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978-1-107-04314-5 - Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism

Michael G. Findley, Daniel L. Nielson and J. C. Sharman

Excerpt

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1 | *Introduction*

The notorious Lu Zhang

In December 2009 Thai special forces seized a cargo plane at Bangkok Airport. The manifest claimed the airplane carried drilling equipment intended for oil exploration. Instead, 35 tons of weapons crammed the hold – arms that included rocket launchers and anti-aircraft missiles. The weapons originated in North Korea and were bound for Iran, mocking the United Nations arms embargo that targeted two of the three “Axes of Evil” (Michaels and Coker 2009).

Law enforcement officials traced the arms shipment to an obscure Chinese national, Lu Zhang, who was a recent immigrant to New Zealand. The 28-year-old woman served as the sole director of SP Trading, the company that hired the plane and apparently engineered this arms trade. In fact, Lu directed scores of other companies.

But, apparently, Lu Zhang had no idea that she was a notorious arms trader and international financial criminal until officials contacted her. Rather, she had worked as a short-order cook at a Burger King in Auckland. Representatives of the GT Group, a shady incorporation service specializing in setting up companies for others, had hired Lu as a patsy. To supplement her income, for fifteen dollars each she signed the documents they placed in front of her.

The genius of the scheme meant that any corporations set up by the GT Group could not be traced beyond Lu Zhang. New Zealand law requires that only a single “nominee” director of a company be named; the actual owners can remain completely anonymous. To this day the perpetrators of the North-Korea-to-Iran arms deal remain unknown and at large, their identities protected by the anonymous shell corporation set up by the GT Group. (We will return to the GT Group in Chapter 2 since it is associated with a series of other criminal schemes enabled by shell companies.)

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A New Zealand court convicted Lu Zhang of 74 counts of giving a false address but quickly discharged her from custody when it was clear she had no knowledge of any other crimes. Astoundingly, the rest of the GT Group's actions were perfectly legal according to New Zealand law (Francis 2010; Field 2011; Ryle 2011). Despite the fact that the GT Group also formed shell companies used to launder money for the Mexican Sinaloa drug cartels, and others employed to perpetrate a \$230 million tax fraud against the Russian government, the firm remains in business today under a different name (Preasca et al. 2012).

It is not supposed to work this way. Indeed, international organizations and the governments of the world have jointly propagated a list of rules intended to prevent money laundering, terrorist financing, and other financial crimes like those linked to the GT Group's shell companies and to thousands of other untraceable anonymous corporations around the world. Governments have also empowered an international institution, the Financial Action Task Force (FATF), to implement the standards. Nearly every country in the world has agreed to abide by the FATF rules.

The FATF aggressively exposes and blacklists countries that fail to incorporate its international standards into domestic law. First published in 2000, the inaugural blacklist mostly targeted tax havens such as the Bahamas, the Cayman Islands, Liechtenstein, and Panama, but later targets included Israel, the Philippines, and Russia – signaling that states with significant resources could also come under censure. Governments worked hard to remove themselves from the blacklist and, tellingly, by 2007 no countries remained listed by the FATF as having failed to commit to the transparency standards. By conventional international relations (IR) measures, the case would be mostly closed: a global problem was identified, an international institution was empowered to enforce new standards, and countries relatively quickly came into statutory compliance with the rules. Problem largely solved.

Compliance, experiments, and transnational relations

Or is it? It turns out that governments are not the main locus of compliance with international financial transparency standards. Rather, firms such as the GT Group, which provide incorporation services for

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clients seeking to set up new businesses, are the primary points where international standards mandating that shell companies can be traced back to their real owners are either followed or violated. Is GT Group the rule or the exception? What makes some of those selling shell companies abide by rules while others routinely defy them?

This book is based on an experiment soliciting offers for prohibited untraceable or anonymous shell corporations. Our research team posed as a variety of low- and high-risk customers, including would-be money launderers, corrupt officials, and terrorist financiers when requesting the anonymous companies. We made more than 7,400 email solicitations to nearly 3,800 corporate service providers (CSPs) that make and sell shell companies in 181 countries. The design of the experiment allows us to test whether international rules are actually effective when they mandate that CSPs must collect identity documents from their customers. Furthermore, the random assignment of different email approaches also provides unique insight into what causes those who sell shell companies to either comply with or violate international rules.

The significance of this issue is that shell companies that cannot be traced back to their real owners are widely held to be one of the most common means for laundering money, giving and receiving bribes, busting sanctions, evading taxes, and financing terrorism. Yet until now, no one has known the effectiveness of the requirements that authorities be able to look through the “corporate veil” to find the real individuals in control of shell companies. Our study goes a long way to remedying this fundamental ignorance. By identifying the serious weaknesses in the existing regime in this book and related work we hope to provoke governments to much greater efforts in enforcing corporate transparency (Baradaran et al. 2013, 2014; Findley et al. 2013).

In focusing on transnational actors, private firms, as the key locus of compliance, our results show that such actors routinely flout international standards, even while fully aware of the standards that should apply. Half of all responses to the thousands of inquiries described in this book failed to demand certified photo identification. And half of those required no photo identification at all. Untraceable shell companies like SP Trading are thus relatively easy to acquire in today’s global economy.

Shell companies per se are usually legitimate devices in business practice, acting as holding companies, providing limited liability, and

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serving as neutral vehicles for joint ventures. But there are few if any legitimate business purposes employing *anonymous* shell companies. If organized crime depends on financial secrecy, untraceable shell companies are the most important means of providing it. Anonymous shells highlight the central challenges of global governance according to which governments struggle to manage burgeoning transnational interactions.

Many other questions involving international standards and practices share the same logic as the issue of financial transparency that is central to this book. Firms play key roles in trade agreements when they choose to dump products in competitors' markets overseas. Banks, brokerages, and private individuals invest and divest in response to exchange-rate pacts, or, alternatively, aggregated financial behavior by a plethora of actors provokes international monetary coordination. Private individuals and companies are the actors that decide whether or not to pollute the environment, destroy biodiversity, or poach endangered species in violation of international environmental conventions. And individual police officers, military personnel, and prison wardens choose to respect or violate the personal integrity of their prisoners and therefore comply or not with international human rights accords.

Examining inter-governmental actions in such cases illuminates only parts of the picture. And they may not be the most interesting or important parts. Uncovering actual patterns of behavior in each of these and many other vital areas requires a different focus, a new framework, and a better method. We take steps toward providing all three here in the Introduction, and in the remainder of the book we demonstrate the potential of this new approach through our global shell company experiment, the first of its kind in international relations.

We call our approach the experimental science of transnational relations (Experimental TR, hereafter).¹ Experimental TR has three main components: an empirical focus on non-state actors as the locus of behavior, a conceptual reorientation around transnational relations far less dependent on states, and a methodological commitment to field experimental methods.

First, this book calls for an empirical refocusing of international relations scholarship in a manner that would shine new light on

¹ We thank Robert Keohane for suggesting this label.

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understudied, interesting, and vital areas of world politics. We urge a focus on the subjects that carry out most of the international activity in the world. In this study we target the actual locus of transnational action in our issue area: firm-by-firm compliance with international corporate transparency standards.

Second, we develop a conceptual approach that complements traditional international relations scholarship. We situate this study in a broader framework that encompasses all transnational activity including but also extending well beyond state-to-state relations. While states mediate many important international interactions, the vast majority of transnational activities occur at most within the shadow of government control. And many of those activities prove very important for world affairs, especially in the aggregate.

Third, we demonstrate how the most powerful method in science can be brought to bear on important questions that this new focus and framework provoke. We do this by executing the first randomized field experiment on a global scale. Field experiments provide for the accurate diagnosis of causal relationships (high internal validity), but also allow us to generalize to similar phenomena outside the particular study (high external validity). Just as the random assignment to control (placebo) and treatment groups in drug trials isolates the effect of a new medicine, so too the random assignment of low-risk “Placebo” emails and different high-risk “treatment” emails isolated the effects of different kinds of risk on the likelihood of (a) being offered a shell company and (b) being required to provide proof of identity. In expectation, randomization balances not only all of the observable factors that might confound results, but also neutralizes all unobservable confounds. The power of the method enables precise tests of the observable implications of many international relations theories. In particular, experiments allow for the resolution of an impasse that has stymied progress on one of the biggest questions in international relations scholarship: when and why actors comply with international rules.

In this book we are speaking to two broad audiences. First, we address international relations scholars interested in transnational relations, international law, and the potential of experiments to reveal causal effects in related issue areas. Second, we provide rich data for policy-makers and practitioners about the availability of anonymous shell corporations throughout the world and the factors that make

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their acquisition more or less difficult. Both audiences will benefit from the significant synergy among these topics, but IR scholars may especially gain from the remainder of this chapter along with close examination of Chapter 5 on laws and standards, Chapter 6 on penalties and norms, and Chapter 7 on ways forward for Experimental TR. Policy-makers and practitioners may wish to pay special attention to Chapter 2 providing background on financial transparency, Chapter 3 on descriptive patterns of global practice in the availability of anonymous shells, and Chapter 4 reporting the results of the Terrorism, Corruption, and Premium treatments, as well as Chapter 5 on laws and standards. Nevertheless, both audiences will likely benefit from understanding the context of international relations scholarship that motivated the study, which we describe in the remainder of this chapter.

The foundation of IR is that international politics occurs in an anarchical environment where there is no central enforcer, and thus compliance with international rules presents particular challenges. Despite this, many scholars of international law have observed that most states act in a manner consistent with most laws most of the time (Henkin 1979; Chayes and Chayes 1993). Yet this observation tells us relatively little about whether international rules actually cause compliance, with compliance understood as when “the actual behavior of a given subject conforms to prescribed behavior,” as opposed to non-compliance, “when actual behavior departs significantly from prescribed behavior” (Young 1979).

Compliance with international standards might be high precisely because states agreed to those standards where compliance proves easiest (Raustiala and Slaughter 2002; Drezner 2007). If this is so, self-selection – and not the inherent constraining power of international law – explains compliance. Indeed, an authoritative review has noted, “Almost all studies of the influence of treaties on state behaviour encounter serious issues of endogeneity and selection” (Simmons 2010: 273), meaning that cause and effect cannot be disentangled. It is hard to see a way to resolve this problem using only observational data. Von Stein (2005: 612) laments the inability to use experiments to tease out causal effects in international relations. The implication: if only they could be employed, field experiments could break this impasse. In this book we argue that Experimental TR offers a way forward.

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The shell game experiment

This study therefore provides a detailed illustration of Experimental TR. In it we focus on actors that undertake important transnational behavior by forming corporations for foreign customers. Corporate service providers comply with international rules when they demand notarized identification documents from their clients. Failure to require certified ID enables the formation of untraceable, anonymous shell corporations, which can be used for tax evasion, sanctions-busting, money laundering, terrorist financing, and many other criminal activities. Our central question probes the degree to which firms around the world are in compliance with international corporate transparency standards and, by extension, the degree to which the states that approve international standards effectively monitor and encourage compliance with the standards.

We are especially interested in whether different information in our various email “treatments” can increase or decrease the rate at which those selling shell companies require the identity documents that international rules mandate (the compliance rate). With university and Institutional Review Board clearance, we adopted alias identities and sent 7,456 emails in two to three rounds to 3,771 firms in 181 countries. All of the emails requested confidential incorporation, but we randomly assigned different conditions to learn if the target firms would exercise more or less vigilance when (1) informed specifically about international law, (2) warned about enforcement by a domestic government agency, (3) told about possible legal penalties, (4) prompted to behave appropriately, (5) offered a premium payment, (6) apprised of a voluntary private certification body and its standards, or (7) informed of standards jointly promoted by both the private body and an international organization.

We also assessed firms’ sensitivity to changes in the identity of the requester, including (8) a United States citizen, (9) a citizen of a corruption-prone country working in government procurement, and (10) a citizen of a country associated with terrorism and claiming to work in Saudi Arabia for Islamic charities. We compare all of these experimental conditions to a “Placebo” condition where the requester claims to originate from a minor-power, low-corruption wealthy country.

The basic descriptive results contradict the conventional wisdom in international relations and policy circles. Firms in tax haven countries

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proved significantly more compliant with international law compared to both wealthy and developing countries. Services in poor countries sometimes followed international standards with significantly more diligence than rich countries. Overall, firms in wealthy countries were the least inclined to comply with international standards.

With the experiments we learned that prompting firms with information about international law had no significant effects on the compliance rate, but attributing the rules to a private standards body marginally increased compliance compared to the public standards. Associating the rules with the Internal Revenue Service (IRS) in the United States significantly decreased non-compliance, which is one of the few encouraging experimental results we encountered. Posing as a US citizen caused a significant decrease in compliance rates compared to the Placebo. Promising a premium payment also decreased compliance. Additionally, invoking norms of appropriateness caused lower compliance in a few analyses, though not robustly. And mentioning legal penalties decreased refusal rates and, in some specifications, compliance rates as well.

In the Corruption condition response rates fell but, against expectations, *so did compliance rates*. We suspect a collusion effect: firms inclined to comply drop out when the risk increases, but non-compliant services appear undeterred – and may even be encouraged – by corrupt customers. Finally, the Terrorism condition caused a decrease both in response rates and in non-compliance – a second encouraging result. But the Terrorism condition also caused a decrease in part-compliance, compliance and (in the US) refusal rates, which tempers our optimism.

In the chapters that follow we develop each of these results more fully and draw lessons about compliance in international relations. First, however, we now introduce the three components of Experimental TR – locus of behavior, transnational relations, and field experimental methods – by using illustrations drawn from the recent history of anonymous shell corporations. With its focus on international financial transparency, the study provides an extended example of how to undertake Experimental TR and the results it can produce.

Locus of behavior: firm compliance and the challenge of heterogeneity

A tiny home in sleepy Cheyenne, Wyoming, houses 2,000 companies. Mailboxes crowd the main room from floor to ceiling – and each

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box is the formal residence of a shell corporation. Shell companies do not employ workers, sell products, or conduct any other substantive business. But because corporations are “legal persons,” they can shield owners from legal liability and hide identities while enabling people to move millions – or even billions – of dollars around the world in ways that are impossible to trace. The corporate service provider Wyoming Corporate Services Inc. (WCSI) excels at protecting its clients. And many of its customers are particularly unsavory. Transactions and assets can be traced back to shell companies established by this firm, but not to the real person in control.

A Reuters News Service special report by Kelly Carr and Brian Grow detailed some of the activities of shell companies formed by Wyoming Corporate Services Inc. (at the time of writing, more than two years after the Reuters report, Wyoming Corporate Services Inc. is still in business selling shell companies). One company shields earnings from illegal internet poker businesses. Another sold fake truck parts to the Pentagon. Others hawked controlled pharmaceuticals illegally and routed earnings from unlawful sub-prime credit cards. Still others have been sued for unpaid taxes, securities fraud, and trademark infringement. One company apparently shelters the still-considerable real estate assets of Pavlo Lazarenko, the former Prime Minister of Ukraine now serving an eight-year US federal prison term in California for wire fraud, extortion, and money laundering. Transparency International named Lazarenko the eighth most corrupt politician in the world.

WCSI's website touted the allure of shell companies and distilled the essence of the problem of shell company misuse: “A corporation is a legal person created by state statute that can be used as a fall guy, a servant, a good friend or a decoy. A person you control ... yet cannot be held accountable for its actions. Imagine the possibilities!” (Carr and Grow 2011). Of course, as the many noxious activities of Wyoming Corporate Services Inc. shell companies illustrate, financial criminals have vivid imaginations. It is precisely these sorts of dangers that global corporate transparency standards are designed to prevent.

When analysts want to know about compliance with corporate transparency standards, they turn to the Financial Action Task Force, which issues comprehensive evaluation reports assessing its member states. Among other matters, the reports detail the degree to which the governments have issued national laws regulating incorporation services and business law firms as they form new companies for clients. But as we detail in Chapter 3, the official FATF reports on government-level

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statutory compliance with global standards correlate weakly with the actual incorporation behavior of the thousands of firms in our experiments (see also Baradaran et al. 2013). We suspect that this pattern extends well beyond the issue area of international financial transparency: governments may do one thing, but individuals and organizations are often likely to be doing something quite different.

The challenge for many areas of international relations is that states do not perform most of the actions central to compliance with international standards. Individuals, firms, and non-governmental organizations (NGOs) do. Yet international relations scholars interested in the effects of international regulations typically fail to investigate non-state actors. State-level statutory compliance is not unimportant, of course; indeed it is likely an important step towards achieving compliance by those targeted individuals and organizations. But a focus on states alone misses the most important part of the compliance story.

Of course, we are far from the first analysts to note that the locus of much international behavior occurs beneath and beyond the level of national governments (see Nye and Keohane 1971; Keohane and Nye 1972). Important contributions from realists, liberal institutionalists, and constructivists have all underscored the key roles that individual citizens and private organizations play in international affairs, particularly in relation to compliance (e.g. Keohane et al. 1993: 16; Drezner 2007: 13; Avant et al. 2010: 15; Simmons 2010: 273). Indeed, in their seminal work on compliance, Downs et al. (1996) highlight maritime regimes, where the maintenance of oil tankers features prominently. As important as oil tankers are in maritime regimes, however, their maintenance clearly falls outside the everyday actions of governments.

The transnational relations literature extends well beyond the realm of compliance with international law. Constructivists have argued that “norm entrepreneurs” have shifted the global environmental and human rights agendas (Risse-Kappen 1995; Keck and Sikkink 1998; Sikkink 2011). Neoliberal institutionalists have investigated the roles of multinational corporations in driving trade accords and foreign investment (Milner 1988; Jensen 2003), and they have also studied the effects of private standards-setting bodies on corporate behavior (Mattli and Büthe 2003, 2011; Mosley 2009). These important scholars all agree that non-state actors matter in international relations.

That said, we readily acknowledge that international laws, standards, and norms create the authoritative context in which all of these