

12. RISK ASSESSMENT OF LEGAL PERSONS, LEGAL ARRANGEMENTS AND BENEFICIAL OWNERSHIP-RELATED RISKS

12.1 Background and Context

Despite the essential and legitimate role, the corporate vehicles play in the global economy, under certain conditions, they have been misused for illicit purposes, ML, bribery and corruption, insider dealings, tax fraud, TF, and other illegal activities. This is because, for criminals who try to circumvent measures for AML/CFT, corporate vehicles are an attractive way to disguise and convert the proceeds of crime before introducing them into the financial system (*FATF Guidance – Transparency and Beneficial Ownership, 2014*).

The objective of this study is to assess the ML related risk of legal structures, created/operate in Sri Lanka. This is the 1st of such assessment conducted on legal structures in Sri Lanka.

Table 1: Scope of the Assessment

	Legal Persons	Legal Arrangements
Scope	All types of legal persons created under the Companies Act, No. 7 of 2007	Express Trusts registered under the Trust Ordinance
Legislation	Companies Act, No. 7 of 2007 (<i>herein referred as Companies Act</i>)	Trusts Ordinance, No. 9 of 1917 and Trusts (Amendment) Act, No. 6 of 2018
Registration	Department of the Registrar of Companies	Registrar General's Department

The assessment consists of 4 modules, as Mapping, Threat Assessment, Vulnerability Assessment and Entity Risk Assessment. Data and information were considered for the five-year period 2017 - 2021. Data collection for the assessment included information and statistics obtained from DRC, RGD and other related institutions, questionnaires, interviews, publicly available reports and indices on Sri Lanka as well as other related open-source documents. The working group also referred related Acts, regulations, rules, and guidelines in the assessment.

12.2 The Assessment

The Threat level relating to Legal Persons, Legal Arrangements and BO related risks was identified as **Medium** and the overall vulnerability level of the same was derived at **Medium High** Level. Accordingly, the overall ML risk level of legal persons, legal arrangements and BO related risks was identified as **Medium High**.

Summary of the modules which were assessed at the assessment were outlined as follows.

12.2.1 Mapping

As per the Companies Act, there are 8 types of legal persons that can be registered with the DRC which has been considered for the assessment,

- a) **Limited company:** a company that issues shares, the holders of which have the liability to contribute to the assets of the company, if any, specified in the company's articles as attaching to those shares. Limited liability companies are further categorized as private limited companies and public limited companies.
- b) **Unlimited company:** a company that issues shares, the holders of which have an unlimited liability to contribute to the assets of the company under its articles.
- c) **Company limited by guarantee:** a company that does not issue shares, the members of which undertake to contribute to the assets of the company in the event of its being put into liquidation, in an amount specified in the company's articles.
- d) **Overseas company:** any company or body corporate incorporated outside Sri Lanka and established a place of business within Sri Lanka.
- e) **Offshore company:** a company or a body corporate incorporated under the laws of any foreign country, which has power to carry on any business outside Sri Lanka; but shall not be entitled to carry on any business within Sri Lanka.
- f) **Quoted Public Company (QPC) /listed company:** a company, where any shares or securities of which are quoted on a licensed stock exchange.
- g) **Association:** Associations are registered by the Registrar of Companies under section 34 of Companies Act, for promoting commerce, art, science, religion, charity, sport, or any other useful object, and intends to apply its profits, if any, or other income in promoting its objects.

Table 2: Type and Number of Legal Persons created under the Companies Act

Company Type	No. of entities by 31.12.2021	No. of entities by 31.12.2022
Pvt. Ltd.	143,863	161,266
Public Ltd.	4,351	4,388
Overseas	493	508
Off-shore	11	11
Unlimited	3	3
QPC	254	254
Limited by Guarantee	839	965
Associations	2,780	3,018

Source: Department of the Registrar of Companies

In the Sri Lankan context, the requirement on BO is yet to be introduced to the Companies Act. However, measures have been taken by the FIU to introduce the concept of BO through CDD Measures. Requirements relating to BO have been included in the CDD Rules and Guidelines issued on identification of BOs.

Trust Ordinance, No. 9 of 1917 was amended in 2018 with the objective of introducing requirements of FATF Recommendation 25 relating to legal arrangements. In terms of the Trusts (Amendment) Act, No. 6 of 2018 and subsequent Trusts (Information Relating to Express Trusts) Regulations of 2018, upon creation of an Express Trust in relation to any immovable or movable property, the trustee of such Trust is required to obtain and maintain information as specified in the Regulation. It also addresses the requirements of verifying and updating information every three months and specifies penalties for non-compliances against the requirements introduced in the amendment.

Table 3: Number of Trusts Registered under the Trust Ordinance, No. 9 of 1917

	2017	2018	2019	2020	2021
No. of Trusts	137	197	196	185	186

Source: Registrar General's Department

12.2.2 Money Laundering Threat Assessment

As per the assessment, overall ML threat of the legal structures created in Sri Lanka is at **Medium** level. The threat level has been arrived at analyzing enforcement data such as STRs, MLA requests sent /received, criminal investigations, civil enforcement/ forfeiture actions, proceeds in such cases, criminal prosecutions, and criminal convictions for the assessment period. In the threat analysis, the threat perception was also considered through information collected from credible open sources and threat perceptions by public and private sector experts. It has been observed that there is a limited or low level of STRs, criminal investigations and criminal prosecutions and convictions on abuse of legal structures on ML. At the same time, MLA requests sent on abuse of legal structures for ML during 2017-2021 was 15 per cent out of total MLA requests sent. During the 5-year period, only two MLA requests were received relating to abuse of legal structures for ML. Criminally investigated proceeds that was laundered through legal structures, on ML were not at a high level as per the general understanding based on the cases by relevant authorities. No sufficient data was available on civil enforcement actions on ML abuse of legal structures.

When it comes to threat perception, credible open sources, civil society/academic experts, public sector experts (AGD, LEAs, Tax authorities, DRC) and private sector expert (LBs and TCSPs) perceived medium level of abuse of legal structures for ML purposes.

Under the Threat Assessment, the existence of 15 typologies relating to abuse of legal structures were also analyzed through a questionnaire sent to all LBs. The majority of such typologies found to be existed but in limited frequency. Few typologies were reported as does not exist in Sri Lanka. Summary of the analysis is given in Table 4 below.

Table 4: Typologies Analysis

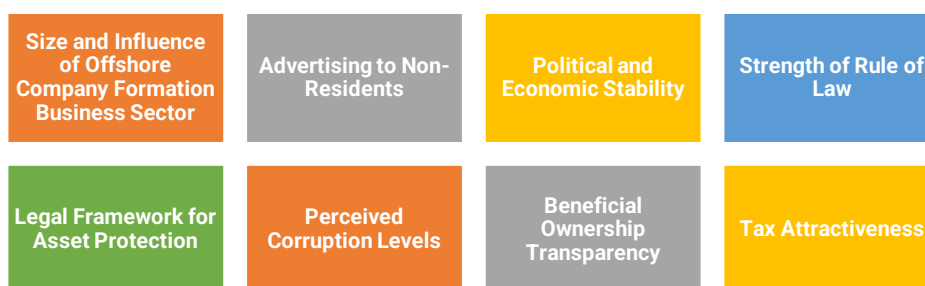
Exist
<ul style="list-style-type: none"> • Foreign ownership/control by shell companies • Use of nominee directors/nominee shareholders/front men
Exist but Limited
<ul style="list-style-type: none"> • Multi-jurisdiction Splitting • Anomalous complex ownership/control structures • Control through power of attorney • Use of trusts or foundations in ownership/control structures • Use of private investment funds/hedge funds • Use of International Business Companies/exempt companies • Use of large professional firms • Use of fake ID documents for formation/registration
Does not Exist
<ul style="list-style-type: none"> • Use of legal persons as company directors • Use of bearer shares (cannot exist as per the legal terms on shares) • Use of fictitious entities • Abuse of professional privilege • Use of deceptive names of legal structures

12.2.3 Vulnerability Assessment

The vulnerability of legal structures has been assessed based on the level of Sri Lanka’s attractiveness for non-resident incorporations and strength of mitigation measures. Accordingly, the assessment resulted a **Medium High** level of vulnerability of legal structures for ML with a medium level of attractiveness for non-resident incorporations and a low level of strength of mitigation measures.

Attractiveness for non-resident incorporations: was measured using eight factors where overall attractiveness of Sri Lanka was assessed at medium level.

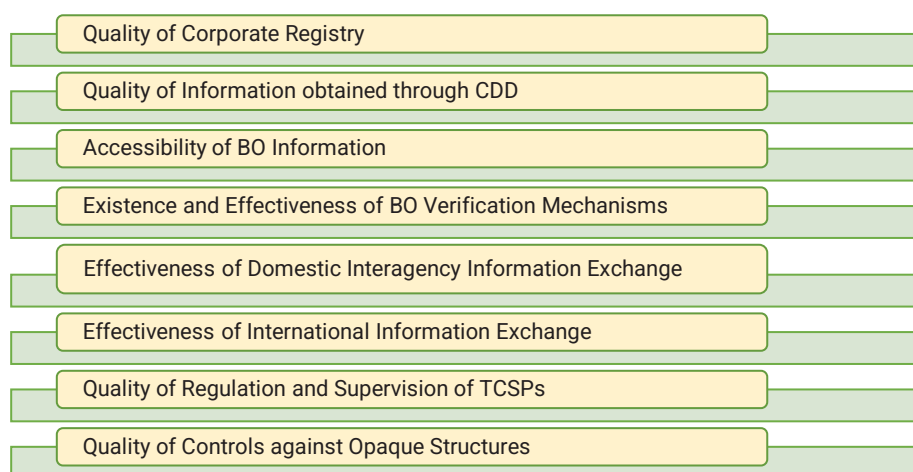
Figure 1: Attractiveness for Non-Resident Incorporations Score



The share of offshore companies out of total number of legal structures as at December 31, 2021 stood below 1 per cent, as well as, during 2017-2021 no offshore companies have been registered in Sri Lanka. The availability of many advertising campaigns for the promotion of company formation for non-residents¹ and strength of rule of law² and legal framework for asset protection³ in Sri Lanka have a positive impact on the attractiveness for non-resident incorporation. At the same time, low political and economic stability⁴ mainly due to unexpected fluctuations occurred as a result of Easter Sunday attack and COVID-19 Pandemic, complex and frequently changing taxation policies⁵, deficiencies in BO transparency due to non-availability of legal requirements on BO identification and verification of legal persons as well as high perceived corruption level⁶ have made a negative impact on the level of attractiveness for non-resident incorporations.

Strength of Mitigation Measures: was measured considering eight factors.

Figure 2: Strength of Mitigation Measures



a) The quality of corporate registries was assessed at medium level :

A comprehensive coverage of legal persons and structures was observed with limited exemptions such as partnerships. There are 8 types of legal persons in Sri Lanka which are registered under the Companies Act as described before. All express trusts created in Sri Lanka should be registered with the RGD as required by the Trust Ordinance and its subsequent amendments. Further, a sufficient level of accurate and up-to-date basic information is available on legal persons with the DRC. Facilities are available in the current eROC system to automatically alert legal entities when an update is required or inform entities of possible penalties if information is not updated. General public have online access to the eROC to search basic information with a fee and LEAs have been given online access to information on request free of charge. However, the staff strength of the DRC and RGD is at an insufficient level.

1 <https://www.drc.gov.lk>, <https://investsrilanka.com>, <https://gic.gov.lk>

2 Rule of Law Index, 2021 Investment Climate Statement by US Department of State

3 Doing Business in Sri Lanka, www.treasury.gov.lk

4 <https://www.cbsl.gov.lk>, The Economic Freedom Index, The Sri Lankan Economy—Charting a New Course by Asian Development Bank

5 <http://www.ird.gov.lk>, A step by step guide to Doing Business in Sri Lanka

6 The Corruption Perception Index by Transparency International, Global Corruption Barometer by Transparency International, www.ciaboc.gov.lk

b) Quality of information obtained through CDD was assessed at medium level :

The FIU has issued CDD Rules to FIs, Designated Non-Finance Business and Insurance in 2016, 2018 and 2019 respectively under Section 2(3) of the FTRA has prescribed the CDD requirements that should be applied by such institutions, which also states the requirements to be complied relating to legal structures. The Designated Non-Finance Business CDD Rule is applicable to DNFBPs including real estate dealers, accountants, legal professionals, notaries and TCSPs. The FIU initiated conducting awareness for TCSPs on AML/CFT requirements in latter part of 2021. When a financial institution or DNFBP conducts transactions with a legal structure, they are required to undertake risk profiling measures and conduct due diligence as per the risk identified.

c) Quality of regulation and supervision of TCSPs was assessed at medium level:

Section 221 of the Companies Act establishes the legal requirement of having a Secretary for legal persons. Regulations on Secretaries were also issued under the Companies Act and the administration of such regulations are vested with the DRC. With respect to AML/CFT coverage, the FIU issued Designated Non-Finance Business (Customer Due Diligence) Rules, No. 1 of 2018 under Section 3(2) of the FTRA, prescribing the requirements relating to risk assessment, CDD, record keeping, internal control, use of new technologies etc for TCSPs. Furthermore, the FIU issued Guidelines on AML/CFT Compliance Obligations for Accountants and TCSPs in 2020. During both 2020 and 2021, the FIU carried out offsite risk assessment on the TCSPs to identify implementation of CDD within identified TCSPs. However, so far, no onsite examinations have been conducted on TCSPs.

d) Level of accessibility of Beneficial Ownership Information was rated as low:

The low level of accessibility of BO information was mainly due to non-availability of legal requirements relating to BO of legal persons under Companies Act. Accordingly, DRC has no legal requirement to maintain registry of BO of legal persons as well as LEAs or competent authorities do not possess direct access to such details. However, as per section 6B (1) of the Trusts (Amendment) Act, No. 6 of 2018, Registrar General is required to provide information relating to express trusts registered with RGD to the FIU or any authority sanctioned by the FIU, and as per the section 19B (1)(a) of the same Act, trustee and a co-trustee, required to provide any information in the record maintained relating to express trusts, to any relevant authority as defined in the Act. In addition, CDD Rules also require all FIs, Insurance and DNFBPs to record BO of legal persons and legal arrangements whenever they are dealing with such customers. LEAs and the FIU have access to such BO information maintained by RIs. General public do not have access to any BO information of legal persons as well as legal arrangements.

e) Level of existence and effectiveness of BO verification mechanisms was rated as very low:

Since there is no legal requirement for the DRC to maintain a register of BO of legal persons, a BO register for legal persons does not exist and hence no mechanisms available to verify the accuracy, cross-check with other sources and perform enhanced checks on red flags for BO information.

f) Domestic interagency information exchange was rated at medium level:

Mechanisms are available to cooperate with all government authorities by sharing information relating to companies registered whenever there is a request for such information. As at end of 2021, DRC has provided information to agencies such as Central Bank, Magistrate's Courts, Sri Lanka Police (CID, Colombo Crime Division, Fraud Investigation Bureau, CTID, etc.), CIABOC, SIS, Exercise Department of Sri Lanka, AGD and IRD.

g) Effectiveness of international information exchange was rated at medium level:

Access is available to BO information by the FIU through FIs, which can be shared with its counterparts through Egmont Group. Further, Sri Lanka has entered into a Multilateral Treaty with South Asian Association for Regional Cooperation (SAARC) and double tax agreements with 45 countries to exchange tax information.

h) Effectiveness of enforcement of sanctions/fines was rated at medium level:

Companies Act, identifies offences for non-compliance with the Act and prescribes penalties for such violations. Similarly, Section 19 (C) of the Trust Ordinance (Amendment) Act, No. 6 of 2018 prescribes penalties for non-compliance with the Act.

i) Quality of controls against opaque structures was rated at medium level:

No mechanisms are available to ensure BO transparency measures on opaque legal persons, as similar to other legal structures specified under the Companies Act. Also, the Act does not have provisions to disclose PEP status of shareholders or beneficial owners, although, PEP disclosure is included in CDD rules issued for FIs, DNFbps and Insurance companies. Further, there are no prohibitions or restrictions under the Companies Act on any person acting as nominee directors. However, a company cannot be registered with identical names or similar names that are already registered. The concept of "Bearer Shares" does not exist in Sri Lanka in terms of the definition of the shareholder as per the Companies Act. In addition, CDD Rules issued specify BO identification mechanisms when a legal entity is entering into a business relationship with an RI. In relation to trusts, the BO transparency for structures owned/controlled by trusts should be available as required by the provisions of Trusts (Amendment), No. 6 of 2018.

12.3 Entity Risk Assessment

Due to data limitations, the entity risk assessment was performed for private limited liability companies, public limited liability companies, overseas companies and companies limited by guarantee. Further, data on assets and financial flows on each legal structure were not available in conducting the entity risk assessment.

Table 5 : Summary of Entity Risk Assessment

Entity Type	Entity Risk Level	Attributes
Private Limited Liability Companies	Medium	<ul style="list-style-type: none"> • Out of total legal structures, around 94 per cent comprises of private limited liability companies. • 85 per cent of companies had 100 per cent local ownership while companies with foreign ownership mainly distributed among countries such as India, China, Malaysia, Singapore, USA and UK (Survey Results) • Ease and speed of formation/registration of private limited companies is high, where, with the introduction of eROC, a company could be formed within 1 day. • Average cost of formation of a private limited company is around Rs. 10,000 /USD 32 (plus tax and depends on number of directors) • No specific residency requirement is available for directors or office bearers in the Companies Act. However, the Act specifies that only a natural person is qualified to hold director's position (Section 202 (2) (f) of the Companies Act). • No provisions are available relating to identification and verification of BO of legal persons. • Private limited companies are the most prone category for ML/TF, based on the STRs reported by RIs as well as LEAs.
Public Limited Liability Companies	Medium	<ul style="list-style-type: none"> • 2nd largest legal structure type created in Sri Lanka totaling around 3 per cent. • Cross border exposure of public limited companies is low, as 72 per cent of companies had 100 per cent local ownership while companies with foreign ownership mainly distributed among countries such as India, UK, Malaysia, Netherland, UAE and Hong Kong (Survey Results). • Ease and speed of formation/registration of public limited company is at satisfactory level. Even though, the cost is relatively low, it would take comparatively longer time compared to private limited companies in the formation process. There is no specific residency requirement for directors or office bearers in the Companies Act. However, the Act specifies that only a natural person is qualified to hold director's position. • The average cost of formation of a public limited company is Rs. 8,000/ USD 25 (plus tax and depends on number of directors). • There are no provisions available relating to identification and verification of BO of legal persons.

Companies Limited by Guarantee	Medium	<ul style="list-style-type: none"> • Out of total legal persons registered in Sri Lanka only 0.5 per cent represent companies limited by guarantee. • Cross border exposure of Companies Limited by Guarantee is very low as only a below 1 per cent had foreign ownership (Survey Results). • Ease and speed of formation/registration is high and takes less time for formation. • Average cost of formation of a company limited by guarantee is Rs. 30,000/ USD 94. • There are no provisions available relating to identification and verification of BO of legal persons.
Overseas Companies	Medium	<ul style="list-style-type: none"> • Out of total legal persons registered in Sri Lanka only 0.3 per cent represent overseas companies. • Cross border exposure of overseas companies is very high. As per the survey results, apart from 15 companies that had some domestic ownership ranging from 3 per cent to 75 per cent. The rest of the companies had 100 per cent foreign ownership. Foreign ownership was distributed among many countries such as India, Pakistan, Maldives, Malaysia, UK, USA, Australia, Germany, Singapore, Japan, China (Survey Results). • Informal international cooperation on information sharing on overseas companies, between FIU to FIU or Police to Police, is very effective, while formal cooperation on the same is relatively low. Sri Lanka has made many MLA requests, however, only few MLA requests were received by Sri Lanka from other jurisdictions on all types of legal structures. • Overseas companies are required to obtain registration under Companies Act and also it is required to have a local representative. • Comprehensiveness of basic information is high as most of the basic information relating to legal persons are available with ROC. • There are no provisions available in the Companies Act relating to identification and verification of BO of legal persons.

Figure 3: Risk Assessment of Legal Persons, Legal Arrangements and Beneficial Ownership-related Risks

