The self-congratulatory announcements emanating from OECD headquarters in the 16th Arondissement as to its success in establishing “new global standards” based on its 1998 “Harmful Tax Competition” initiative lack critical review. Indeed, very little, if anything, is written about the actual outcomes. In fact, after some early success on tax information exchange, the so-called standards are uneven in application; they do not apply in the United States, China, Russia, South East Asia or Africa and are therefore not even remotely global. Where they do apply is in remote
parts of the globe; the offshore financial centres, none of which had a voice at the table on their introduction.

Other articles describe the detail of the procedures currently available to onshore tax authorities and law enforcement in the Cayman Islands, other British Overseas Territories, and the Crown Dependencies. We can take it that the state of tax, all crimes, and anti-money laundering transparency in all of them is absolute. But this appears to be missed by most. Indeed, typically, the narrative remains exactly to the contrary. We need look no further than the propaganda of the self-styled Tax Justice Network and the Pavlovian response of any UK Labour MP, (Dame Margaret Hodge is the best current exponent now we have lost Gordon Brown and Jeremy Corbyn but the confusion extends to both side of the House - see Mr. Andrew Mitchell MP Con.) whose pronouncements both ignore the comparatively impenetrable United States regime and still confuse the opaque Panamanian and US regimes with the entirely transparent and compliant position of the Cayman Islands. And without ever asking the seemingly obvious question as to why the Papers were called Panamanian? That is one nonsense. But even less has been written about the effect of the Cayman Islands tax and all crimes transparency. In fact, what we now know is that with proactive tax reporting on all investors and the investigatory carte blanche given to onshore tax authorities under the tax information treaties (with full details of beneficial ownership available), scrutiny of the structuring of between US$5-6 trillion of capital in and through the Cayman Islands has not increased onshore tax revenues by any statistically meaningful amount. Or, put in the plainest terms, structuring in and through the Cayman Islands was at no time “Harmful” because there is no evidence that it reduced onshore tax revenues whether by evasion or avoidance.

Of the four indicia in the 1998 Report, no one doubted at the time, and certainly not US Treasury Secretary O’Neil who spoke out decisively that tax transparency to prevent or dissuade tax evasion was the only legitimate OECD objective. But having now achieved that beyond doubt, where then is the recognition and equality of treatment owed to the Cayman Islands and, just as importantly, recognition of the value that a properly functioning offshore financial centre adds in facilitating international capital flows for inward onshore investment and the onshore tax revenues thereby created? Why the continued discrimination? New York Attorney General Cyrus Vance has observed before a Senate Sub-Committee that the cooperation and disclosure provided by the Cayman Islands regime is superior to that available in the US, but recognitions of that sort remain few and far between. If fairness and equal treatment were at the heart of the OECD initiative, that should have resulted in complete acceptance of the Cayman Islands’ role as an offshore financial centre. So, we can conclude that the OECD initiative has nothing to do with fairness or equality. And here then lies the problem in the Cayman Islands Government acquiescing to the EU resuscitation of the “no substantial activity” head of the OECD 1998 Harmful Tax Competition Report by enacting it (under threat of blacklisting) in its new iteration: the economic substance legislation.
Legal, Accounting, and Intellectual Substance

We see a slightly more oblique but equally damaging reference to the same mischaracterisation in every Financial Times or Guardian article about the Cayman Islands, which is typically and robotically illustrated with picture of a beach and a palm tree. The message is clear and offensive. Simply put, “And by the way, nothing whatsoever of value or substance really goes on there”. But what goes on should be apparent to anyone with the slightest understanding of law and economics. The creation of some US$5-6 trillion of equity, debt or hybrid obligation by Cayman Islands entities issuing to investors legally enforceable intangible rights does not occur without substance, specifically sophisticated legal, accounting, and intellectual substance. What the EU Commissioners and the OECD (and less importantly the editors of the FT and the Guardian) are trying to say is twofold. Firstly, that the creation of intangible rights through professional structuring is of no substance and no recognition should be afforded to it; and secondly, it cannot be recognised unless the entity issuing the legally enforceable obligation is housed in one building with real people managing not just the creation of the legal right but the business of the issuer. But, on analysis, this makes sense only to EU Tax Commissioner Pierre Moscovici and his colleagues in the OECD, whose understanding appears limited to how a French company manufactures an agricultural implement.

There is no principle in the common law legal world that requires an entity to be managed in its jurisdiction of establishment or that requires its lawyer to share a building with its CEO. This is simply cynical retro euro engineering designed specifically to discriminate against small offshore financial centres which are capable of providing high levels of expertise in common law legal structuring to the embarrassment of onshore European onshore financial centres whose governing law nobody wants. It follows, also, that the EU and the OECD diktat is diametrically opposed to the understanding of the investors holding the US$5-6 trillion worth of intangible assets issued by Cayman islands entities who are confident in relying solely on the documents creating the rights, the law of the pace, a legal opinion backed by insurance, and its Courts to give the rights to those assets’ validity and enforceability. This is the only substance test of relevance. The investors do not rely on the size and staffing of a Cayman Islands building. The EU and OECD suggestion is novel and different to any understanding that applies to financial structuring of intangibles in any common law onshore financial centre and whether governed by New York or English law. Nothing in the OECD BEPS 5 initiative recognises the value added by the application of legal know how in a tax neutral jurisdiction in the structuring of intangible financial interests. So much for equality of treatment. And let us not overlook the irony. These entirely perverse thoughts are coming from a French EU Tax Commissioner and a French based organisation, the OECD, regardless of the fact that one of the very few expressions that English common law considered it worthwhile to adopt from the Code Napoleon without translation was “chose in action”.

[v]
False Narrative

The Cayman Islands Government’s acquiescence in adopting the EU’s and OECD’s extraterritorial economic substance rules regrettably does nothing but lend acceptance to their perversely flawed thinking. In acquiescing to EU tax and regulatory initiatives, the Cayman Islands Government is simply feeding an insatiable multi-headed hydra with the false narrative on which it thrives. The one thing the EU and the OECD cannot ever admit to is that they were unprincipled and wrong in determining Cayman Islands structuring to be “harmful”. And it is not in the nature of the EU or the OECD to apologise for their errors.

No doubt astonished that the transparency initiatives improved rather than extinguished the Cayman Islands financial services industry, the new EU and OECD strategy is to layer unnecessary regulation upon regulation in an endeavour to suffocate the free flow of capital in and through the Cayman Islands. Or, at the very least, to render the Cayman Islands financial services industry as cumbersome and cost ineffective as that of Luxembourg and Dublin. And so, the Cayman Islands now faces not a tax transparency initiative, and not merely the preposterous economic substance initiative, but a new application of extraterritorial EU regulation in the shape of the mandated regulation of private equity vehicles. No matter that these vehicles are not regulated in the United States, no matter that these vehicles are not conducting business in the EU, and no matter that these are not vehicles in which EU investors are investing. These points apart, what is also missing in the Cayman Government acquiescing in this regulatory overload is any understanding of what it was that made the Cayman Islands attractive in the first place. If we go back to the early 1990s and the original Cayman Islands Mutual Funds Law, a bright line was drawn that recognised three essentials:

1. Cayman Islands funds and structures necessarily invest in an onshore jurisdiction, and directly or indirectly are subject to prudential regulation in that jurisdiction; and

2. Given that principle, investors in Cayman Islands structures recognise that duplication of regulatory oversight in the Cayman Islands is unnecessary and are entirely comfortable with minimalist oversight by, the Cayman Islands Monetary Authority (CIMA).

3. Cayman is not a retail jurisdiction and serves sophisticated institutional investors only who undertake their own risk analysis.
Regrettably, in not merely acquiescing but encouraging external regulatory pressures, the Cayman Islands Government and CIMA, assisted by the local accounting profession, have lost sight of the clear bright line. We can conclude that the advice given to the Cayman Islands Government in formulating its policy of acquiescence has been coloured by myopia and self-interest. There is no clearer example of this than the insistence by the Cayman audit firms that a Cayman auditor sign off not only for mutual funds and master funds but now, similarly, for private equity vehicles under the new Private Funds Law 2020, introduced at what should have been the irrelevant insistence of the EU Code of Conduct Group.

Let us not underestimate the value to the accounting profession of providing a local audit sign off to some 10,000 hedge funds and now, also at least 10,000 private equity vehicles. The value of additional local audit fees to the accountants may be as high as some US$150 million annually. And this in respect of audit work invariably already undertaken by the related or namesake audit firm in the onshore jurisdiction where the books and records of the Cayman vehicle are most usually located. And with no value added to investors given that liability on the local audit is limited by the letter of engagement to a derisory multiple of the annual local auditor’s fee.

This is not the first time this has happened. Similar self-interest, dressed up as a global regulatory standard, drove the unnecessary requirement for local audit of a master fund in addition to its feeder funds, notwithstanding that the local auditors were simply duplicating the audit of the same invested dollar. The increase in cost base to users of the Cayman Islands is, therefore, significant and for no principled reason. Nor does there exist any reason to which an investor in a Cayman Islands open, or now, closed ended fund would attribute any added value. It is this regrettable short-sighted internal self-interest that encourages now the external legislative and regulatory threats of the EU and the OECD and which poses as great a concern to the ongoing viability of the Cayman Islands.

**FATF Incompetence**

We see a similar concern with the misguided and duplicative regulatory advances of the Financial Action Task Force (FATF) and through its local agent, the Caribbean Financial Action Task Force (CFATF). It has been forgotten that when the FATF first approached the Cayman Islands in the early 1990s the expressed concern was of illicit proceeds of crime in circulation globally amounting to US$1.5 trillion a year. Now, 30 years later, notwithstanding the billions of dollars of expenditure on regulation and compliance insisted on by the FATF, the annual figure for illicit funds in circulation is estimated at between US$2-4 trillion a year. No private sector organisation with that track record would still be in business. By any standard, the FATF is incompetent and neither the OECD nor the FATF could survive a cost benefit analysis. And nor does the FATF care to understand the mechanics of cross border money flows. Originally, the know your client (KYC) anti-money laundering due diligence and documentation identifying the client was required to be produced once and once only at the institution in which the funds were first placed in an approved FATF jurisdiction. The promise, now dishonoured, was that all financial institutions subsequently in that chain of money flow could rely on the initial documentation. The latest
regulatory incarnation requires that virtually all service providers in the same structure must undertake original KYC and due diligence, all in respect of the same dollar.

This ludicrous overreach and obfuscation of the original principle is no better illustrated than by the most recent legislation insisted on by the FATF requiring that a Cayman Islands fund must have its own anti-money laundering officer and compliance officer to undertake the due diligence on the flows of investor monies into that fund. But the reality is that the flow of monies in 99 per cent of cases will pass from the administrator directly to the prime broker, neither of which may be located in the Cayman Islands and both of which will have undertaken the necessary enquiry. But again, if we reckon the costs of these officers annually to be no less than US$3,500 for every one of 20,000 funds, the increase in costs for no value added is significant and wholly unnecessary. And it is regarded as duplicative by investors.

This is the more so because, notwithstanding the duplication of anti-money laundering regulation now enacted in the Cayman Islands, the evidence is clear that no statistically relevant money laundering occurs in the jurisdiction. We need to look to Danske and Deutsche Bank to find US$200 billion laundered; to Wachovia Bank in Miami to find US$376 billion laundered; to Bank of New York Mellon which laundered the US$7 billion of Mr. Mogilevich, and so on. Yet the approach of the FATF and CATF, confounded at the absence of evidence of illicit funding in the Cayman Islands, is to insist on more regulation in a delusional effort to locate a non-existent problem and prove a counterfactual. And regrettably, CIMA, after a typically cursory consultative process, appears to be persuaded by this approach. The level of fines and penalties available to CIMA for substantively irrelevant procedural breaches of duplicative anti-money laundering regulation is wholly disproportionate to the evidence of predicate money laundering offences.

**New Stage Of The War**

We have entered a new stage of the war for financial services. The attacks by the EU, the OECD, and the FATF on offshore financial centres like the Cayman Islands are now focused primarily on increasing the costs of operation by way of unnecessary and duplicative regulation that is in no way proportionate to any evidence-based analysis of a substantive problem, serves no useful purpose, and adds no value to investors or criminal enforcement.

The Cayman Islands Government urgently needs to undertake a thorough evidence-based review of the fundamental objectives of its regulatory regime, should rely on disinterested professionals with actual understanding for advice, and should formulate and present coherent arguments based on evidence and proportionality for the repeal and modification of a good deal of it.
Footnotes:


[ii] Of course, changes in onshore controlled foreign corporation legislation such as the US Tax Cuts and Jobs Act 2017 in introducing GILTI income may affect the percentage of offshore profits that may be legitimately deferred and thereby increase onshore taxation but that does not come about as a change in transparency.

[iii] Compare this to the effects of transparency on the 17,000 Scottish limited partnerships which, when scrutinised by HMRC, were found to have laundered US$80 billion. As a result of the beneficial ownership disclosure requirements, 80% of that number were deregistered.

[iv] (i) no or low taxes; (ii) no administrative transparency; (iii) no exchange of information, (iv) no substantial activity.

[v] No doubt, EU investors and non-EU investors seeking investment in the EU will, to reduce taxation, favour Dublin and Luxembourg.

ABOUT THE AUTHOR

Anthony Travers OBE is the Senior Partner of Travers Thorp Alberga, former Chairman of Cayman Finance and former President of the Cayman Islands Law Society. He has extensive experience in all aspects of Cayman Islands law and has worked closely with the Government in the development of Cayman Islands legislation particularly the Mutual funds and Private Equity legislation and legislation relating to the establishment of Private Trusts. Anthony was made an Officer of the Most Excellent Order (OBE) for his services to the Government and the Financial sector in August 1998. Anthony has written numerous articles and speaks regularly at conferences and seminars.