there is compliance under an MLAT, the process is often much too slow to be helpful. It routinely takes a year and often much longer to obtain critical bank records and other evidence. This is a significant problem, especially where funds, as they often are, have been funneled through companies and bank accounts in several jurisdictions, requiring MLAT applications to several jurisdictions to trace a single transaction. As time passes, leads dry up, suspects and witnesses disappear and statutes of limitations continue to run.

Finally, the treaties themselves are often inadequate, as when they do not provide for the exchange of information for all tax crimes. As the cases I have cited

illustrate, tax crimes are often intertwined with other serious offenses such as securities fraud and bribery. Furthermore, in the early stages of an investigation, when bank records and other documentary evidence may be all we have to go on, it is often impossible to tell exactly what crimes have been committed. For that reason, treaties which exclude significant offenses, such as tax evasion, can prevent an investigation of serious crimes from ever getting underway.

In part because of the inadequacy of the MLAT procedures, we have had only very limited success in making criminal cases involving tax havens and secrecy jurisdictions. In some cases, like BCCI, we have succeeded by virtue of personal diplomacy, in other cases by fortuitous contact with a sympathetic off-shore official.

But all too often, we just have to get lucky. For example, in the Brazilian debt case, a key witness who had managed the shell companies in Antigua was willing to cooperate because he had relocated to England. We also discovered computer records when we searched the defendant's house. In the Kimes murder case, the defendants happened to keep wire transfers and other bank records in their Lincoln Town Car, which was seized by the police. But law enforcement should not have to rely on diplomacy, a fortuitous personal connection or good luck to make these cases.

There have been signs in some recent cases of real progress toward cooperation in a few formerly uncooperative off-shore jurisdictions. One such case involved Robert Brennan of First Jersey Securities, whom federal law enforcement officials have been pursuing for 25 years for assorted financial crimes. These efforts were unsuccessful until Brennan filed for bankruptcy to avoid a civil judgment the Securities and Exchange Commission won against him in 1995. Brennan had several million dollars concealed in accounts on the Isle of Man which he did not disclose to the bankruptcy court. He also had $22 million in three asset protection trusts, one of which, the Cardinal Trust, he directed to be moved, first to Mauritius and then to the island of Nevis during the course of the bankruptcy proceedings.

In 1999 my office started to deal with authorities on the Isle of Man, to gather evidence in connection with several securities fraud cases we were working on. The Manx authorities were quite helpful, and using available legal processes we were able to obtain evidence against several people, including Brennan. By the spring of 2000, we obtained court orders on the Isle of Man directing one Peter Bond, who managed Brennan's off-shore companies and served as director of one of the corporate trustees, to give evidence; Mr. Bond then agreed to come to the United States and testify. The United States Attorney's Office in New Jersey, using that evidence and other proof convicted Brennan, who is scheduled to be sentenced next week.

The Manx cooperation, like that of Jersey and Guernsey officials in other cases, has been invaluable in bringing criminal charges against American swindlers stealing from Americans. More such cooperation is needed.

But progress in this area has been much too slow; we may even be going backwards. As one off-shore jurisdiction attempts to reform, the bad guys simply look for another -- and they are all too easy to find. Just last week, my office secured indictments in a $6 million fraud in the export of meat products from the United States to Russia, in which a Russian-owned company incorporated in the Island of Niue played an important role. Niue, for those, like me, who are unfamiliar with it, is a tiny Polynesian atoll with a population of 1800; it is described in the internet literature as a "self-governing territory in free association with New Zealand."

Obviously, there is much work to be done to get the off-shore genie back in the bottle.

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I have long maintained that you cannot fight "crime in the streets" without also fighting "crime in the suites," which is to say white-collar crime. To be credible the law must be enforced without fear or favor. To do so, in today's interconnected world, law enforcement in the United States, including state and local prosecutors, needs access to critical evidence wherever it may be physically located. There must be a legal mechanism

to require the production of off-shore records on a reasonable and timely basis for all serious crimes, including tax crimes.

Make no mistake about it, tax fraud and evasion are serious crimes. As Justice Oliver Wendell Holmes said, "Taxes are what we pay for a civilized society." We must see to it that everyone pays his or her fair share of the taxes mandated by federal and state legislation. In a democracy such as ours, where we rely largely on voluntary compliance with the tax laws, the tax system must not only be fair, it must be perceived as fair.

Only two days ago, the Financial Times reported a complaint by the deputy speaker of the assembly in the Caymans that, "It's the poor who pay taxes in this country." In the Caymans there are no income, capital gains, corporations, inheritance or sales taxes, but most food is taxed at 20 percent. In a more cynical vein, a notorious New York tax delinquent once observed that "only the little people pay taxes." We cannot afford to allow that cynical view to become accepted wisdom in this country.

Tax havens which rely on bank and corporate secrecy are knowingly assisting customers of theirs to commit tax fraud; lawful tax shelters do not need to be kept secret. We need to make certain that there is a free exchange of accurate information between these nations and the U.S. I am not advocating the indiscriminate disclosure of financial information on a wholesale basis, but rather the disclosure

of specified information to appropriate tax and prosecuting authorities where they have reason to request it. That is the same basis on which disclosure of bank information is made to tax authorities and criminal investigators in the U.S.

Of course, it is not only enforcement of the tax laws that requires access to information from abroad. Last year, New York enacted a strong money laundering statute. We need access to off-shore records to make this law effective against the money brokers that service drug dealers and their foreign suppliers and generate cash to bribe Wall Street stockbrokers.

What is at stake here is not just the ability of the police and prosecutors to make a few more criminal cases. Criminal conduct can have far-reaching consequences. In the early 1990's, Venezuelan bankers used as many as 3500 off-shore corporations, in Aruba, Curacao and elsewhere, to loot banks in Venezuela, resulting in the collapse of one-half of the banks in that country, with predictably disastrous effects for the nation's economy.

The unfairness of allowing some citizens to avoid paying their fair share of taxes erodes confidence in the tax system and the voluntary compliance on which the system is based. In addition, permitting some businesses to gain unfair tax advantages in off-shore venues destroys the level playing field on which our system of free enterprise depends.

The absence of responsible supervision in off-shore jurisdictions also encourages players in the financial markets to engage in reckless behavior which, as the near-collapse of Long Term Capital taught us, will likely have disastrous consequences for our domestic financial institutions and the economy if we do not do something to control such activities. The recent failure of just two such funds, Manhattan Capital and Evergreen Security, Ltd., has cost investors

$500 million.

Finally, and perhaps most important, the obvious inequity of a system that allows certain individuals and companies to hide their financial affairs in off-shore havens undermines respect for government and the rule of law.

This is too important a matter to be left to the desultory ways of authorities in these off-shore jurisdictions. The United States, in cooperation with other OECD countries, must explore and implement effective measures to break down the culture of secrecy and obstruction that prevails in the tax havens. Legislation or regulations that made doing business in off-shore jurisdictions less attractive and profitable for U.S. taxpayers might have salutary effects, as would stricter oversight of financial institutions that do business with off-shore entities. In extreme cases, we should consider denying U.S. correspondent banking services to financial institutions in intransigent off-shore jurisdictions.

Certainly, more aggressive enforcement of the tax laws against off-shore hedge funds and limited partnerships would be a sound first step to restoring confidence in the fairness of the American tax system. It might even bring some of that $800 billion in the Caymans back to our shores.

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