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On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers

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Current trends in international legal scholarship have shifted from a paradigm of state actors working within recognized sources of international law to one that includes transnational regulatory networks working within generally accepted standards. The new paradigm can be seen in operation in the efforts by onshore countries to restrict the activities of offshore financial centers. Onshore countries have attempted to use regulatory networks to advance new standards for income taxation, prudential regulation, and money laundering. In part because of the way in which the IMF participated in the process, onshore centers have largely succeeded in securing compliance with financial regulatory and money laundering standards, but have failed with income taxation. The new paradigm should view regulatory networks in the context of a system of states and international organizations that possess the qualities of such networks. This new system of global governance advances fairness and objectivity and, in particular, may protect weak states from the hard power of the stronger.

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Let us rather turn to a much-praised strength of the modern person, with the truly awkward question whether, on account of his well-known historical ‘Objectivity,’ he has a right to call himself . . . just, and just to a higher degree than the people of other times. Is it true that this objectivity originates from a heightened need and demand for justice? Or does it . . . merely create the appearance that justice might be its real cause? Does this objectivity perhaps tempt one to a detrimental and too flattering bias . . .?  

FRIEDRICH NIETZSCHE, ON THE USE AND ABUSE OF HISTORY FOR LIFE 9 (1873)

I. INTRODUCTION

A. Transnational Regulatory Networks and Global Governance

Over the past decade and a half scholarly inquiry into the source and operation of international law has undergone significant development. The earlier paradigm was one of unitary state actors, working either by themselves or through formal international organizations, within the context of recognized sources of international law (i.e. international conventions, international customary law, general principles of law recognized by ‘civilized’ nations, judicial decisions, and teachings of experts). The focus of inquiry was primarily on the rights and obligations of states (including those found in the charters of international organizations), the adjudication of breaches, and the imposition of sanctions. Throughout, two key factors in the development of international law have been ‘principle’ or ‘ideology’ (or what is inherently right or wrong) and the self-interest of states.

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1 Available at http://records.viu.ca/~johnstoi/Nietzsche/history.htm.


The new focus looks beyond these basic parameters. Instead of treating states as unitary actors, scholars have drawn attention to the disaggregation of state sovereignty: states act in the international system not just through their executive but through their various domestic governmental institutions, including ministries, courts, legislatures, and regulatory agencies. These various governmental units may communicate with each other through global policy networks and not just through the State (e.g. foreign ministries) or formal international organizations.

According to a number of scholars, key players in these developments have been domestic regulatory agencies, including those that supervise the banking, insurance, and securities sectors. These domestic regulators are guided in large part by the application of technical expertise. They share their expertise and other information through semi-formal Trans Regulatory Networks or TRNs. Scholars have cited the Basel Committee on Banking Supervision, The International Association of Insurance Supervisors, and the International Organization of Securities Commissioners as among the more influential TRNs. These informal groups of national regulators have no legal personality, have little or no staff, and little or no formal system of internal governance. Rather, they consist of officials from national regulators who agree to meet on an occasional basis and to reach agreement by consensus. Scholars have also noted that such TRNs may themselves coordinate through semi-formal supra-TRNs like the Financial Stability Forum.

These regulatory TRNs, through application of the collective expertise of their members and through the building of consensus, develop best practices or standards to address technical regulatory issues faced by most or all domestic regulators. These standards are then promulgated as technical guidance for all regulators. For example, the Basel Committee is concerned with the preserving the safety and soundness of the banking system. Composed of a number of domestic banking regulators from the most important banking centers, The Basel Committee’s various standards are designed to promote a public good—a sound banking system—that is of benefit to all. And, in a world with an increasingly inter-connected financial system where one weak link may jeopardize the entire system, the diffusion of best practices among all regulators benefits each jurisdiction individually. If the Basel Committee’s standards are truly well

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7 Id. at 1046-7 and Anne-Marie Slaughter, Sovereignty and Power, supra note ___ at 315. The Basel Committee is discussed in depth infra at ___.

8 The International Association of Insurance Supervisors and the International Organization of Securities Commissioners are discussed infra at ___.

9 The FSF includes as the IMF, a treaty-based international organization. Id. The FSF is discussed infra at ___.

designed to address the technical problem of how best to regulate and supervise the banking system, problems of conflicting principle or ideology, or of national self-interest, should be minimized.\(^1\)

Also according to scholars, acceptance of these best practices or standards is primarily accomplished not through the ‘hard power’ of sanctions\(^12\) but through more subtle pressure or “persuasion.”\(^13\) “[The system] co-opts people rather than coerces them.”\(^14\) TRNs help educate local regulators and convince them that the standards agreed upon are truly best practices. In addition, scholars have argued that the market, reacting to the regulatory best practices, can also provide incentives for performance.\(^15\) Many scholars have referred to this shift from traditional international law to less formal standard-building through TRNs as part of a global move from ‘government’ to ‘governance.’\(^16\)

Because TRNs bring highly developed expertise to address common problems, the solutions they offer should be less ideologically or politically motivated than that of states acting individually or in like-minded groups. Like turning to organizations of doctors for medical advice or engineers for views on building bridges, turning to banking regulators for views on how to maintain a safe and sound banking system simply makes good sense. Implementing their advice, therefore, should be in the best interests of everyone. While states are motivated to develop policies that are self-serving TRNs are motivated primarily to develop policies that are truly ‘best practices.’ While states may rely on the hard power of carrots and sticks to enforce their views TRNs rely more on simple persuasion. The emergence of TRNs, therefore, may be of great benefit to the world.

**B. The Limitations of TRNs**

Scholars of the globalization of regulatory law have, however, noted some problems when standard-setting is shifted from the national to the global level, from local regulators to international standard-setting bodies.\(^17\) Chief among these is a potential lack of legitimacy.

\(^{11}\) This is not to say that the resulting standards would then prove to be wise, in that purely technical failures might still result. The recent crisis affecting the world wide banking sector would suggest that, at a minimum, banking supervisory standards were poorly conceived from a purely technical perspective.

\(^{12}\) “As defined by Joseph Nye, hard power is ‘command power that can be used to induce others to change their position.’”\(^28\) It works through both carrots and sticks, rewards and threats. Soft power, by contrast, flows from the ability to convince others what you want. n28. JOSEPH S. NYE, JR., THE PARADOX OF AMERICAN POWER: WHY THE WORLD’S ONLY SUPERPOWER CAN’T GO IT ALONE 9 (2002) [hereinafter Nye, PARADOX]. Nye first elaborated the concept of soft power in an earlier work. JOSEPH S. NYE, JR., BOUND TO LEAD: THE CHANGING NATURE OF AMERICAN POWER 188-201 (1991).” Slaughter, Sovereignty and Power, supra note ___ at 291.

\(^{13}\) Anne-Marie Slaughter, Government Networks, Global Informational Agencies, and Disaggregated Democracy, 24 MICH. J. INT’L L. 1041, 1043 (2003). Of course, even breaches in accepted international law may result only in peer pressure and not formal ‘hard power’ sanctions.

\(^{14}\) Anne-Marie Slaughter, Sovereignty and Power, supra note ___ at 291.

\(^{15}\) Rolf H. Weber and Douglas W. Arner, Toward a New Design, supra note ___ at 411.


First, accountability of TRNs may be limited, in that bureaucrats operating at the TRN level may not be accountable to individual state governments or to people as a whole. Next, it is typically true that not every domestic regulatory authority is represented within a typical TRN. The Basel Committee, for example, includes only the regulatory authorities of certain developed countries. This can cause at least two problems. First, a lack of representation may lead to the appearance that the interests of member regulatory bodies are promoted over those of non-members; to the extent that issues faced by regulators are not identical, ‘global’ standards may not be truly global. And, to the extent that national regulators favor the interests of their own states over a hypothetical best practice for the world as a whole, the resulting standards may be tainted by state self-interest. This lack of accountability and tainting by self interest may adversely affect both the perception of the standards as legitimate and the actual quality of the standards themselves. Next, TRNs like the Basel Committee do not normally have a mechanism for reviewing any particular standard outside of the TRN itself (meaning the TRN reviews its own work), which also may affect both perception of legitimacy and the quality of the standards proposed. Finally, TRNs do not normally have neutral or objective way of monitoring compliance.

Scholars have argued that these problems may be overcome with a combination of adequate procedural standards (including sufficient transparency in the adoption of rules, adequate participation by different state regulatory authorities, reasoned decision-making, and effective review of final rules and decisions) and substantive standards (including that any rules adopted are proportional, rational, employ the least restrictive means to accomplish the desired result, and satisfy legitimate expectations). Naturally, these procedural and substantive standards may be very difficult to implement in fact. A key problem is that the inherent conflicts among different national regulators must be resolved if the TRN is to agree to one or more best practices. This will lead to concessions and tradeoffs, breaching some or all of the procedural or substantive standards.

C. TRNs, quasi-TRNs, Organizations with TRN Characteristics, and States Themselves

This Article has so far addressed the paradigmatic TRN like the Basel Committee. But there may be other groups that have some, though not all, TRN characteristics. This Article proposes a taxonomy based on the characteristics of TRNs (and other networks of sub-state units) that distinguish them from states acting alone.

The first category includes quasi-TRNs, or those organizations like the Financial Action Task Force on money laundering and terrorism financing that have most, but not all, TRN attributes. As with TRN like the Basel Committee, the FATF has worked to create various

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19 Id. at 116.
20 Id.
22 Id. at 37-42.
24 The Financial Action Task Force is discussed extensively infra at ___.
25 Anti-money laundering principles involve both regulatory and non-regulatory (mostly related to criminal justice) matters. For purposes of simplicity, this Article will refer to TRNs as including matters that are primarily regulatory.
standards and best practices. Also like the Basel Committee, the FATF has no legal personality and no formal system of internal governance. While it has a few staff it relies primarily on the expertise of its members to conduct its work and it reaches agreement by consensus. Unlike the Basel Committee, the members of the FATF are states. However, as a practical matter states members are represented at the FATF by sub-state units, including regulatory authorities (most particularly banking supervisors), as well as law enforcement. While the Basel Committee is less susceptible to state control than the FATF, it retains at least some of the beneficial qualities of serving as a repository of local expertise.

The second includes international treaty organizations, which this Article divides into two types. The first includes international financial institutions like the International Monetary Fund, World Bank, or regional development banks. While these are accepted as parts of the traditional international legal system, they do share some characteristics of TRNs. Like the Basel Committee, the IMF has created some technical standards, although none in the traditional regulatory areas such as banking, securities, or insurance. Unlike the Basel Committee or the FATF, however, the IMF is a treaty organization with state membership, with a large paid professional staff, and with a formal governance structure. However, states are represented at the IMF through their central banks or finance ministries, and the organization’s staff is selected largely because of its technical expertise, including in financial regulatory areas. While the organization itself is controlled by states, staff, with its expertise, may still exercise its expertise with some significant freedom from the control of those states.

It may also be that organizations like the IMF have non-TRN characteristics that address some of the problems that scholars have identified with TRNs. For example, unlike the Basel Committee with a membership limited to only a few national banking regulators the IMF’s membership includes early every state, and its staff includes individuals from nearly every country in the world. This may potentially allay some legitimacy concerns. In addition, IMF staff might be able to review the standards proposed by TRNs or to play a role in monitoring compliance. As will be discussed infra, these are key roles the IMF has played.

The second type of international treaty organization is more dominated by member states than the first, such as the Organization for Economic Cooperation and Development. However, even the OECD may exhibit some TRN characteristics; for example, the OECD, through its members, can tap into significant domestic expertise in the fiscal area. The third category includes states acting together in groups or in informal clubs such as the G-8. When acting in such groups, they often focus on particular technical issues rather than simply on ‘principle’ or ‘ideology’ or on state interests. A forth possible category would be added supra-national quasi-federalist multi-state polities like the European Union.

While TRNs may use soft power to convince national regulators as to what constitutes a standard or best practice those regulators are the ones who may exercise hard power. The acceptance of the standard may be an exercise of soft power, but regulatory sanctions based on that standard is backed by the police power of the state itself. Regulatory power typically applies only to the resident of the state in which the regulator has jurisdiction, but applying such power

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26 The IMF is discussed in detail infra at ___.
27 E.g. the special data dissemination standards, which provide guidance as to how countries should disseminate key economic and financial data. See generally http://dsbb.imf.org/Applications/web/dsbhome/.
28 The OECD is discussed in detail infra at ___.

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to its resident can force the resident to stop doing business with states that have not applied the standard. This brings market pressure to bear on the non-complying state to comply. If states whose residents have significant market power are prevented from doing business with the non-complying state, market pressure on the non-complying state will be significant. Thus, the application of hard power is more effective if it is coordinated among states whose residents have dominating market presence.29

TRNs, quasi-TRNs, international organizations with TRN characteristics, and states themselves operate in an interrelated fashion. Obviously they do not all come into play, or come into play in the same way, with respect to every issue of global governance. However, those that do come into play with respect to a particular regulatory issue will bring along their different characteristics (along with their different pluses and minus) to the process. Each will influence each other, and of course, the final result.

D. Global Standards and Offshore Centers: An Overview of a System in Action

This Article will analyze how offshore centers, certain TRNs, quasi-TRNs, international organizations with TRN characteristics, and states themselves interacted over claims that offshore centers30 had failed to comply with certain income tax and financial regulatory and anti-money laundering standards. The Article argues that this particular system can be seen as an organic whole and that it is the presence of certain key characteristics within the system that had a significant effect on the system’s operation. The Article notes that the coordinated application of the hard power by local tax officials and regulators—applied to local residents when conducting business through ‘non-complying’ offshore centers—played an essential role in the system’s operation. The Article argues that the IMF, with its blend of key TRN and certain key non-TRN characteristics, played an important role in legitimating such coordinated action among domestic regulators in the case of financial and anti-money laundering standards. It also argues that the IMF played an important role in restraining the application of local power in the case of income tax ‘standards,’ thereby helping ensure that OFCs were treated more fairly by the system than they would have otherwise have been. Because of the important role played by the IMF the Article will focus on the period leading to end of the first round of IMF assessments of offshore centers in 2004. Following discussion of this initial period, the Article will briefly note a number of key developments up to the present time.

The evolution of the global response to allegations that offshore centers were poor global fiscal and regulatory citizens involves every element of the complex interrelationship of TRNs, quasi-TRNs, international organizations with TRN characteristics, and states. The bad news is

29 Another reason that onshore jurisdictions may have sought a coordinated response may have been to prevent anyone from receiving a competitive advantage by using OFCs to escape domestic tax or regulatory costs. Once the OFC’s allegedly noxious activities were shut down no one’s residents could benefit by using them.
30 There are a number of different ways of defining what constitutes offshore financial center. Ahmed Zoromé, in his paper Concept of Offshore Financial Centers: In Search of an Operational Definition (IMF 2007), available at http://www.imf.org/external/pubs/ft/wp/2007/wp0787.pdf, notes the primarily orientation of business toward nonresidents, favorable regulatory environment, low-or zero-taxation scheme, disproportion between the size of the financial sector and the domestic financing needs, dealings in currencies that are not the currency of the country where the center is located, offshore banking activity is essentially entrepôt business, and centers separated from major regulating units (states). Id at 5. Because this chapter is concerned primarily with the OECD’s harmful tax practices project, the IMFs Offshore Financial Center assessment project, and the FATF’s Non-Cooperating Countries and Territories Project, it will refer to the key traits and lists of jurisdictions used in those programs. See Appendix.
that the factual details of that interaction are not always easy to tease out and analyze. The basic themes of the story are not so difficult to understand. Governments of a number of the world’s largest onshore jurisdictions, all developed economies with significant financial sectors and relatively high levels of income taxation have been trying to rein in the activities of offshore financial centers for a long time.\textsuperscript{31} Onshore countries focused on three financial areas where they claimed offshore jurisdictions were acting improperly: income taxation, prudential financial regulation, and anti-money laundering and terrorism financing regulation. Beginning in early 1990s these onshore jurisdictions began significantly to increase their criticisms.\textsuperscript{32} Their tactics evolved, in part by bringing individually ever more collective pressure to bear on OFCs through a combination of state-sponsored carrots and sticks, then collectively through the European Union and organizations like the G-7. When this failed, these states worked though the OECD (which, as noted above, share at least some attributes with TRNs), the FATF (which, also as noted, has more of the attributes of a TRN) and the IMF (which, as noted, has some TRN attributes as well as other attributes that might make up for TRN failings). The Basel Committee (and to a lesser extent the IAIS and IOSCO, the insurance and securities analogues to the Basel Committee) also became involved. In one sense, the OECD, the FATF, and the Basel Committee exercised only the ‘soft power’ of trying to persuade local tax authorities, financial regulators, and law enforcement (and, where statutory changes were required, legislators) that their standards actually were the best practices. Of course, domestic regulators were free to apply (or threaten to apply) hard power over their own residents who did business with OFCs that did not comply with such standards, including those OFCs deemed to be non-complying by the TRN or quasi-TRN. By doing so, local authorities would constrain the business dealings of residents with non-complying OFCs, thereby putting pressure on OFCs through the operation of the market. Of course, this is exactly what they did.

In the case of income taxation, states worked primarily through the OECD, which had as part of its formal mandate matters relating to taxation and which claimed significant technical expertise, through both its own staff and the staff of its member states. However, for various reasons both ideological and political, the OECD had not been able to develop a generally accepted technical standard for income taxation. Instead, the OECD developed a kind of \textit{ad hoc} set of non-standards that were most favorable to its members. Neither the OECD’s ‘standards’ nor its method of assessing compliance was viewed by OFCs (and many popular and academic commentators) as legitimate. The threatened application by the OECD and its members of collective hard power through imposition of domestic action against residents was roundly criticized. OECD members sought to involve the IMF, at least in part because its near universal membership and technically expert and independent staff might make up for the OECD’s legitimacy deficit. For various reasons, the IMF declined to become involved. Through a process of negotiation, offshore centers wound up meeting most OECD demands more than halfway.

The case of banking supervision was the closest to the new paradigm of TRNs establishing standards and using soft power to implement them. The Basel Committee on Banking Supervision was dominated by the regulatory agencies of a number of large onshore

\textsuperscript{31}Some commentators have referred to OFCs as “object states.” See Benjamin Hartman, \textit{Coercing Cooperation from Offshore Centers: Identity and Coincidence of International Obligations Against Money Laundering and Harmful Tax Competition}, 24 B.C. Int’l & Comp. L. Rev. 253, 258-259 (2001) (discussing how G-7 countries have used sanctions to force compliance by smaller, mainly offshore centers with anti-money laundering and tax standards).

\textsuperscript{32}Other commentators have referred to these as “subject states.” \textit{Id.} at 259-261.
jurisdictions, but the standards adopted were accepted as largely technical and expert in nature. Nevertheless there was no independent review body, either to review the standards themselves or to monitor implementation. The onshore states turned to the IMF to review the standards and to assess compliance. The IMF assessment process demonstrated that most OFCs actually were complying with the standards, thereby helping protect OFCs from any threatened application of hard power by domestic regulators.

In the case of money laundering and terrorism financing, states worked primarily through the FATF. While less overtly political than the OECD, the FATF still suffered from domination of large states—even though representation at the FATF was through various sub-state units. These sub-state units were able to bring considerable expertise to the FATF’s development of anti-money laundering standards, and as a result they were viewed as being largely technical in nature. However, the fact those onshore states had more to gain from the adoption of the standards than offshore jurisdictions adversely affected acceptance by OFCs. Also, the absence of an independent body to review the standards or to monitor implementation was a far greater problem with the anti-money laundering standards than the banking supervisory standards. Nevertheless, member states proceeded to use hard power of domestic regulators against those the FATF concluded were not complying with the standard. The result was significant criticism by non-FATF member states and other commentators. Onshore centers then prevailed upon the IMF to become involved, resulting in an IMF review and assessment process that had far greater legitimacy and, perhaps, accuracy. The IMF assessment demonstrated that most OFCs actually were complying with the standards, which helped protect OFCs from the threatened application of hard power by domestic regulators.

This Article will now turn to a detailed analysis of what happened and conclude with observations as to how the TRNs, quasi-TRNs, international organizations with TRN characteristics, and states themselves operated to influence fiscal and financial regulatory changes. Based on this analysis, this article concludes with some additions and modifications to the current scholarship on TRNs and some observations on the basic question of how standards are used and abused in the application of international rules.

II. THE SYSTEM IN ACTION: OFCs AND INCOME TAXATION, PRUDENTIAL REGULATION, AND MONEY LAUNDERING

A. Overview

At its heart, the complaint that onshore jurisdictions had with offshore centers was that the latter provided a willing sanctuary for tax evasion, poor financial regulation, and money laundering by onshore residents. Onshore centers couched these complaints in terms of both domestic damage (the onshore centers themselves suffered, though not the OFCs) and universal damage (all jurisdictions suffered, including OFCs). There was, however, no generally accepted international legal framework to address the causes of the alleged damages.

Onshore centers claimed that the taxes and financial regulations that OFCs assisted in avoiding were, while costly, necessary to protect the welfare of their own citizens. By allowing some residents to escape from their grasp, offshore financial centers handed out tickets for a free ride in exchange for the financial benefits of handling the onshore resident’s business. Also, by allowing onshore residents to circumvent prudential regulations, offshore financial centers threaten the safety and soundness of all financial systems. And by allowing onshore residents to
circumvent anti-money laundering (and later terrorism financing policies), OFCs were also enablers of both serious and often violent crime and terrorism both at home and abroad.33

While the complaint against these three OFC behaviors developed over a more or less similar time period (from the late 1970s to the present) each did not develop exactly at the same time—and over the period in question they often had a different relative importance.

B. Income Tax

1. The Basic Indictment.34—There is little question that, at least early on, most offshore centers (as well as some onshore centers)35 offered onshore residents an opportunity to evade taxes on income from capital by neither levying tax on income from non-resident capital investments nor reporting such income to resident countries. In effect, these offshore tax havens invited onshore taxpayers to shift their capital investments from onshore financial intermediaries to tax haven-based intermediaries.

The central aspect of this arrangement is relatively simple: while the residence onshore jurisdiction levies a positive tax rate on the financial intermediary and the income it pays to the foreign resident, the tax haven levies low or no tax on that income.36 None of this would be a problem if the tax haven were to disclose to the residence onshore jurisdiction tax authorities when their taxpayer had earned income in the tax haven; at such a point the residence authorities could insist that it be included as income. When a domestic financial intermediary makes such a payment it must report the income, making it difficult for the resident to exclude the income

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33 Onshore jurisdictions had raised a number of other more minor complaints such as protecting assets from judicial attachment or seizure in non-criminal cases such as civil judgments.

34 This short section is a summary and, in some cases a reorganization, of arguments on tax havens and harmful tax practices. The arguments began very early. See generally RICHARD A. GORDON, TAX HAVENS AND THEIR USES BY UNITED STATES TAXPAYERS: AN OVERVIEW (U.S. Treasury 1981), available at http://www.jstor.org/stable/view/1143111?seq=2 (not the author of this article) and OECD, INTERNATIONAL TAX AVOIDANCE AND EVASION, FOUR RELATED STUDIES 14-16 (1987). The G-7 stated their concern over “Tax schemes aimed at attracting financial and other geographically mobile activities [that] can create harmful tax competition between States, carrying risks of distorting trade and investment and [leading] to the erosion of national tax bases.” Communiqué, Economic Summit, Lyon, France - Group of Seven G-7 (June 1996), available at http://findarticles.com/p/articles/mi_m1584/is_nSUPP-2_v7ai_18777690. They were later developed by the OECD in HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 19-25 (OECD 1998), available at http://www.oecd.org/dataoecd/33/0/1904176.pdf.


36 The financial intermediary can also shift income to it from its US operations through the use of favorable transfer pricing.
from her or his tax return. However, tax havens did not provide such payment information to the foreign jurisdiction, in part because they did not collect such information themselves. By undertaking what was later termed ‘harmful tax practices’ the offshore financial center in effect allowed the foreign resident to evade onshore taxes due on that income.

Because offshore financial center tax havens had no significant domestic economic activity beyond basic financial intermediation and therefore little need for local investment, the capital is then on-lent somewhere else, typically back into the resident’s country or some other onshore country. In other words, according to the onshore jurisdictions the tax haven-based financial intermediary played no real economic role other than to permit tax evasion.

2. The System in Action.—Serious concern over the use of tax havens by U.S. citizens began in 1979 when the Oversight Subcommittee of the U.S. House Ways and Means Committee held hearings, which focused primarily on Caribbean OFCs. Two years later Richard A. Gordon, then an analyst with the U.S. Treasury Department, completed a report for the U.S. Treasury entitled Tax Havens and their Uses by United States Taxpayers. In the three years following the publication of the Gordon Report the U.S. Congress held a series of additional hearings on tax haven ‘abuse’ (which also included a short discussion of tax havens’ role in money laundering). The U.S. Treasury focused on preventing tax haven abuse thorough the exchange of taxpayer information. In 1983 President Ronald Reagan signed into law the Caribbean Basin Economic Recovery Act, which provided jurisdictions (many of which were offshore centers) that agreed to an information-exchange agreement with the U.S. some economic benefits. More importantly, in 1984 the Tax Reform Act authorized the government to deny a general exemption of withholding tax on portfolio interest paid to any person within a jurisdiction that did not provide the U.S. sufficient information to prevent evasion of U.S. income tax by U.S. persons. In addition, the U.S. refused to conclude tax treaties with jurisdictions that did not include exchange of information agreements (tax treaties provide some key carrots, such as a lower withholding tax rate on payments to non-residents).

While some progress was made in information exchange agreements over the next ten years most of the key offshore centers did not sign on. In addition, some offshore centers that did agree to enter into information exchange agreements were less than forthcoming in implementing those agreements. Also, there was a fundamental problem with relying solely on requests for information on particular U.S. taxpayers to prevent U.S. persons in general from using a tax haven to avoid U.S. tax: the U.S. tax authorities would not, ab initio, know what information to request. What would be far better, from the U.S. point of view, would be if tax havens charged a positive rate of tax and/or if they made it more difficult for U.S. taxpayers using the tax haven as a ‘residence’ to hide the fact that they were in fact U.S. persons.

There were good reasons why offshore centers neither levied income taxes on U.S. residents nor frequently on their own residents. First, because offshore centers were essentially

37 This includes both income actually received as interest, a dividend, partnership share etc., and income that is deemed to have been earned by the taxpayer even if not yet received. An important type of deemed received income is income from capital that is easily shifted into low or no tax jurisdictions. By deeming the income received, the taxpayer cannot benefit from deferring U.S. tax until the date the income is actually received.


39 Not the author of this Article.

40 See GORDON, TAX HAVENS AND THEIR USES, supra note ___.

41 The U.S. also exerted at least some diplomatic pressure on tax havens through the informal application of other carrots such as trade benefits, visa requirements, etc.
transit points for capital flowing from one onshore jurisdiction to another, little or no income on
that capital had an economic source in the offshore center itself. This meant that there were good
theoretical reasons not to tax flows of income from capital in the offshore center.\(^\text{42}\) Next, because
the vast majority of offshore centers were quite small and produced few goods domestically
(many were islands with little or no domestic industry) most goods were imported. These
jurisdictions concluded that it was administratively easier to raise needed government revenue
through taxes levied on imports than taxes levied on income. There were also reasons based in
economic theory to conclude that indirect taxes were preferable to income taxes. In fact, there
was already a general consensus among many economists that taxes on income from capital were
undesirable due to the disincentive effects on savings.\(^\text{43}\) There were also good reasons why
offshore centers did not wish to act as a reporting agent for the U.S. tax authorities. Such
reporting would be expensive, particularly so given that most offshore centers had no income tax
themselves and therefore had no pre-existing infrastructure for reporting. Finally, implementing
an income tax and/or reporting income earned by non-residents to their tax authority would have
the effect of benefiting foreign jurisdictions without creating a domestic benefit; in fact, the costs
born locally, including the loss of business, might be considerable.

Throughout the 1980s the U.S. had raised the problem of tax haven ‘abuse’ with other
major onshore jurisdictions, a number of which had also expressed considerable concern,
especially France and to a somewhat lesser extent Germany and the United Kingdom (U.K.
loyalties were somewhat divided, in that a significant number of the tax havens were also
overseas territories of the U.K.)\(^\text{44}\) During this period representatives of these countries also
raised the issue at meetings of the G-7 (and later G-8).

The larger on-shore jurisdictions then turned to the Organization for Economic Co-
operation and Development. The OECD was (and is) an international organization created by
treaty that limits membership (largely) to developed countries. While membership has been
increasing at the time it included the European Union members plus Iceland, Norway, Sweden,
the United States, Canada, Japan, and Turkey. The purposes of the OECD as expressed in its
founding convention included the promotion of policies designed to achieve economic growth
and fiscal stability;\(^\text{45}\) the OECD’s primary role was to carry out relevant studies and act as a
forum where members could “co-operate closely and \emph{where appropriate take coordinated action}
(emphasis added).”\(^\text{46}\) Much of the OECD’s prior work involving taxation had focused on
developing model double taxation conventions, including a draft convention on exchange of

\(^{42}\) Officials from a number of offshore centers argued to IMF staff members argued that because they were neither
source nor resident jurisdictions they had no reason to tax cash flows ‘passing through us.’ For an overview of
international tax theory see Michael J. Graetz, Foundations of International Income Taxation (2003) (\emph{inter alia},
describing the economic and administrative foundations for taxation of income in source and residence
jurisdictions).

\(^{43}\) Although there are many other reasons for favoring an income tax, including the ability to tax wealthy persons,
who have less marginal utility in each additional currency unit earned, at higher effective rates than less wealthy
Disagreements over these two views helped inform the different attitudes towards tax havens expressed by the
Democratic Administration of President William Clinton and the Republican Administration of George W. Bush.
This is discussed at greater length infra.

\(^{44}\) This issue is discussed at greater length infra at ___.

\(^{45}\) Convention on the Organisation for Economic Co-operation and Development, Arts. 1 and 2, available at
http://www.oecd.org/document/7/0,3343,en_2649_34483_1915847_1_1_1_1,00.html.

\(^{46}\) Id. at Art. 3 c.
taxpayer information.\textsuperscript{47} Now, the United States and France (and to a slightly lesser extent Germany and Japan) called on the OECD to study the effect of tax havens.

In 1987 the OECD published a key study on tax havens\textsuperscript{48} that in many ways mirrored the conclusions of the Gordon Report. The OECD Study, prepared by staff from member treasury departments/finance ministries (and with participation of outside consultants) also focused on the importance of exchange of information, especially with respect to bank records, and the problems of shell companies whose beneficial owner and controller could not be easily identified (noting, incidentally, that this ‘lack of transparency’ also created opportunities for money laundering).\textsuperscript{49} The study proposed that tax treaty benefits not be extended to jurisdictions that did not provide adequate information exchange, as well as other counter-measures reminiscent of those proposed in the U.S. in 1984.

Beginning in the mid-1980s (but continuing through the 1990s) the larger onshore jurisdictions attempted to involve the International Monetary Fund in analyzing and criticizing offshore center income tax policies. Under the IMF’s Articles of Agreement members are obligated to direct their ‘economic and financial policies’ toward the objective of fostering orderly economic growth and underlying economic and financial conditions; the Articles also give the IMF the jurisdiction to exercise surveillance over these policies,\textsuperscript{50} which they do by writing and discussing (mostly) annual reports on each member’s economies.\textsuperscript{51} The Articles also allow the Fund to provide financial assistance to member countries that are experiencing balance of payments problems with conditions on the loans that would not only help resolve the problems but that would make it more likely that the loans would be repaid.\textsuperscript{52} Finally, the Articles allowed the Fund to provide technical assistance to members (and others) providing that the assistance is consistent with the purposes of the Fund.\textsuperscript{53}

Given the importance of taxation to each of these three areas it is not surprising that the Fund has a long tradition of attending to tax matters when conducting surveillance, designing conditions for the use of Fund financial resources, and providing technical assistance.\textsuperscript{54} The onshore jurisdictions intimated that they would like the Fund to support anti-tax haven activities thought its surveillance, conditionality, and technical assistance.

However, with respect to the first two—surveillance and conditionality—the IMF (meaning the Executive Board, management, and staff)\textsuperscript{55} concluded that its jurisdiction lay

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{47} Information on the OECD and its activities past and present can be found at its website, available at http://www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html.
\item \textsuperscript{48} OECD, INTERNATIONAL TAX AVOIDANCE, \textit{supra} note \underline{\ldots}.
\item \textsuperscript{49} \textit{Id.} at 45.
\item \textsuperscript{52} Art. V Section 3, Articles of Agreement, \textit{supra} note \underline{\ldots}. \textit{See IMF Conditionality, A Factsheet, available at http://www.imf.org/external/np/exr/facts/conditio.htm.}
\item \textsuperscript{54} There is an enormous amount of material on the Fund’s activities with respect to each of these three areas of activity. Surveillance reports, country reports on the use of Fund resources (including reviews of country performance resulting in disbursement of funds to the borrowing member) and reports on Fund technical assistance are now available on the Fund’s website, available at http://www.imf.org/external/pubind.htm.
\item \textsuperscript{55} The governance of the IMF is discussed at greater length \textit{infra} at pp. \underline{\ldots}.
\end{itemize}
\end{footnotesize}
uniquely in how a particular member’s tax policies affected its own economic and fiscal well-being. The issue of the effects of a member’s tax policies on the economic or fiscal well-being of other members was not. With respect to tax technical assistance, which at the time was strictly voluntary the question of external implications of domestic tax policy was generally not raised. Had it been, the effects of such voluntary Fund-to-jurisdiction advice on curbing OFC’s so-called harmful tax practices would have been, at best, trivial.  

There are a number of reasons as to why the Fund as an institution concluded that it had no jurisdiction to become involved in the harmful tax practices project. Although the actual evidence is sketchy and largely anecdotal it appears that the political concerns of a number of key Executive Board members was important—though probably not determinative. The IMF Board consists of twenty-four members: the five IMF members with the greatest voting power, the United States, Japan Germany, the United Kingdom, and France. Each selects an Executive Board member directly, while other IMF members elect Board members from self-organized constituencies. The United Kingdom was one of the onshore jurisdictions expressing concern over the harmful tax practices of offshore centers, albeit with less energy and conviction that the United States or France. As such, the UK was primarily representing the concerns of the U.K. Treasury. However, at the IMF the U.K. also represents the interests of the British Overseas Territories and Crown Dependencies because they were, for Fund purposes, part of the United Kingdom. Of these, Anguilla, Bermuda, the British Virgin Islands, Cayman Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Montserrat, and the Turks and Caicos Islands were offshore centers that were allegedly engaging in harmful tax practices. These U.K. territories and dependencies had jurisdiction over their own domestic tax policies they were not under the control of the U.K. Treasury. This created a tension between the U.K.’s more limited domestic interests as expressed through their concern over harmful tax practices and the UK’s broader ‘imperial’ interests expressed through their need to represent the interests of overseas territories and crown dependencies at the IMF.

Another member of the IMF Board with divided loyalties was Canada. Canada, a G-7 member country since 1976, lead an elective IMF Executive Board constituency that included the independent Commonwealth countries of Antigua and Barbuda, Bahamas, Barbados, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, each of which was also an offshore financial center with ‘suspect’ tax practices. The Canadian chair (which also represented Ireland and Jamaica) was well known for actively representing the interests of the members of its constituency.

Also important was the view of the IMF management and staff, as articulated by the Legal Department in a number of un-published memoranda, that there was nothing in the IMF Articles of Agreement that created any membership obligation that a member should take action to benefit another member—at their own expense. This would mean that jurisdictions engaging in tax practices had on tax systems of other countries and speculated that those countries could force a change in the tax policies of tax havens by a concerted levying of significant withholding tax on all payments to such havens and levying significant tax on all payments from them. See Vito Tanzi, Globalization, Tax Competition, and the Future of Tax Systems (1996). However, such a critique was not integrated into the Fund’s surveillance or conditionality.

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56 All but five offshore centers (Andorra, Monaco, Liechtenstein, Tuvalu, and Nauru) are either members of the IMF either directly or as an overseas territory, dependency, special administrative area, etc. of a member.
57 During the early 90s Vito Tanzi, the then head of the Fiscal Affairs Department, began to criticize the adverse effects that tax havens had on tax systems of other countries and speculated that those countries could force a change in the tax policies of tax havens by a concerted levying of significant withholding tax on all payments to such havens and levying significant tax on all payments from them. See Vito Tanzi, Globalization, Tax Competition, and the Future of Tax Systems (1996). However, such a critique was not integrated into the Fund’s surveillance or conditionality.
58 One of which was written by the author in the form of a legal opinion and, while endorsed by the General Counsel, was not publically released.
in allegedly harmful tax practices would only be counseled to adjust those practices if they were harmful to the jurisdiction itself rather than to other members. As this was not the problem the Fund could not be expected to conclude that the choice of offshore jurisdictions to adopt domestic tax policies that caused harm to other members (by undermining the income tax base of other jurisdictions) was somehow in breach some kind of Fund obligation. This principle of ‘no obligation to sacrifice for another member’ applied particularly well for tax matters, in that there was no other international law that recognized any principle of international tax comity, i.e. that the courts (and administrative agencies) of one country should enforce the revenue laws of another country except on the basis of reciprocity.

Following the election of President Bill Clinton and the (re) appointment of Donald Lubick to the position of Assistant Secretary of the Treasury for Tax Policy the United States began to advance a more aggressive policy to moderate so-called harmful tax practices. Concluding that a coordinated approach would be more effective, the U.S. and France (in particular) worked with the remaining five members of the G-7 to mobilize the OECD to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases” and report back to the G-7 1998.

A problem with such a coordinated approach was that a number of OECD jurisdictions were themselves offshore centers and guilty of the same behavior. For example, Luxembourg and Switzerland whose low or no tax on income from capital tax and strict bank secrecy made them key offshore centers. Nevertheless, the OECD as an organization duly issued a report entitled Harmful Tax Competition: An Emerging Global Issue. Among other things the report called for the OECD to develop a list of uncooperative tax havens and “a number of Recommendations for action at the level of national legislation and in tax treaties.” The report also noted that “[c]ountries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so (emphasis added),” later noting that while there was nothing inherently wrong with countries “that are able to finance their public services with no or nominal income taxes” those that “offer themselves as places to be used by non-residents to escape [income] tax in their country of residence” were in breach of accepted standards of behavior.” Nevertheless, the Report listed a number of “key factors” in identifying “harmful preferential tax regimes,” i.e. breaches of accepted standards: (1) the regime imposes

59 Assistant Secretary Lubick had held the same position under President Jimmy Carter.
60 Id. at 9.
61 Id. at 15.
62 At the time of the drafting Report there was much discussion about how the success of the modern welfare state depended on effective taxation of income from capital, and that tax havens, by permitting avoidance or evasion of that tax, were therefore endangering the welfare state. See generally Reuven S. Avi-Yonah, Globalization, Tax competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000) (arguing that tax havens allow large amounts of income from capital to go untaxed depriving countries of revenue and forcing them to rely on forms of taxation less progressive than the income tax, threatening the welfare state).
low or no taxes on the relevant income (from geographically mobile financial and other service activities); (2) the regime is “ring-fenced” from the domestic economy (meaning that there is a domestic income tax, but that non-resident taxpayers are exempt income) (3) the regime lacks transparency, e.g. the details of the regime or its application are not apparent or there is inadequate regulatory supervision or financial disclosure; and (4) there is no effective exchange of information with respect to the regime.  

The Report discussed how many OECD members continued to act as tax havens, but chose to leave these members out of consideration and instead to restrict its list to offshore centers. Not surprisingly, the fact that OECD member would not be subject to the harmful tax practices project became a major criticism by project opponents.  

During the 1990s the European Union also began the process of addressing the more specific problem of tax evasion on savings income when an individual resident of one E.U. member country held an account in a financial institution in another E.U. member country whose tax authority did not withhold tax on interest paid to the non-resident and or the reporting of the payment of that interest to the resident jurisdiction’s tax authority. The process of negotiation was long and difficult, focusing eventually on the objections of EU tax havens.  

Another major problem for the OECD was identifying internationally accepted standards of income tax behavior. As the Report correctly noted, there was no generally accepted standard that countries have an income tax, or more specifically, a tax on income from capital. As argued earlier by OFCs, it was problematic at the least to argue that jurisdictions should be compelled to enforce a tax on the income from capital of their non-residents, especially given no international standard and no international rule of tax comity.  

The OECD’s next Report, issued in 2000, appeared to accept some of the arguments raised against the harmful tax practices project. While the Report restated the four “key factors” it noted at the beginning that the project was “not primarily about collecting taxes” or “promot[ing] the harmonisation of income taxes” or “dictating to any country what should be the appropriate level of tax rates.” Rather, the project is about “ensuring that the burden of taxation is fairly shared and that tax should not be the dominant factor in making capital allocation decisions…. The project will, by promoting a co-operative framework, support the effective fiscal sovereignty of countries over the design of their tax systems (emphasis added).  

There are many obvious problems and contradictions with this short statement. The project apparently is about collecting taxes in cases where there is no harmonization of tax rates; tax havens, by making it possible to reduce or eliminate tax on income from capital regardless of where the investment is actually located, actually ensures that tax is no factor in making capital allocation decisions; and effective implementation of the project will (they hope) result in offshore centers and other tax havens in changing the design of their tax systems. One can almost pity the OECD. They outline the ideological reason why there is no generally accepted standard, then pretend that they have one that works.

66 Id.
67 See Shorman, Havens in a Storm, supra note ___ at 44-5.
70 Id. at 5.
The Report also compiled a preliminary list of tax havens from which a list of ‘uncooperative’ tax havens was to be distilled over the next twelve months. The Report concluded that in order to avoid inclusion on the list of ‘Uncooperative Tax Havens’ the jurisdiction would have to make a public political commitment to adopt a schedule of progressive changes to eliminate its harmful tax practices (i.e. the four key factors) by the end of 2005.\footnote{Id. at 17-19.} The OECD also laid out a plan of dialogue with so-called ‘cooperative’ jurisdictions.\footnote{Id. at 20-21.} It was also around this time that the Financial Stability Forum (another quasi-TRN, to be discussed at greater length \emph{infra}) released its Group III list of jurisdictions that had the most problematic financial supervisory systems.\footnote{Discussed \emph{infra} at \underline{\hspace{1cm}}.} Twenty five offshore centers were included in this list, including nearly all those on the OECD tax haven list.

Not long after the release of the Report then Secretary of the U.S. Treasury Lawrence Summers issued a statement to the International Monetary and Fiscal Committee of the IMF calling ‘abuse of the global financial system’ a ‘global fiscal bad’ and called on the IMF and the World Bank to prepare a joint report on their roles in protecting the integrity of the financial system against abuse.\footnote{Statement by Treasury Secretary Lawrence H. Summers to the International Monetary and Finance Committee Prague, Czech Republic, September 24, 2000, \textit{available} at http://www.imf.org/external/am/2000/imfc/eng/usa.htm} The statement was issued as the IMF was implementing its Financial Sector Assessment program and Offshore Financial Center assessment program (both to be \emph{discussed at greater length \emph{infra}}). Some IMF senior staff involved assumed that the statement might have been directed, at least in part, towards the possibility of including harmful tax practices as a subject for assessment under those two programs.

While Secretary Summers specifically mentioned money laundering in his statement, staff prepared a background paper examining financial system abuse as broadly defined, including tax evasion.\footnote{Id. at 19.} The paper also discussed the OECD’s harmful tax practices project and its progress.\footnote{Id. at 19.} A number of IMF Executive Directors spoke with IMF Management and the staff involved in drafting the background paper and made it clear that they opposed any IMF involvement in the harmful tax practices project, in part because the Fund should not be involved in any program that was not ‘voluntary’ or that was ‘coercive.’ The next staff paper (co-authored with World Bank staff) deleted any discussion of harmful tax practices and focused exclusively on money laundering.\footnote{IMF AND WORLD BANK, \textit{Enhancing Contributions to Combating Money Laundering: Policy Paper} (2001), \textit{available} at http://www.imf.org/external/np/ml/2001/eng/042601.PDF.}

The next Report, released in early 2001, included both a list of uncooperative jurisdictions (to be updated by the OECD) for the purpose of coordinating the application of the so-called “defensive measures.” They were actually quite straightforward. They would disallow normally available deductions, exemptions, allowances, credits, as well as apply withholding taxes and increase audits, relating to transactions with residents or entities in the uncooperative jurisdictions.\footnote{Id. at 25.}
While roundly described as the exercise of hard power ‘sanctions’ and criticized as an improper application of financial force by the powerful against the weak, what the OECD also termed ‘countermeasures’ turned out to be primarily an exercise of purely domestic sovereignty by OECD members. They would have affected only the tax liabilities of physical or legal persons resident in the onshore domestic jurisdiction (or the flow of income passing through them to non-residents.) None of the measures proposed would have required an OFC to collect taxes and remit them to an onshore jurisdiction; nor did the onshore jurisdictions threaten to withhold financial or other assistance. In effect, local tax authorities would withhold tax benefits from their own residents when they engaged in activities with tax havens.

Nor did the countermeasures breech any generally accepted international obligation. While such an obligation could arise from a double taxation convention (or possibly a bilateral investment treaty) no such treaties were affected; even if they were, such treaties permit parties unilaterally to withdraw after a notice period. One possible problem was that the deductions, exemptions, credits, to be disallowed (or the reduction or elimination of withholding taxes to be foregone) were international income tax principles generally accepted by countries with income taxes, and certainly by the major onshore jurisdictions. Assuming a tax on income from capital, there are good reasons for the acceptance of these principles, which have been enshrined in the laws of most OECD countries and in the OECD Model Double Taxation Convention. In effect, the anti-tax haven OECD members were saying ‘help us enforce our income taxes on our own people or we will adopt different tax rules when our taxpayers engage in transactions with your taxpayers.’ The threatened countermeasures may have been significant but they were not illegal under international law or custom.

What the countermeasures would do if applied was increase the tax owed by the onshore jurisdiction, i.e. the one over which the onshore country actually had jurisdiction. Increasing that person’s taxes would reduce after tax income, which would reduce the ultimate profitability of that person. That would act a serious disincentive for that person to conduct business with a person located in a blacklisted jurisdiction. That in turn would create a competitive pressure on the offshore jurisdiction to change its rules so that it was no longer blacklisted. This would be the exercise of hard power, but one that was applied to the OFC only indirectly, through the onshore resident party and through the operation of the market.

These countermeasures, however, were offered as part of a concerted effort by OECD members to change how OFCs operated. They came in the form of OECD assessments (not those of neutral parties) and of blacklisting by the OECD (same problem), followed by a concerted application of countermeasures by each local state (acting through its revenue authority). This greatly exacerbated the negative reactions that followed. The OECD program.

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79 See infra at ___ and sources cited.
81 See further discussion in Hartman, Coercing Cooperation from Offshore Centers, supra note ___ at 279-281.
83 Increasing the withholding tax on dividends or interest paid to a non-resident located in an OFC could, at least in theory, be suffered by the offshore resident. However, the offshore resident would not be the actual taxpayer, in that tax is withheld at source, i.e. by the onshore resident. In other words, the effect on the onshore resident would only be indirect.
84 See also the discussion in George Rawlings and Jason Sharma, National Blacklists: A Comparative Analysis, 17 J. OF IN’T TAXATION 38, 47, 64 (2006)
was presented by its opponents as a form of bullying and resulted in immediate protests by officials in those offshore jurisdictions. One complaint was procedural, that the OECD was not a truly representative forum but one dominated by wealthy onshore jurisdictions that essentially ignored all principles of due process. The Secretary General of the Commonwealth, which includes nearly all of the listed English-speaking tax havens, referred to the OECD as “prosecutor, judge, jury, and jailor.” 85 Another was simply that the OECD, by imposing domestic tax policies on small offshore jurisdictions was practicing “economic imperialism” and discriminating against “small states.” 86 Predictably, the most vocal and effective complaints were that the OECD’s ‘defensive countermeasures’ were actually coercive sanctions, in effect the illegitimate application of hard power by the rich and powerful against the small and weak. 87

There was some agreement with this view in the popular press, among economists and think-tanks, and in academia. 88 In effect, the offshore centers adopted what turned out to be a powerful rhetorical argument that the larger onshore centers were trying to impose ‘standards’ that were neither internationally accepted nor even applicable to some of their own members. 89

There is one other highly relevant point: OECD harmful tax practices program was being carried out almost exactly simultaneously with the FATF’s non-cooperating countries and territories initiative, and there was a significant overlap between the two blacklists. 90 One major complaint was that the two issues were being conflated and confused by the press and the public. 91 As this article will discuss infra many of the complaints voiced by these offshore centers with respect to the tax practices program were the same as those voiced about the NCCT initiative.

The OECD appeared to be caught somewhat unawares by the fierce nature of the reaction against the harmful tax practices project. Starting in the spring of 2001 the OECD held regional face-to-face meetings with officials from the listed countries in an attempt to negotiate agreements. 92 But it was at this time that the replacement of the Clinton with the Bush administration resulted in a serious shifting of gears.

Even during the Clinton administration many conservative Republicans had opposed income taxes in general for ideological reasons while others opposed the OECD’s actions as breach of international sovereignty. There had been little support among Republicans in the

86 Statements by the governments of Vanuatu and of Palau, quoted in Id. at 259.
88 See e.g. Benjamin R. Hartman, Coercing Cooperation from Offshore Financial Centers: Identify and Coincidence of International Obligations Against Money Laundering and Harmful Tax Competition, 24 B.C. INT’L & COMP. L. REV. 253 (2002) (arguing that countermeasures are in fact sanctions as a remedy for a breach of international obligations, but that because there are no such obligations with respect to tax the sanctions are illegitimate) and James, Twenty-First Century Pirates of the Caribbean, supra note ___ at 5, “The OECD, like pirates who plied the waters of the Caribbean during the sixteenth through nineteenth centuries, has, through its ill-advised anti-harmful tax competition initiative, effectively robbed fourteen CARICOM nations of their sovereign right to determine their tax and economic policies.”
89 JASON SHARMAN, HAVENS IN A STORM, supra note ___ at 71, 101-48.
90 See Table 1 supra at page ___.
91 Van Fossen, Money Laundering, Global Financial Instability, supra note ___ at 260.
92 See discussion in id. at 259-60.
House and Senate for the OECD initiative; Richard Armey, the House majority leader, even called the OECD "a global network of tax police." According to some press reports (and private discussions with administration officials) Lawrence Lindsey, then Director of the National Economic Council, and R. Glenn Hubbard, Chairman, President’s Council of Economic Advisers (and incidentally Chairman, Economic Policy Committee, Organization for Economic Cooperation and Development) both had expressed views that the availability of tax havens not only helped keep tax rates in the U.S. down, they actually helped U.S. persons companies compete by reducing tax rates. In June of 2001 Treasury Secretary O’Neill told a meeting at the OECD that the U.S. could no longer support the initiative, at least the way in which it was now being pressed. As news of this development found its way back to the IMF a number of staff concluded that the efforts to involve the Fund in anti-tax haven activities would now be over.

By 2002 many of the objections levied by the OECD had been addressed, and the OECD blacklisted only six jurisdictions. By 2004, only four offshore centers remained on the OECD list, all but one of them located in Europe, and by 2005 none was. One reason for this was the ratcheting down of pressure due to the blow-back by OFCs and the adoption of the ‘negotiation’ strategy; another was the reduction of US concern over the issue. The key, however, was the realization that for OFCs serving as a tax secrecy jurisdiction was simply not in their own best interests. As a result, offshore centers agreed to institute key changes to meet the concerns of onshore jurisdictions more than half way, including to be far more responsive in exchanging information. Another key development was the adoption of the European Savings Tax Directive, which took effect in 2005. The Directive requires E.U. member states automatically to exchange information with each other about customers who earn income on savings in one member but reside in another. In lieu of agreeing to such an information exchange, for a transition period the state may levy a withholding tax providing certain other criteria are met. As part of this process, key offshore centers that were dependencies of EU member states took part. This resulted in greater pressure on other offshore centers to comply so as to avoid the adverse effects of ‘blacklisting’ by domestic revenue authorities, whether urged to do so by the OECD or simply on their own.

That being noted, the onshore centers did not get what they most wanted: the end of no (or low) income taxation or, barring that, the full reporting to onshore centers of all non-resident activities. Because of this an onshore resident could more easily evade income taxes by setting up a company and bank account in an offshore jurisdiction than in a jurisdiction that levied tax. While in cases of suspected tax evasion onshore tax authorities could request, and now receive, information from offshore jurisdictions about those specific taxpayers, those authorities would

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93 Quoted in id at 261.
95 Id. This was also reported to the author by a senior civil servant at the OECD.
96 Outcome, conclusion of the meeting of the OECD Global Forum on Taxation in Berlin (3-4 June 2004), available at http://www.oecd.org/document/5/0,3343,en_2649_33745_31967429_1_1_1_1,00.html.
first have to suspect the evasion. Even if they did, they often would not know what information to request.  

C. Prudential Supervision

1. The Basic Indictment. 100 — Onshore jurisdictions claimed that OFCs destabilized the international financial system by failing to implement prudential regulations, which allowed both offshore institutions and onshore institutions that use offshore facilities to avoid onshore regulations, putting them at greater risk of failure. While all prudentially supervised institutions (banks, insurance, and securities firms) were of concern to the onshore jurisdictions, banks were the primary focus of onshore attention. According to onshore jurisdictions, because OFCs either did not promulgate adequate prudential regulations or implement them effectively through a program of compliance, an OFC-chartered bank could act in ways that would threaten its own soundness. These could include lending in excess of a prescribed capital minimum and failing to control for default and concentration risk. Another allegation was that in granting banking licenses OFC regulators did not vet owners and controllers to see if they were ‘fit and proper,’ which would make poor management and poor compliance with prudential principles less likely. Together, these poor prudential practices would lead to a greater likelihood of the bank failing, resulting in losses by creditors, especially depositors. If other, onshore banks were creditors, this could adversely affect those banks, resulting in a chain reaction of defaults that could endanger the entire international financial system.

There were a few money laundering issues raised in the financial supervisory context as well. The anti-money laundering measures were not prudential in nature in that they did not have as a goal keeping the bank solvent, but because their implementation in onshore jurisdictions was most typically through the financial supervisor or regulator they became part of the ‘poor prudential regulation’ indictment. The most important of these had to do with a requirement to identify the physical person who owned and controlled a particular customer account. 101 Of course, such information was also critical for providing tax-related information to the major onshore centers.

The regulatory arbitrage provided by offshore centers allowed their financial institutions, or at least financial institutions with an offshore presence, to operate more profitably by reducing the costs of regulation, rendering completely onshore institutions less profitable and subject to unfair competition.

2. The System in Action. —Domestic bank supervisors had problems in supervising domestic banks with foreign establishments (i.e., branches and subsidiaries located in foreign jurisdictions) whenever those foreign establishments were domiciled in jurisdictions with strict bank secrecy. Supervisors also had trouble in supervising branches and subsidiaries of foreign banks. Briefly, bank supervisors need the entire bank’s financial information (parent and

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99 For a discussion of the different types of tax evasion opportunities that remain, see generally David Spencer and Jason C. Sharmon, International Tax Cooperation, 18 J.OF IN’T. TAXATION 35 (2008).

100 This short section is a summary and reorganization of arguments presented during the early years of the debate (mid to late 1990s) on offshore financial center and poor financial sector supervision. See Errico and Alberto Musalem, Offshore Banking, note ___ at 1-7, and FINANCIAL STABILITY FORUM, REPORT OF THE WORKING GROUP ON OFFSHORE CENTRES 1-2 (2000), available at http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.

branches/subs) to determine if the bank is heeding prudential regulations. In 1975, the Basel Committee on Banking Supervision102 issued a Report on the importance of the supervision of banks’ foreign establishments in ensuring the safety and soundness of domestic banks,103 whose arguments were extended in a paper in 1979 favoring consolidated supervision of bank’s international activities.104 In 1981, the Basel Committee published a Report noting that banking secrecy can impede the flow of information needed by supervisors.105 While the Report did not single out offshore centers it did note that non-members of the Committee “particularly offshore centers” were in broad agreement.106 The Report was followed by a number of others exploring ways in which supervisors should share information about the activities of banks and their foreign branches and subsidiaries.

Of great importance, the Offshore Group of Banking Supervisors,107 a TRN consisting of regulators in offshore centers, generally agreed to the various proposals to ensure the flow of information among supervisors.108

The bankruptcy of the Bank of Credit and Commerce International (BCCI) in 1991 drew attention to the serious problems that could arise when there was no effective consolidated supervision of banks with foreign operations,109 especially when an offshore center with allegedly lax supervision and ‘excessive’ secrecy like the Cayman Islands was involved.110 The following

102 The Basel Committee was established in 1974 by the central bank governors of the G-10: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the U.K., and the U.S. According to the Committee’s website, “One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate,” available at http://www.bis.org/bcbs/history.htm.
106 Id at 1.
109 Founded in 1972, by 1991 BCCI had over 400 branches in 78 countries. The bank was chartered in Luxembourg, but its treasury and other key functions were based in the Cayman Islands and London before moving to Abu Dhabi. However, Luxembourg did not supervise the bank because it had no operations here; nor did the Cayman Islands or the U.K. exercise consolidated because it was not chartered in those jurisdictions. Regulators in the US and UK as well as other countries were aware of these problems and did try to cooperate with respect to supervision of local operations, but inadequate coordination and sharing of information enabled the bank to avoid effective supervision, allowing them to avoid implementing risk management strategies and to hide the mounting losses as a result. It also allowed the bank to engage in massive fraud and money laundering, among other crimes. When would up, around $13 billion was unaccounted for. There was, in particular, a hue and cry in the UK and the US demanding changes to banking supervision. See generally INQUIRY INTO THE SUPERVISION OF THE BANK OF CREDIT AND COMMERCE INTERNATIONAL (1992) (the Bingham Report), available at http://www.hm-treasury.gov.uk and A REPORT TO THE COMMITTEE ON FOREIGN RELATIONS, UNITED STATES SENATE BY SENATOR JOHN KERRY AND SENATOR HANK BROWN (December 1992) 102d Congress 2d Session Senate, available at http://www.fas.org/irp/congress/1992_rpt/bcci/.
110 According to Senator’s Kerry and Brown, “the Grand Caymans did not regulate any bank licensed there. The Caymans lack of regulation was precisely the inducement for banks to charter themselves there . . . .” Id. at 12reg. This allegation was incorrect in that the Cayman’s did regulate bank and bank branches located there.
year the Basel Committee issued a Report on minimum standards for the supervision of international banking groups.111 The minimum standards include that all international banks be supervised by a home country authority that performs consolidated supervision, that banks and their foreign branches or subsidiaries receive the prior consent of both home country supervisor and host country supervisor, and that home country supervisors have the authority to receive information necessary to conduct consolidated supervision. Finally, if these minimum standards are not met, the report suggested that the host country supervisor either prohibit the establishment of foreign branches/subsidiaries or impose restrictive measures on them.

In other words, hard power could be exercised against resident banks by local regulators. As with the OECD’s tax ‘countermeasures,’ however, the market would ensure that the foreign jurisdiction would also suffer as a result.

While the Report put in place a process of improved cooperation among supervisors from both onshore and offshore jurisdictions, problems remained. In 1995, the Meridien Bank International, which was really two banks, with one registered in Luxembourg (though it did no banking business there) and another, its 74% owner, licensed in the Bahamas, and with operational control of much of its activities located in London, collapsed and was placed into liquidation by the Bahamian Supreme Court.112 As with BCCI, regulators and commentators concluded that the use of complicated cross-border corporate structures allowed the bank to escape effective prudential supervision.113

There was little doubt that both BCCI and Meridien showed effective supervision required better attention to cross-border issues, but it was not clear in either case that offshore centers were to blame for the failure. In both instances supervisory authorities in the U.S. and the U.K. appeared to be at least partially at fault by not taking effective action after noting clear warning signs that the banks were not complying. For example, in the BCCI case much was made of the role played by politicians and lobbyists in fending off appropriate supervisory action.114

At the same time, other banking problems unrelated to these specific cross-border supervisory issues were gaining attention. Because the international community’s eventual response to these issues played such a crucial role in shaping the treatment of OFCs this discussion now turns to the series of crises and near crisis in a number of emerging markets, the most prominent of which were in Asia, had particularly adverse effects on domestic banking systems. These macro-economic crises were largely caused by large external borrowings and significant balance of payments deficits. Many banks had excessive external exposures and foreign exchange risk that resulted in insolvency; had local supervision been better, some argued, these banks would not have been so vulnerable to economic shocks and would have made recovery after the crises faster and less disruptive.115

The first of these shocks was the 1994-5 Mexican Peso Crisis. The first significant emerging market sovereign debt crisis since the Brady restructuring of the Latin debt crises in

112 The bank had an exceptional liquidity crisis, which it was allegedly able to hide from regulators by shifting moneys among its many constituent parts.
114 A REPORT TO THE COMMITTEE ON FOREIGN RELATIONS, supra note ___ at 13clifford.htm.
115 See generally LILIANA ROJAS-SUÁREZ, STEVEN RIESS WEISBROD, FINANCIAL MARKET FRAGILITIES IN LATIN AMERICA: FROM BANKING CRISIS RESOLUTION TO CURRENT POLICY CHALLENGES (IMF 1994).
the late 1980s, the Peso Crisis resulted in significant IMF led-intervention. A key analysis by the IMF of the Peso Crisis suggested that macroeconomic variables largely determine the timing of bank failures it was bank-specific prudential indicators that explained the likelihood of bank failure.

By 1995, the two different issues, the lack of effective consolidated supervision of cross-border banking, and the ineffective domestic supervision in many countries suffering macroeconomic shocks, became conflated. In 1995 the G-7 announced that much more work was needed in creating and implementing appropriate prudential supervisory standards in all countries. Specifically, they stated that closer international cooperation in the regulation and supervision of financial institutions was “essential to safeguard the financial system and prevent an erosion of prudential standards” and called on finance ministers to “commission studies and analysis from the international organizations responsible for banking and securities regulation and report on the adequacy of the arrangements. . . .” In particular, they urged that the IMF and World Bank be involved, but that they “concentrate on their core concerns (macro for IMF and structural and sectoral policies for the Bank). In partial response, a Working Group on Stability in Emerging Market Economies was convened under the sponsorship of the Group of 10.

The IMF and World Bank also set up staff working groups to consider these issues while the Basel Committee continued its efforts to refine standards. In 1996 the Basel Committee, again with full cooperation and participation from the OGBS, released another report that addressed a number of practical considerations in implementing the 1992 Report, especially regarding confidentiality of exchanged information. The Basel Committee also accelerated its work on creating a set of generally accepted principles for effective banking supervision; these ‘Core Principles,’ which focused on acceptable standards for prudential regulation of domestic banking, were released late in 1997. In particular, the Core Principles require that supervisors practice consolidated supervision and that they “apply[] appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide . . .” and that they

118 See generally BRENDA GONZALEZ-HERMOSILLO, CEYLA PAZARBASIOGLU, ROBERT BILLINGS, BANKING SYSTEM FRAGILITY: LIKELIHOOD VERSUS TIMING OF FAILURE - AN APPLICATION TO THE MEXICAN FINANCIAL CRISIS (1996).
119 These issues became of significant interest to the IMF, which had generally been more concerned with macro rather than micro policy. See generally Morris Goldstein and Philip Turner, Banking Crises in Emerging Economies: Origins and Policy Options. 46 BIS ECONOMIC PAPERS (1996) and CARL-JOHAN LINDGREN, GILLIAN GARCIA, AND MATTHEW L. SAAL, BANK SOUNDNESS AND MACROECONOMIC POLICY (1996).
121 In addition to Argentina, France, Germany, Hong Kong, Japan, Mexico, the Netherlands, Poland, Singapore, Sweden, United Kingdom the United States, the working group also included Thailand, Korea, Indonesia.
122 THE BASEL COMMITTEE: THE SUPERVISION OF CROSS BORDER BANKING (1996), available at http://www.bis.org/publ/bcbs27.htm. Key issues addressed were preserving confidentiality of information obtained by bank supervisors from foreign supervisors and creating standard procedures for the conduct of cross-border inspections by home-country supervisors.
123 THE BASEL COMMITTEE: THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (1997), available at http://www.bis.org/publ/bcbs30a.htm. The Core Principles cover seven principal areas: preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of banking supervision, information and record-keeping requirements, formal powers of supervisors, and cross-border banking. The work on developing the Core Principles was conducted in close cooperation with both the IMF and World Bank, but particularly with the former.
“require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.”\textsuperscript{124} In releasing the Core Principles, the Basel Committee “suggested that the IMF, World Bank, and other interested organizations use the Principles in assisting individual countries to strengthen their supervisory arrangements in connection with work aimed at promoting overall macroeconomic and financial stability.”\textsuperscript{125} There was no mention of offshore centers.

Similar activities with respect to the creation of best practices or standards were underway for the two other key elements of the regulated financial system, securities markets (including broker-dealers) and insurance, to be carried out by the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).\textsuperscript{126}

In April of 1997 the Working Party on Financial Stability issued its Report, which urged the creation of “an international consensus on the key elements of a sound financial and regulatory system” by representatives of both developed and developing countries, including the “formulation of norms, principles and practices by international groupings of national authorities with relevant expertise and experience” including the Basle Committee, IAIS, and IOSCO.\textsuperscript{127} It also called for the “[p]romotion by multilateral institutions such as the IMF, the World Bank and the regional development banks of the adoption and implementation of sound principles and practices.”\textsuperscript{128} More specifically, the Report suggested that, as part of its Article IV surveillance activities the IMF should “take stock of the progress that countries with clear vulnerabilities have made in the adoption of sound principles and practices developed by the international groupings . . . (emphasis added).” The Report went on to state that “the IMF and World Bank should develop modalities for sharing their assessments of financial sector strength and the regulatory and supervisory regimes in individual economies,”\textsuperscript{129} that IMF conditionality could “include steps to correct shortcomings in the financial sector,” and that the two organizations should provide technical assistance as well. In other words, the IMF (and where appropriate the World Bank) should advance the adoption of banking and other financial sector principles or best practices in its three main areas of work: surveillance, loan conditionality, and technical assistance. Nowhere in the Report are offshore centers mentioned.

Almost immediately after the report was issued (and just before the Basel Committee issued its Core Principles) the Asian financial crisis struck, followed by crises in Russia, Ukraine, and Ecuador. A considerable amount has been written on the history, development, causes, and global responses to the series of economic meltdowns that began in Thailand in July 1997.\textsuperscript{130} There are a number of different views as to what caused the Thailand (the financial

\textsuperscript{124} Id.
\textsuperscript{125} Id., at 2.
\textsuperscript{126} The history and background on these two organizations are on their websites, available at http://www.iosco.org/about/index.cfm?section=history and http://www.iaisweb.org/index.cfm?pageID=28 respectively.
\textsuperscript{128} Id. at 2.
\textsuperscript{129} Id. at 6.
\textsuperscript{130} According to one analyst, by 1999 more than 16,000 articles, journals, and reviews had already been published on the topic. Michael H. Moskow, The Asian Financial Crisis, in THE ASIAN FINANCIAL CRISIS: ORIGINS, IMPLICATIONS, AND SOLUTIONS 11 (1999).
sector and the government) then South Korea and Indonesia\textsuperscript{131} to move towards a massive default on external (and then internal) obligations. One thing virtually all commentators agree on is that the banking systems in each country were not well run; they were under-capitalized and had taken on far too much risk, including exchange rate risk and credit risk. A key problem causing excess credit risk was excessive connected lending, where banks lent money to connected parties at non-arms-length terms. In some instances these were banks lending money to members of an affiliated corporate group; in others it was banks lending money to relatives or business associates of bank officers or board members. In many instances the banks were controlled by the government, which exerted influence on banks to direct lending to favored borrowers. Thus, when the financial crisis hit and investors fled from local currencies, banks were unable to pay their creditors (often foreign banks), resulting in illiquidity and insolvency.\textsuperscript{132} Clearly, the banking systems in these countries had not been adequately supervised.

Another issue was what was termed ‘contagion,’ where a serious loss of investor confidence in one country could spread to other countries as investors lost confidence in similar countries.\textsuperscript{133} Perhaps more importantly, there was significant evidence that bank illiquidity or insolvency in one country could spread to creditor banks in another country, result in illiquidity or insolvency in that country.\textsuperscript{134}

While the problems in these banking systems were not new, they had not been the subject of IMF attention during the annual Article IV consultations. Yet when the IMF stepped in to provide financing, the problem of poor banking supervision was brought immediately to the fore; bank restricting, plus new and improved banking regulation, was key to the reform program.\textsuperscript{135} Bill Murden, then a senior official at the U.S. Treasury Department, put it this way:

The [Working Party on Financial Stability] issued a report in April 1997, in time for the 1997 Denver Summit. The report looked at some of the problems in the financial sectors in emerging markets . . . and recommended a concerted strategy for improving the financial sectors and financial supervision in these economies, including a more in depth role by the IMF and the World Bank . . . . Out of that process came some very significant developments, including the Basle Committee's Core Principles . . . which were released later that fall . . . . A year later, IOSCO issued a similar set of principles. . . . Unfortunately, we did not have time to implement the strategy before the Asia crisis erupted in the summer of 1997 in Thailand and quickly spread to Indonesia and Korea by that fall.\textsuperscript{136}

\textsuperscript{131} Malaysia and the Philippines were also affected but did not default.


\textsuperscript{133} \textsc{Taimer Baig and Ilan Goldfajn}, \textsc{Financial Market Contagion in the Asian Crisis} (1998), \textsc{available at} \textit{http://www.imf.org/external/pubs/ft/wp/wp98155.pdf} (showing evidence for contagion by examining the behavior of financial markets).

\textsuperscript{134} \textsc{Hai Zhou Huang and Chenguang Xu}, \textsc{Financial Institutions, Financial Contagion, and Financial Crises} (2000), \textsc{available at} \textit{http://www.imf.org/external/pubs/ft/wp/2000/wp0092.pdf}.


What Murden did not mention explicitly was that the three countries most hard-hit by the Asian financial crisis, Thailand, Indonesia, and Korea, were part of the working group that issued the Report.

Unlike with the OECD’s harmful tax practices initiative, the promulgation of prudential banking standards did not require the IMF to conclude that a country should make a sacrifice for the benefit of another; unsound domestic banking systems, management and staff concluded, adversely affected the well being of the country itself, as well as having potentially contagion affects on other countries. With respect to this second issue, there was an additional distinction from the harmful tax practices program: Article I(i) of the Fund’s Articles of Agreement included as one of its purposes “[t]o promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.”

This had been interpreted broadly as including oversight of the ‘international financial system,’ which (at least arguably) would include contagion affects from a problem in banks honoring cross-border obligations.

What happened next was a multi-pronged attempt to find ways to prevent future crises, an effort known broadly as ‘strengthening the international financial architecture.’ Unlike with the OECD’s work on harmful tax competition, this work involved, at least in theory, not only the IMF and World Bank, but representatives of developing countries themselves. Among the various prongs was the ongoing work on financial standards—the promulgation of the Basel Core Principles (and to a lesser extent the analogous standards of IAIS and IOSCO) through the work of the IMF and the World Bank. Also in 1998 the G-22, a group of developed and developing countries (including Korea, Thailand, and Indonesia) set up three working groups to examine issues related to strengthening the international financial architecture, one of which was on strengthening financial systems. In theory at least the heads of the IMF, the World Bank, the OECD, and the Bank for International Settlements (another treaty organization) attended meetings as observers, but in practice IMF (and to a lesser extend World Bank) staff were most closely involved in the working group’s activities.

A little later, in the spring of 1999 a new international group, the Financial Stability Forum (FSF), was created. It included central banks, finance ministries, and financial system supervisory authorities from twelve developed countries, plus the IMF, World Bank, BIS, OECD, the Basel Committee, IOSCO and IAIS, as well as some others. Again, IMF staff (and

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138 See infra at pp. ___.
139 In 1998, in order to advance and coordinate the work of the IMF and World Bank the two institutions set up the Financial Sector Liaison Committee.
140 The G-22 consisted of finance ministers and central bank governors from a broad range of developed and developing countries including the three most adversely affected by the Asian financial crisis: Korea, Thailand, and Indonesia and others affected by the 1995 Peso crisis and sovereign insolvencies in former Communist countries: Mexico and Russia. The others were Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong SAR, India, Italy, Japan, Malaysia, Poland, Singapore, and South Africa. GROUP OF 22, REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS (1998) p. i n.1., available at http://www.imf.org/external/np/g22/ifcrep.pdf.
142 Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the United States and the United Kingdom, plus the European Central Bank and three other standard setting organizations related to accounting and payment systems. Financial Stability Forum website, available at http://www.fsforum.org/about/who_we_are.html.
to a lesser extent World Bank staff) were closely involved in promoting the FSF’s research and conclusions.

It was clear that the IMF was going to play a key role in adopting and promulgating any new rules of the road for avoiding future financial crises. In the late spring of 1998 Michel Camdessus, at that time the Managing Director of the IMF, outlined a key aspect of the approach: a set of standards and codes, including banking supervision, that would be “progressively disseminated by the IMF through its surveillance.” Soon after, the Fund published *Toward a Framework for Financial Stability*, which proposed that “The IMF, with its near-universal membership, has an important role to play in . . . the broad dissemination of the work of various organizations, particularly that of the Basle Committee [and] . . . with its broad responsibility to engage in surveillance of member countries’ economic policies . . . can assist in identifying potential vulnerabilities . . . and help the authorities in formulating corrective policies (emphasis added).”

The Group of 22’s Report of the Working Group on Strengthening Financial Systems, released in the fall of 1998, had few surprises. It announced an “international consensus” on banking and securities supervision; specifically endorsing the Basel Core Principles, including principles on information exchange for supervising internationally active financial groups. It also called on the IMF and World Bank to enhance their work in the area, anchored in IMF surveillance. The IMF and World Bank, in coordination with the G-22 and the new Financial Stability Forum, worked to develop a new international effort to encourage the adoption and implementation of financial standards.

This work led to the Financial Sector Assessment Program (FSAP), a new program piloted in 1998 and adopted the next year. The purpose of the FSAP was to identify strengths and vulnerabilities of a country’s financial sector, in part by assessing their compliance with key international financial standards such as the Basel Core Principles and related standards on insurance and securities regulations. The IMF and World Bank agreed that they should divide assessment work between them based on their areas of competence (meaning, primarily, the expertise of staff) with some being exclusively IMF, others exclusively World Bank, and others being of joint responsibility. Basel Core Principle assessments were to be the responsibility of the IMF. The assessments would be summarized in Reports on the Observance of Standards and Codes (ROSCs).

There were a number of key features of the FSAP and most importantly the ROSC program that developed over the first few years. They were that:

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146 *GROUP OF 22, REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS*, supra note ___ at 3-4, 47.
147 *Id* at 46-50. The Report was later endorsed by the G-7, although this was a forgone conclusion. *G7 Leaders Statement on the World Economy* (October 30, 1998), available at http://www.g7.utoronto.ca/finance/g7_103098.html.
148 Much of the thinking for the FSAP had gone on earlier; the pilot program was actually carefully thought out. *See generally* IMF, *INTERNATIONAL STANDARDS AND FUND SURVEILLANCE* (1998).
• the adoption and assessment of internationally recognized standards should remain voluntary;
• assessments need to be independently conducted and consistently applied across countries;
• ROSCs should allow for the different stages of country economic development, range of administrative capacities, and the different cultural and legal traditions across the membership;
• ROSCs should provide the context for the assessment, including the progress made by the country in implementing standards, and the authorities’ plans for further implementation, and that Fund assessments must not resemble ratings for countries and must not presented as pass-fail judgments;
• jurisdictions are to be assessed only against those standards, and those parts of standards, that are relevant to their situation and that therefore standards increasingly set out benchmarks for countries at different stages of development.  

Also, there was some debate in the beginning as to whether countries could be required to publish ROSCs—but as a practical matters countries that chose to participate in the pilot program did not object to publication. Finally, additional technical assistance could then be offered to countries to help address weaknesses identified in the assessment process. Of great importance, in order for assessments to be as objective as possible, detailed methodologies for assessment were required, and which for the BCP was drafted with the close cooperation of IMF staff. In other words, the FSAP and ROSC procedures were designed to ensure as uniformly objective compliance assessment process as possible.

While the FSAP and ROSC programs were being devised and piloted, the IMF and the G-7-dominated Financial Stability Forum turned once again to the issue of offshore centers. During the Asian and follow on financial crises not a single offshore center experienced a significant problem in its regulated financial sector. Nevertheless, both the IMF and FSF managed to find problems with the operations of offshore banking and, at least in part, made valiant efforts to tie these problems to banking problems in the crisis countries.

In early 1999, the Fund issued a Staff Working Paper entitled Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues. IMF staff interest in offshore banking issues had been prompted in part by the continuing expression of interest from the U.S. and French Executive Directors (among others), although many staff members involved express serious doubts about whether offshore centers posed any real threat to the international financial system. Almost bizarrely, the paper concludes that “[o]ffshore banking has most certainly been a factor in the Asian financial crisis [and has] . . . also played a significant, but not catalytic, role in the recent Latin America crisis,” even though the body of the paper identified virtually no role at all. The paper went on, however, to discuss in general terms the issues raised by offshore

151 While IMF management, staff, and Executive Directors often referred to the FSAP and ROSC assessment programs as part of IMF surveillance, from a legal perspective they were actually technical assistance, which under Article V section 2 is strictly voluntary.
154 The paper notes that offshore facilities may have contributed to problems in Thailand and Malaysia themselves. Id. at 34.
banking. The paper claims that there are ‘legitimate’ and ‘illegitimate’ reasons for banks to use OFC facilities; oddly, the report lists among the former ‘convenient’ fiscal and regulatory regimes that, by lowering explicit and ‘implicit’ taxation increase net profit margins.\textsuperscript{155} The paper also notes the ease of incorporation, legal frameworks for protecting the privacy of the principal-agent relationship, and the freedom from exchange controls offered by OFCs. Among the illegitimate are bank secrecy (“almost invariably” a selling point), tax avoidance and evasion, and money laundering.

The Working Paper suggests that the “greater leeway for balance sheet management, generated by favorable regulatory frameworks in OFCs, make offshore banks potentially more vulnerable . . . to solvency and foreign exchange risks.”\textsuperscript{156} And yet, the Working Paper also concludes that offshore banks are \textit{less} likely to be unprofitable and \textit{more likely} to be profitable than onshore banks. It also notes that, typically, a much larger percentage of offshore bank investments tend to be in other, onshore banks and that offshore banks are often simply intermediate deposits between offshore and onshore banks.\textsuperscript{157} In what at least appears to be a desperate effort to find a way to condemn offshore banking from a prudential perspective, the Working Paper concludes that while offshore banks far more likely to be liquid (since their regulators do not enforce capital standards with the verve of their onshore counterparts) the offshore banks may be more highly leveraged and therefore less ‘solvent’, although no risk-weighted data was available.\textsuperscript{158} In short, the Working Paper found little actual factual material to support the charge that offshore center banks were somehow dangerous, although it concluded that they were nevertheless.

The Working Paper was followed the next year by a report of the FSF’s working group on offshore centers. Not surprisingly—given the content of the IMF Staff Working Paper—the FSF Report concluded that “OFCs, to date, do not appear to have been a major causal factor in the creation of systemic financial problems.”\textsuperscript{159} The Report did, however, also conclude that OFCs \textit{could} cause contagion problems in the future due to the growth in assets and liabilities of OFC financial institutions (and the inter-bank nature of the market) and the suspected growth in off-balance sheet activities.\textsuperscript{160} The Report distinguished between OFCs with weak supervision and those with strong supervision and went on to distinguish between prudential concerns and what they termed ‘market integrity concerns,’ the latter having a meaning similar to the IMF Staff Paper’s ‘illegitimate purposes.’\textsuperscript{161} The Report listed as a key prudential problem the old OFC tax issue of information exchange, but it added a far more general concern over a lack of prudential supervision. Again similar to the IMF Staff Paper, the FSF Report also noted that lax supervision equaled higher profits, but added that jurisdictions that followed international standards were at risk of losing business to the lax jurisdictions.\textsuperscript{162}

With respect to market integrity, the Report noted that while offshore center did not pose immediate risks to international financial stability, by hampering international surveillance and law enforcement they eroded the integrity of international financial markets and therefore

\textsuperscript{155} \textit{Id.} at 6-7.
\textsuperscript{156} \textit{Id.} at 27-29.
\textsuperscript{157} \textit{Id.} at 14-16.
\textsuperscript{158} \textit{Id.} at 29.
\textsuperscript{159} \textit{Financial Stability Forum, Report of the Working Group on Offshore Centers} 1, 16 (2000).
\textsuperscript{160} \textit{Id.}
\textsuperscript{161} \textit{Id.} at 2.
\textsuperscript{162} \textit{Id.} at 18.
represented a potential threat to global financial systems. The Report highlighted “a lack of information on beneficial ownership of corporate vehicles . . . [that] can thwart efforts directed against illegal business activities.”

Noting the work of the IMF in the FSAP program and in preparing ROSCs, the Report called for a similar assessment program for all OFCs, based on a priority list of those with the greatest problems. The Report recommended focusing on three areas (1) cross-border co-operation, information sharing, and confidentiality, (2) supervisory powers and practices, and (3) customer identification and record-keeping. Specifically, it suggested that the assessment program include subsets of the BCP, IAIS and IOSCO principles (as well as of the FATF anti-money laundering recommendations) all linked to these three areas. The Report also listed a menu of possible incentives to enhance OFCs adherence to ‘international standards’, from limiting market access to OFC-based institutions, increased due diligence for onshore financial institutions when doing business with offshore based ones, to restricting or prohibiting financial transactions with those institutions.

At the time, many IMF staff reacted with dismay to the Report. Many staff agreed with the general conclusion that offshore centers had not been a weak link in the world financial system. And while they agreed that many offshore jurisdictions applied a light supervisory hand, they did not believe that the result was a weak banking system; agreeing with the Staff Working Paper, they felt that offshore banks were healthy—largely they did not make risky investments. Instead, it appeared that the proposed offshore center assessment program was addressed more to solving other issues referenced in the Report, including the fear of onshore jurisdictions that they could be losing out to offshore ones in the global competition for banking services. But of greatest concern was that by focusing on information sharing, customer identification and transparency of ownership, the Working Group was really concerned about tax, and to a lesser extent, money laundering. And, as discussed above, many staff believed that it was illegitimate for the IMF to suggest that one jurisdiction should commit sacrifices to benefit another. A number of staff most closely involved in putting together the new offshore center program expressed their belief that the program had little or nothing to do with prudential regulation, which they believes actually was a legitimate subject for IMF involvement. Instead, they wondered if it was all a subterfuge to help the OECD and its member states in the harmful tax practices project.

Given the strong support voiced by the Financial Stability Forum for some kind of offshore center assessment program to go along with the FSAP and ROSC programs already in train, it was no surprise that IMF management moved promptly to propose a pilot assessment program. The IMF papers on the subject parroted back some of the weakly argued allegations that OFCs may have played some kind of role in recent banking failures and the need to improve

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163 Id. at 1.
164 Id. at 20–28.
165 Id. at 28.
166 Id., at 58–68.
167 Id. at 32.
168 Unless, of course, investing in onshore banks was risky—which much, during the current international financial crisis—turned out to be the case.
169 There was also a view that much of the concerns over money laundering could also be due to fears of tax evasion.
cross-border information exchange, customer identification, and transparency of ownership of legal persons. Interestingly, they also discussed at some length other OFC initiatives, including the OECD tax competition program and the recent anti-money laundering initiative of the FATF involving so-called non-cooperating countries and territories (NCCT). Like the tax competition program, the NCCT program (which is discussed extensively in the next section of this chapter) assessed a selected group of jurisdictions, most of which were OFCs, and threatened them with ‘countermeasures’ if they did not comply with a set of anti-money laundering standards created by the FATF. One of the staff involved in drafting the IMF background papers noted that by discussing the work of the OECD and FATF, including their aggressive threats to levy ‘countermeasures,’ would make it less likely that the Executive Board would endorse any IMF involvement in either tax or AML initiatives.

However, the proposed assessment program differed from the FSF recommendations by suggesting that all jurisdictions should be assessed on the entire set of Basel Core Principles (BCP) (and the Concordat and relevant Basle Committee reports) plus insurance and securities standards where appropriate. The Report also noted that those onshore centers where offshore bank branches/subsidiaries were subjected to consolidated supervision would also have to be assessed, even noting that there were serious gaps because onshore supervisors often do a poor job. The proposal threw a few bones with respect to anti-money laundering issues, noting that Basel Core Principle 15 included ensuring an effective anti-money laundering program.

Of key importance, the Report made no mention of the exercise of hard power—no carrots or sticks. While the Report accepted the FSF proposal of 3 ‘modules,’ with the first being an assisted self-assessment, the second and third assessments would be just like assessments in the FSAP program, that is, strictly voluntary, resulting in ROSCs to be published only with the agreement of the jurisdiction involved. As with the FSAP program, additional technical assistance could then be offered to OFCs to help address weaknesses identified in the assessment process. The IMF Executive Board agreed, emphasizing the strictly voluntary and cooperative nature of the exercise.

As a result, what the FSF had proposed—a selective assessment of BCP and AML principles with a threat of possible ‘countermeasures’ if the OFC didn’t measure up—was replaced with a voluntary extension of the BCP assessment part of the FSAP/ROSC program to offshore centers. In effect, the FSF (and its sponsors in the major onshore jurisdictions) was hoisted on its own petard. At least arguably, the FSF wanted the IMF’s OFC program to address what was outside the mandate of the Fund: the competitive advantage offshore banks had due to a less rigorous regulatory environment (plus issues of unfair tax competition and money laundering). In order to make the argument for IMF involvement, the FSF had to claim that it was all really an issue of bad prudential regulation. The IMF accepted this argument and

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171 Id. at 15-16.

172 BCP 15 states that “Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.” THE BASEL CORE PRINCIPLES ON BANKING SUPERVISION 6 (1997), available at http://www.bis.org/publ/bcbs30a.pdf?noframes=1. BCP assessment of this Principle tended to be cursory.

173 IMF, OFFSHORE FINANCIAL CENTERS, supra note ___ at 16-17.

174 Id. at 19-20.

proposed that it fold OFCs into its onshore assessment program, all without adopting the proposals that would have targeted the FSF’s real concerns. All offshore centers consented to being assessed and to publishing their assessments.\footnote{Although it took Nauru and Niue some time to agree to a Module 2 assessment.} The reason for this are varied and no doubt included a significant amount of lobbying, but there were a number of practical reasons as well. IMF staff heard a number of different comments voiced by officials in offshore jurisdictions as to why. Certainly in some instances there was a fear that if a particular jurisdiction did not participate it would be assumed to be in serious non-compliance with the Basel Core Principles, which could then be cited by onshore regulators as a reason for restricting banking activities with offshore institutions. In other words, onshore regulators could exercise hard power with domestic banks that would have negative effects on offshore banks. Next, many offshore centers believed that their banks were safe and sound and that a truly impartial assessment by the international civil servants of the IMF would likely give them at least passing marks. They may not have trusted the onshore jurisdictions to be fair, but unlike with the OECD, they placed faith in the skills and impartiality of IMF staff (or at least they decided that the IMF staff was more impartial than the sub-state regulatory members of the Basel Committee on Banking Supervision). Offshore centers were already the subject of essentially involuntary assessments under the OECD’s harmful tax practices program (and the FATF’s NCCT program, to be discussed infra); they might in some instances have hoped that the cooperative and less biased IMF assessment could be used as a tool to counter the work of the G-7 civil servants who dominated OECD and the FATF.

As it turned out, overall offshore centers did quite well in their assessments. By the time of the first OFC progress report to the Executive Board, there had been 12 self-assessments and 10 IMF-staff assessments leading to ROSCs for compliance with the Basel Core Principles (and a smaller number of ROSCs for IAIS and IOSCO principles).\footnote{IMF, OFFSHORE FINANCIAL CENTER PROGRAM: A PROGRESS REPORT 3 (2002).} While some of the newer (and poorer) offshore centers fared poorly, the older established offshore centers performed better than many onshore centers. The most significant problems lay in the set-up and operations of the supervisors themselves, including the examination process,\footnote{Id. at 10 – 12.} and in particular supervision over credit risk and market risk.\footnote{Id.} However, while the Report notes that a lack of effective supervisory implementation may result in problems, the Report does not suggest that any of the banking systems assessed were in any way actually weak. Frequent discussions among assessors suggested that none was actually concerned over potential bank failures. Although local bank examination of credit and market risk were a problem, banks themselves did not appear to be behaving too riskily, in part because so much of their business was actually intermediation between depositors and other onshore banks, and in part because many of the banks were also the subject of consolidated supervision by onshore jurisdictions.\footnote{As the current financial criksen has shown this may have been not terribly reassuring, but at least onshore regulators—and their state governments—had no reason to complain that the offshore centers were riskier.} In that regard, staff assessments had generally found good cooperation with respect to sharing information with onshore regulators.\footnote{IMF, OFFSHORE FINANCIAL CENTER PROGRAM, supra note ___ at 17-18.} Of particular interest, staff noted that OFCs so far had a better record of compliance with the Basel Core Principles than did onshore jurisdictions.\footnote{Id. at 13.}
These first impressions were largely confirmed as Offshore Financial Center Program continued forward, eventually covering all offshore centers by 2004. One significant effect of the assessments was that OFCs did work to improved their prudential supervisory programs, including by passing new laws and regulations to bring them into fuller compliance the Basle Core Principles (especially with respect to the independence of the supervisor, on-site examinations, and a focus on credit and market risk) but it was not at all clear that these improvements materially improved the actual safety and soundness of the various banking systems. In a 2003 review of the program, staff did not find much risk posed by poor prudential supervision. An informal review by IMF staff in 2006 found that there was “strong compliance [with the Basel Core Principles] with over 70% compliant with 22 out of 30 principles, with strengthening required for independence, onsite and offsite supervision [and] also for credit risk [and] market risk, but these are less material (emphasis added). There were two other developments, one quite major and the other somewhat less so. The major development was the intensified examination of anti-money laundering provisions in the aftermath of the attacks of September 11, 2001, which culminated in the inclusion of an assessment of compliance with the FATF ant-money laundering standards in both the FSAP and Offshore Financial Center Programs. The second but related development was the inclusion for a number of years of an assessment of the supervision of the trust and company service providers sector. Many offshore centers specialize at least in part in providing efficient and inexpensive offshore company chartering (meaning that the company, while incorporated in the offshore center, cannot transact business there). Many also specialize in providing trust management services. In part to protect the users of these services and in part to prevent the use of companies for fraudulent or other illegal purposes, many offshore centers required the licensing and even supervision of trust and company service providers. In many offshore jurisdictions international companies could only be founded by licensed providers, and only after due diligence was performed to ensure that the company would not be used for illegitimate purposes. In 2002 the OGBS established a Working Group to create an international standard for regulating the sector together with participation of the OECD, the IMF and the FATF. In September 2002 The Working Group issued a Statement of Best Practice. For two years the OFC program included assessments of compliance with this Statement after which staff concluded that there was too much the redundancy with the anti-money laundering assessments.

184 IMF, Offshore Financial Center Program: A Progress Report 22-24 (2002), available at http://www.imf.org/external/np/mae/oshore/2002/eng/032802.htm. “Overall compliance with the Basel Core Principles was generally appropriate to the nature of the business conducted, especially in important jurisdictions where compliance was found to be broadly in line with that in advanced economies.”
186 International Supervision of OFCs (2007), copy on file with the author.
What was most peculiar about the assessment was that no onshore center licensed or supervised this sector. This was a case where offshore centers, through the work of the Offshore Group of Banking Supervisors and the IMF, were able to show the world that they were doing a better job than onshore centers.

Because soon after the attacks of September 11th, 2001 the Offshore Financial Center Assessment Program gave increasing emphasis on anti-money laundering and terrorism financing this article will discuss the effects of the OFC program after addressing that development.

D. Money Laundering and Terrorism Financing

1. The Basic Indictment.\textsuperscript{189} — Onshore jurisdictions also claimed that OFCs assisted criminals by failing to implement anti-money laundering principles, which allowed criminals more easily to retain the proceeds of their crimes. Among the most important rules was a requirement that financial institutions ‘know their customer,’ including knowing who controlled the account and whether the source of the funds was likely to be criminal. These principles also required financial institutions to monitor accounts to see if they might indicate criminal proceeds and report to a government agency when they did. Finally, the principles stated that this information should be made available to other jurisdictions.

By not enforcing such rules, onshore centers claimed that criminals were allowed to hide the fact that they owned or controlled an account, either because the accounts were actually anonymous (such as numbered accounts) or because the account holder was a company or other legal arrangement where the owner and controller was not revealed. Next, the criminal could make deposits of his ill-gotten gains to these accounts, often through a transfer from another bank, without any questions being asked as to the origin of the funds. When the criminal wanted use of the funds money he would implement a transfer to an account in his or her own name, typically in large onshore jurisdiction. By running criminal proceeds through these effectively anonymous accounts, onshore banks would not be able to discover the origins of the funds or whether the account had been controlled by a criminal, thereby laundering the proceeds. Any request for information by another jurisdiction would either be rebuffed because the information was not available or because of laws protecting financial secrecy.

Other principles also included having jurisdictions extend cooperation to each other in investigating and prosecuting alleged criminals involved in laundering. Offshore centers, it was alleged, either rebuffed such requests directly or provided such poor cooperation that little assistance was actually given. Following the terrorist attacks of September 11, 2001 onshore jurisdictions extended their criticism to include inadequate cooperation in the ‘global war on terror.’ One requirement of this ‘war,’ adopted as international law by the U.N. Security Council, was to seize accounts owned or controlled by known terrorists and terrorist organizations. Most of the complaints by the larger onshore jurisdictions were that a failure to implement ‘know your customer’ rules made it impossible to seize the funds of known terrorists.\textsuperscript{190}

\textsuperscript{189} This short section is a summary and reorganization of arguments presented during the initial of debate (late 1990s) on jurisdictions that were deemed to be “non-cooperative” with respect to anti-money laundering efforts. See OECD, \textit{REPORT ON NON-COOPERATIVE COUNTRIES AND TERRITORIES 1-2} (February 2000), \textit{available} at http://www.fatf-gafi.org/dataoecd/57/22/33921735.pdf.

\textsuperscript{190} \textit{FATF Meets in Emergency Session} 29-30 (October 2001), \textit{available} at http://www.fatf-gafi.org/dataoecd/35/4/35688033.pdf. While the 8 Special Recommendations on Terrorism Financing adopted by
2. The System in Action. —Sustained global interest in anti-money laundering policies began in the 1980s, primarily in the context of concern over international drug trafficking. Because the drug trade (and other illegal activated) generated huge profits, criminals found it necessary to find a way to introduce the cash into the formal financial system so that it could be moved, spent, or invested without drawing the attention of law enforcement. However, simple deposits or transfers of huge amounts of cash could draw the attention of law enforcement. Criminals therefore needed to disguise the illegal origins of the proceeds of crime and/or their ownership of the proceeds, and early anti-money laundering legislation made it a crime for financial institutions knowingly to participate in such activities.\textsuperscript{191} However, to be truly effective an anti-laundering regime needed to be implemented in every jurisdiction where drug money might be laundered and introduced into the international financial system. As a result, a number of the major onshore centers, most notably the U.S. and France, took the lead in pressing for an international anti-money laundering effort.

The first major international agreement to enact uniform anti-money laundering laws was the U.N. Convention against the Illicit Traffic in Narcotic Drugs and Psychotropic Substances (also called the Vienna Convention.)\textsuperscript{192} The Convention required all parties to enact legislation providing for the identification and confiscation of laundered drug money and set out procedures doe mutual legal assistance in countering money laundering. In 1990, the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (Strasbourg Convention) was adopted,\textsuperscript{193} and the following year the first European Directive on the prevention of the use of the financial system for the purpose of money laundering.\textsuperscript{194}

The next major international step to enhance global anti-money laundering efforts came with the creation of the Financial Action Task Force in 1989 following the G-7 Summit in Paris.\textsuperscript{195} The original Task Force consisted of sixteen OECD countries with the United States and France taking leadership roles. The Task Force was inter-governmental in nature, with members represented by sub-state entities like financial supervisors, criminal investigators, and prosecutors rather than states. While the FATF had a small secretariat, the work of the FATF was carried on almost entirely by its members. Less than a year later the FATF published its first set of Forty Recommendations, which were designed to provide a comprehensive plan of action for fighting money laundering and which looked somewhat like an AML standard. Drafted primarily by representatives from U.S. sub-state participants, the Recommendations covered the criminalizing of money laundering and the freezing and seizing of criminal proceeds, preventive measures for banks such as customer identification and record keeping, transaction monitoring and the filing of suspicious activity reports when a financial institution suspected

the FATF soon after September 11, 2001 required the freezing of terrorist assets and the implementation of U.N. security Council resolutions that included specific names of terrorists and terrorist organizations, the FATF’s so-called Un-cooperative Countries and Territories process started nearly two years earlier was not changed to include terrorism financing in the initiative beyond the request that countries complete a separate terrorism financing questionnaire. \textit{FATF Acts Against Terrorist Financing, Money Laundering and Non-cooperative Jurisdictions} (February 2002), available at http://www.fatf-gafi.org/dataoecd/50/36/33935095.pdf.

\textsuperscript{191} See the discussion in Richard Gordon, \textit{Anti-money-laundering Policies: Selected Legal, Political, and Economic Issues} in \textit{CURRENT DEV. IN MONETARY AND FINANCIAL L. 407, 410 (1999)}.


\textsuperscript{193} 8.XI.1990.


\textsuperscript{195} \textit{About the FATF}, available at http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1,00.html.
money laundering, and cross border cooperation in investigating and prosecuting money laundering.

In 1991 the FATF began its program of yearly self-evaluations of compliance by completing questionnaire, and its mutual evaluation program.\textsuperscript{196} The mutual evaluations involved on-site assessments of compliance with the Recommendations, undertaken by experts drawn solely from other members. The following year FATF helped set up the Caribbean Financial Action Task Force, the first FATF-Style regional body designed to advance adoption of the FATF 40.\textsuperscript{197} While membership in regional bodies required a political commitment to implement the FATF 40 and to undergo mutual evaluations, no treaty obligation was involved and no timetable set for implementation.\textsuperscript{198}

The FATF also worked on developing appropriate ‘countermeasures’ to those jurisdictions that failed adequately to implement anti-money laundering policies.\textsuperscript{199} The FATF also expanded its membership to include 24 members of the OECD plus Hong Kong, Singapore and representatives of the European Commission and the Gulf Co-operation Council.

In 1996 a revised version of the 40 Recommendations were completed that extended AML preventive measures to non-bank financial institutions.\textsuperscript{200} In addition, the Asia-Pacific Group on Money Laundering, a FATF-Style regional body, was formed, and the mutual evaluation procedures of the CFATF and the OGBS were assessed as being in conformity with the FATF’s principles.\textsuperscript{201} It also agreed to apply “preliminary sanctions against certain [FATF] members” that did not comply with the 40 (note that the term ‘countermeasures’ was not used).\textsuperscript{202} In 1997, with the creation of the Select Committee of Experts on the Evaluation of Anti-money Laundering Measures (then known as the PC-R-EV), European Council’s FATF-Style regional body,\textsuperscript{203} such anti-money laundering regional organizations existed for nearly every significant offshore center.

During the early 1990s FATF members expressed concern about jurisdictions they believed were key weak links in enforcing anti-money laundering rules. At that time many onshore jurisdictions, including almost all poorer or developing countries, had little or no AML rules or enforcement. However, it was the role played by some key offshore jurisdictions that was frequently mentioned as the most troublesome. These jurisdictions allegedly had benefits to launderers that the vast number of poorer and developing countries did not: they were usually ‘tax havens,’ they had a first world financial infrastructure (including branches or subsidiaries of onshore banks or domestic onshore banks that were an accepted part of the international financial system, and trust and company service providers to assist in access to the financial system), and a first world legal system to protect property rights. The 1996 FATF 40 included Recommendation 21, which stated that financial institutions should give heightened due diligence to business


\textsuperscript{198} \textit{See generally} \url{http://www.cfatf.org/}. The “uncommitted” commitment to implement the FATF 40 was discussed at a number of CFTAT meetings and later at APF and PC-R-EV.

\textsuperscript{199} \textit{Id.} at 17.

\textsuperscript{200} \textit{FATF, The 40 Recommendations} (1996), \textit{available} at \url{http://www.oecd.org/dataoecd/15/51/40262612.pdf}.


\textsuperscript{202} \textit{Id.} at \url{http://www.jya.com/fatf96-97.htm#B.%20Application%20of%20the%20FATF%20Policy%20for%20Non-Complying%20Members}.

\textsuperscript{203} \url{http://www.coe.int/t/dghl/monitoring/moneyval/About/MONEYVAL_in_brief_en.asp}.
relations and transactions with persons from jurisdictions that “do not or insufficiently apply [the] Recommendations.” Such heightened due diligence could result in a financial institution refusing to undertake transactions with the person from a non-complying jurisdiction, but the Recommendation was vague on this issue. The Recommendation was an invitation, however, for local regulators to use hard power on their domestic institutions to ensure compliance on the part of non-resident institutions, in manner quite similar to that recommended for both tax and prudential standards enforcement.

There are a number of reasons why offshore centers might not have wished to make full implementation of the FATF’s recommendations a priority. The primary purpose of anti-money laundering rules is to reduce criminal incidence by reducing the ability to enjoy the profits of crime. However, the vast majority of criminals and criminal activities were onshore not off; therefore, implementing such policies was likely to help onshore jurisdictions far more. Because implementation of such policies was relatively costly, especially to financial institutions, there may have been relatively little ‘non-altruistic’ reasons to expend such cash. Also, because the implementation of anti-money laundering rules required clients of financial institutions to jump through more hoops regarding such matters as identification, implementation might have hurt business.

By 1999 key FATF members, lead again primarily by the United States and France, determined that diplomatic efforts, plus the threat of implementation of Recommendation 21, had not been enough to encourage these allegedly troublesome jurisdictions to change. Taking as their model the OECD’s harmful tax competition project (the modest FATF Secretariat was physically housed at the OECD’s Paris headquarters), FATF delegates began to formulate an analogous anti-money laundering program, putting together what became known as the Non-Cooperating Countries and Territories (or NCCT) process. In doing so, the FATF made a number of crucial decisions.

First, analogous to the harmful tax practices program, the FATF delegates chose not to include in its initial review all jurisdictions that failed to follow the FATF 40, but rather those they believed were causing the most practical problems. For this purpose they put together an Ad Hoc group to determine which jurisdictions should be included in the initial review. The reasons for so doing were obvious, most countries in the world had yet to adopt and implement the FATF 40; to cover all countries would require too many resources. However, by selecting only a subset of such countries the left themselves open to criticism. It was also odd that the FAT added countries as non-cooperating in future rounds of assessment that were not included in the first round. In part as a result, the FATF members selected a relatively large number of

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205 See further discussion of this issue in Hartman, Coercing Cooperation from Offshore Financial Centers, supra note ___ at 273-278.
208 See, e.g., FATF Recommendation 5, supra note ___.
209 “FATF members have been invited to mention those jurisdictions where, in the recent past, there have been difficulties, with an explanation of the nature of the difficulties that were encountered. FATF, REPORT ON NON-COOPERATIVE COUNTRIES AND TERRITORIES 6 (2000), available at http://www.fatf-gafi.org/dataoecd/57/22/33921735.pdf.
210 Id. at 6-7.
jurisdictions for review, including a number of large onshore jurisdictions like Russia. 211 Eventually a total of 47 countries or territories were examined in two rounds of reviews.

Unlike the harmful tax practices program or even the prudential supervisory program, the FATF already had a standard formally endorsed by virtually all of the jurisdictions they wished to examine: the FATF 40. While when signing on to the FATF-style regional bodies the jurisdictions had not pledged to implement the FATF 40 by a specific date, at least they had accepted it as the applicable standard against which their anti-money laundering policies should be judged though a mutual evaluation process. Nevertheless, the FATF decided neither to apply the full FATF 40 as the standard by which cooperation would be judged nor to rely on the FATF-style regional body mutual evaluations to determine compliance. Rather, the FATF chose to create a special set of 25 criteria based on a subset of the FATF 40, and to assess compliance with the 25 criteria themselves. 212 A “certain subjectivity” in assessments was also contemplated. 213

Many of the 25 criteria focused on the core of the preventive measures in the FATF 40, including inadequate regulation and supervision of financial institution, inadequate fit and proper test rules for the licensing and creation of financial institutions, inadequate customer identification requirements for financial institutions, excessive secrecy provisions regarding financial institutions, and a lack of efficient suspicious transaction reporting system, while others focused on law enforcement (lack of a financial intelligence unit), and on international cooperation. But others were not even included in the 1996 FATF 40: “inadequate commercial law requirements for registration of business and legal entities” and “lack of identification of the beneficial owner(s) of legal and business entities.”

For jurisdictions that were found to be non-cooperative with respect to these criteria, proposed responses could include “specific actions . . . by other multi-lateral fora (e.g., the G-7, the OECD, the Basle Committee, IOSCO and the International Financial Institutions) to seek the issuance of public statements or other appropriate action. In particular, the World Bank and the International Monetary Fund, could examine the consequences of a particular jurisdiction’s failure to take appropriate corrective action, in connection with their activities (emphasis added). 214 Others involved applying financial institutions Recommendation 21 with respect to heightened due diligence. 215 And finally, again reminiscent of the OECD’s harmful tax project, the Report proposed the application by FATF members (as opposed to financial institutions located within FATF members), collectively or individually, of “countermeasures”: including conditioning, restricting, targeting or even prohibiting financial transactions with non-cooperative jurisdictions. 216

In February of 2000 the FATF published it first review. 217 The vast majority of the OFCs listed in the initial 47 did not make it to the ‘uncooperative’ list. While it was not clear from the

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211See http://www.fatf-gafi.org/document/51/0,3343,en_32250379_32236992_33916403_1_1_1_1,00.html.
212Id.
213“No specific criteria can be considered a litmus test of a particular jurisdiction’s level of co-operation in the international fight against money laundering. Rather, each jurisdiction must be judged by the overall, total effect of its laws and programmes in preventing abuse of the financial sector or impeding efforts of foreign judicial and administrative authorities.” FATF, REPORT ON NON-COOPERATIVE COUNTRIES (2000), supra note ___ at 6.
214Id. at 7.
215Id. at 8.
216Id.
report as to why this was the case, a number of persons who were part of the review process reported that the UK had worked to keep its offshore territories off the list, while Canada also worked to keep a number of territories with which it had close relations and which it represented on the Executive Board of the IMF. One UK territory that was one of the most important of all OFCs in terms of total business transacted that did make the list was the Cayman Islands. Another important jurisdiction was Liechtenstein. The report noted that both had no requirement for customer ID and recordkeeping, the most essential of the AML preventive measures, as well as little active bank supervision. Other jurisdictions like the Bahamas, Dominica, and the Marshall Islands were listed primarily for not providing information on beneficial ownership of legal persons or arrangements, something that most onshore jurisdictions also did not do. A number of other relatively minor OFCs (in terms of total business transacted) were on the list and were also uncooperative tax havens; three of these, The Cook Islands, Nauru and Niue, also had no customer identification requirement. A number of others with serious shortcomings, including Russia and Lebanon, were not offshore centers at all.

As noted earlier, the NCCT process was proceeding more or less in parallel with the with the OECDs harmful tax project, jurisdictions named as NCCTs complained as well, and for many of the same reasons: the defensive ‘countermeasures’ were actually coercive sanctions, or the illegitimate application of power by the rich and powerful against the small and weak. Again, there was some agreement with this view in the popular press as well as in academia. While the FATF 40 was at least arguable a standard accepted by virtually all of the OFCs on the NCCT list via their membership in an FATF-style regional body, the 25 criteria by which they were assessed were not. This allowed the offshore centers to claim that the larger onshore centers were trying to impose standards that were neither internationally accepted nor applied to some of their own members. As with the tax competition program, another key complaint was that the process of assessing the jurisdiction’s compliance lacked all the hallmarks of due process; in particular, the assessments were certainly neither uniform nor impartially applied. Objectivity was noticeably absent.

Ever since the mid 1990s, a number of key onshore centers, again most notably the US and France, had been trying to involve the IMF and World Bank in promoting anti-money laundering principles. For example, the U.S. Executive Director’s office suggested on a number of occasions that because money laundering had adverse macroeconomic effects it was well within the IMF’s mandate. In 1996 a staff member in the Monetary and Exchange Affairs published a Paper on the macroeconomic implications of money laundering. In the Paper, he argued that laundering created inaccuracies in macroeconomic data, investment decisions based on ease of laundering rather than on rate of return, erosion of confidence in financial markets, tax

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218 Id. at 11.
219 Id. at 2, 5, 7.
220 See e.g. Benjamin R. Hartman, Coercing Cooperation from Offshore Financial Centers: Identify and Coincidence of International Obligations Against Money Laundering and Harmful Tax Competition, 24 B.C. Int’l & Comp. L. Rev. 253 (2002) (arguing that countermeasures are in fact sanctions as a remedy for a breach of international obligations, but that because there are no such obligations with respect to tax the sanctions are illegitimate) and James, Twenty-First Century Pirates of the Caribbean, supra note ___ at 5, “The OECD, like pirates who plied the waters of the Caribbean during the sixteenth through nineteenth centuries, has, through its ill-advised anti-harmful tax competition initiative, effectively robbed fourteen CARICOM nations of their sovereign right to determine their tax and economic policies.”
221 JASON SHARMAN, HAVENS IN A STORM, supra note ___ at 71, 101-48.
evasion, and finally an increase in underlying criminal activities (i.e. predicate offenses) that would result in the promotion of private economic benefits over social welfare.\footnote{222}{PETER QUIRK, MACROECONOMIC IMPLICATIONS OF MONEY LAUNDERING (1996).}

In response, the IMF Legal Department disputed each of these views, suggesting that if a problem existed it was that anti-laundering policies resulted in inaccurate macroeconomic data, skewed investment decisions, erosion of confidence in markets, and tax evasion.\footnote{223}{Richard Gordon, Anti-money-laundering Policies, supra note ___ at 410-413. Although published as an opinion by a senior lawyer in the Legal Department it was done so with the encouragement of the IMF’s then General Counsel.}

As for the argument that crime is bad, the article noted that while this might be true it would it would lead to a view that all anti-crime efforts should be within the IMF’s mandate, and that this would be prima facie unworkable.\footnote{224}{Id at 414-417.}

Informal discussions among the Legal Department, Executive Board offices other than the U.S. and France, management, and senior staff at other IMF Departments confirmed a strong general inclination for the IMF to avoid money laundering issues because they were primarily criminal enforcement related and therefore beyond the Fund’s mandate and expertise.

Nevertheless, in part to placate the American and French governments, the IMF agreed to send staff members as observers to FATF and FATF-Style regional bodies. As the FSAP/ROSC program was being developed the U.S. developed a slightly different tack. In early 2000 U.S. Treasury Secretary Lawrence Summers sent a letter to the International Monetary and Financial Committee\footnote{225}{The IMFC is composed of 24 IMF governors, ministers, or others of comparable rank. It advises IMF’s Board of Governors. Each member country that appoints, and each group of member countries that elects, an Executive Director appoints a member of the IMFC. See IMF Website, available at http://www.imf.org/external/np/exr/facts/groups.htm.} at the Fund and the Development Committee at the Bank\footnote{226}{The formal title of which is Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries. It is composed of 24 World Bank governors or finance or development ministers or others of comparable rank. It advises IMF and World Bank Board of Governors on development issues. Each World Bank member country that appoints, and each group of member countries that elects, a World Bank Executive Director appoints a member of the IMFC. See IMF Website, available at http://web.worldbank.org/WEBSITE/EXTERNAL/DEVCOMMEXT/0,,contentMDK:20121744--menuPK:60001652--pagePK:64000837--piPK:64000843--theSitePK:277473,00.html} urging the two to “step up” their efforts to combat money laundering. Noting the recent “increased engagement” on financial sector issues and assessments, Secretary Summers urged that IMF and World Bank include money laundering measures in financial sector reform programs.\footnote{227}{Treasury Secretary Lawrence H. Summers Statement to the Development Committee of the World Bank and the IMFC (April 17, 2000), available at http://www.imf.org/external/spring/2000/usa.htm.}

In particular, the U.S. was lobbying to include the FATF 40 as a standard to be assessed under the FSAP/ROSC and OFC programs. The reaction from most other Executive Directors, management, and staff was again largely negative. Two Staff Reports were drafted and discussed at the Executive Board that largely rejected the idea, but suggested instead that the existing assessment of the anti-money laundering principles in the BCP, IOSCO, and IAIS principles be enhanced and that the IMF and World Bank work more closely with the FATF in ensuring compliance with these principles.\footnote{228}{IMF, FINANCIAL SYSTEM ABUSE, FINANCIAL CRIME, AND MONEY LAUNDERING (2001), supra note ___, and ENHANCING CONTRIBUTIONS TO COMBATING MONEY LAUNDERING: POLICY PAPER (2001), available at http://www.imf.org/external/np/ml/2001/eng/042601.PDF.} The Staff Reports also suggested that the World Bank and IMF might recognize the FATF 40 as the anti-money laundering world standard, but that it would be up to the FATF
and FATF-Style Regional bodies to assess compliance. The Board went along, noting, however, that the IMF should not become involved in “law enforcement.”

A key concern expressed by all the non-OECD Executive Directors at this time (and privately by a few OECD Directors) was that the FATF NCCT process was, in their opinion, anything but voluntary and cooperative in nature, and therefore anathema to both the Fund and Bank’s culture and tradition in general and to the FSAP/ROSC/OFC program specifically. They did not want the two international financial institutions to be seen to support in anyway the NCCT process, and contemplated ways in which the IMF and World Bank might work to soften or eliminate the entire NCCT program.

In spite of criticism the NCCT process had been continuing without the support of the two international financial institutions. In June of 2000 the Bahamas, the Cayman Islands, and Liechtenstein had been removed from the list, while a number of onshore countries, including Egypt, Guatemala, Hungary, Indonesia, Myanmar, and Nigeria, had been added. While the addition of these onshore countries muted somewhat the complaints that the NCCT process involved a ganging up of the powerful over the most weak, it also added voices of countries with significantly larger populations and political influence to criticism of the process.

The change in U.S. administrations, so important in re-framing the U.S.’s advocacy for the harmful tax practices program, also affected U.S. support for anti-money laundering activities. At the IMF it was rumored that the new officials involved in formulating U.S. policy towards tax havens believed that much of the U.S. policy on anti-money laundering was actually a subterfuge for closing down tax havens. The reason, it was rumored, was that the most important of the 25 NCCT criteria were linked to piercing bank secrecy and sharing of information, which were also central to uncovering U.S. persons who use tax havens to avoid or evade U.S. tax. As an advisor in the IMF’s U.S. Executive Director’s office said, “Sometimes I think that everything comes back to tax.”

At this point the efforts of the major onshore jurisdictions to involve the IMF (and to a lesser extent the World Bank) in their harmful tax practices and NCCT projects had largely failed beyond an enhanced emphasis on Basel Core Principle 15, which required banks to have effective anti-money laundering programs. While the IMF’s project to assess OFC’s compliance with the Basel Core Principles (and more occasionally the IOSCO and IAIS principles) was proceeding, most offshore centers were actually receiving very good assessments.

Any remaining effort to derail plans for significant IMF and World Bank involvement in promoting compliance with AML principles was rendered almost entirely irrelevant by the September 11, 2001 terrorist attacks on the United States. Although the attacks were done on the cheap, the U.S. Treasury Department began immediately to push other members of the FATF to include terrorism financing as a central part of its mandate. On October 29 and 30 the FATF, meeting in an extraordinary plenary in Washington, adopted eight new recommendations on terrorist financing. Soon after, the IMF Managing Director created a special task force to

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229 Id., at 15-16.
232 Both Indonesia (which chose an alternate Executive Director for one of the South-East Asian constituencies) and Nigeria both had significant oil wealth, which added to their influence at the IMF Board, and Egypt (which chose the Executive Director for the non-Saudi Arab constituency) was highly influential in the Arab World, which also had significant influence on the Board.
consider how to intensify IMF involvement in anti-money laundering and anti-terrorism financing work. On November 5, 2001 the Task Force issued a Report recommending that the IMF and World Bank endorse the FATF 40 plus the 8 new Special Recommendations and to begin to include the assessment of compliance with the FATF 40 + 8 into the FSAP and OFC programs, and that AML/CFT ROSCs be prepared once the rules for ROSC assessments could be achieved. The Task Force managed to find the previously missing mandate for activity in this area in the IMF’s role in overseeing the international financial system. Intellectually this was a stretch but politically the results were unavoidable: the IMF’s management and executive Board simply could not say no in the charged atmosphere that was the immediate aftermath of the terrorist attacks. In fact, the Task Force Report states quite explicitly that the IMF’s involvement should be based at least not on its mandate but on the fact that “the Fund is a collaborative institution with near universal membership, which lends the Fund legitimacy and acceptance, and makes it a natural forum for sharing information and developing common approaches to issues. These strengths also make the Fund a vehicle for actively promoting desirable policies and standards in member countries (emphasis added).” The Report also noted that the IMF already had experience in assessing compliance with other standards.

While the Task force members were drafting the report U.S. and French Executive Directors had made clear that they wanted not only for all offshore center assessments to include money laundering assessments, but that the offshore program be accelerated. There was some resistance to this on the part of many members of the Task Force, who felt that the events of 9/11 had nothing to do with offshore centers and that resources could better be used elsewhere. Nevertheless, in the end the Task Force Report proposed increasing the number of OFC assessments from a target of 10 to a target of 20 per year so that two thirds of the 42 OFC on the Financial Stability Forum’s list would be assessed by the end of 2002. The Executive Board agreed.

The Report noted a number of other issues, including that (in order for assessments of compliance to be as objective and uniform as possible) the FATF 40 + 9 needed an assessment methodology; without such a methodology, which existed with respect to the Basel Core Principles assessments, there could be no objectivity. The Report also suggested that the IMF and World Bank should not be involved in assessing compliance with criminal law matters and raised the question of how the activities of the IMF and World Bank would intersect with that of the FATF and FATF-Style Regional Bodies. Finally, the report discussed the NCCT process, which clearly breached the rules of the game for producing ROSCs: the NCCT process was not voluntary, not independently applied across countries (e.g. there was no methodology for assessment), and there were pass-fail ratings.

The author of this Article was a member of the Task Force.


Id. at 5-6.

Id. at 10.

Id. at 10-11.

Id. at 10-11.

Id. at
Although they did not explicitly mention the NCCT process, the Executive Board agreed that these issues had to be resolved before AML ROSCs could be prepared, and in particular that the process be “compatible with the uniform, voluntary, and cooperative nature of the ROSC exercise.”

At this point an intense series of discussions began among key FATF members (primarily the U.S., France, and the U.K.) and senior staff with respect to the continuation of the NCCT process. In effect, management at the IMF and World Bank had concluded that the Executive Board would not endorse an AML ROSC while the FATF continued the NCCT process, while key FATF members insisted that the NCCT process was working should be allowed to continue. Another issue was the assessment methodology document, which was needed if assessments were to be uniform and objective. The FATF had agreed to complete the document and had delegated the job to the U.S. delegation, but their initial version was little more than a restatement of the FATF 40 + 9. As a result IMF and World Bank staff agreed to complete the methodology with IMF staff taking the lead. The result was a highly detailed set of criteria that one staff member noted would “make it very hard for the FATF to be easy on themselves and hard on others.” IMF staff began to use the draft methodology to make AML assessments in the OFC program, but not to publish ROSCs.

By April the Fund’s IMFC Committee, chaired by the U.K., called on the Fund to complete the methodology AML/CFT methodology and the development of “assessment procedures compatible with the uniform, voluntary, and cooperative nature of the ROSC process.”

In June of 2002, the FATF released its next NCCT Report; 15 jurisdictions were still listed, just under half of which were offshore centers, and none of which was particularly important in terms of total business: the Cook Islands, Dominica, Grenada, Marshall Islands, Nauru, Niue, St. Vincent and the Grenadines. However, a number of the remaining onshore jurisdictions (including Egypt, Indonesia, Nigeria, the Philippines, Russia, and Ukraine) were influential with respect to the IMF Executive Board; indeed they elected four Executive Directors or Alternates.

The next staff paper proposed a pilot program of AML assessments based on the new methodology to be undertaken by the IMF and World Bank and the FATF and FSRBs. However, given the IMFC’s statement, the authors insisted on standing up to the U.S. and France and insist that all assessments embrace a process that was:

- **uniform**, including using the same methodology for all assessments (the FATF’s NCCT process uses a different methodology from those of mutual evaluations),
- **voluntary** (the FATF NCCT process is mandatory and can result in the imposition of sanctions) and **cooperative**, including not using a pass-fail approach (the FATF NCCT process labels jurisdictions either “cooperative” or “non-cooperative”) and giving the jurisdiction the opportunity to publish a right of

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240. *IMF Board Discusses the Fund's Intensified Involvement*, supra note ___.

241. The author of this Article was a principal author of the methodology.


reply alongside the ROSC (the FATF NCCT process does not allow such a right of reply)(emphasis in the original).\footnote{244}

The FATF flatly refused to give up the current NCCT round. After additional negotiations, the president of the FATF, then held by Germany, agreed only that FATF “was prepared to indicate that it has no plans, at present, to undertake a further round of the NCCT exercise.”

Thus followed another round of discussions with Executive Directors. A majority of those opposed to the NCCT process still favored accepting the FATF’s offer; they felt that it was the best they could get, and that having impartial IMF assessment of NCCT countries would act as a significant counterbalance to the ‘impartial’ and ‘unfair’ NCCT assessments. Most of these Executive Directors did not represent jurisdictions on the NCCT. Others, including those representing the constituencies headed by Nigeria, Egypt, and Russia, felt that such benefits would be outweighed the legitimacy that an IMF/World Bank-endorsed FATF ROSC would confer on the FATF and therefore on the NCCT process.

In the end the Board was split, with a majority decided to go ahead with a 12-month pilot of AML assessments with accompanying ROSCs by the IMF/World Bank doing some, including OFCs, and the FATF and FSRBs continuing to assess their own members. However, they insisted that FATF first agree to undertaking its mutual evaluations of its own members in a manner consistent with the ROSC process (including a endorsing the new methodology and its use in undertaking FATF/FSRB and IMF/World Bank assessments) that that it agree “not [to] undertake a further round of the [NCCT] initiative, at least during the period of the 12-month pilot project.”\footnote{245}

However, a number of Directors expressed their disapproval, saying that those conditions did not go far enough. They said that reports on observance associated with FATF-led assessments should not be designated ROSCs “unless the FATF undertook a blanket commitment not to undertake any further country assessments without the consent of the country, and acknowledge that it would accept the results of any Fund/Bank-led assessments.”\footnote{246}

As the pilot program went forward, by the end of 2002, the eight offshore centers assessed, which included the formerly listed Liechtenstein, did quite well, with only Vanuatu showing a few remaining significant problems. This was not a surprise, in that all the other jurisdictions assessed were never on an NCCT list. The assessments merely showcased how effective jurisdictions were in implementing their AML programs, in most cases noting great improvement in recent years.\footnote{247}


\footnote{246} Id.

However, the remaining OFCs on the FATF NCCT list did not request an immediate assessment. The following year the Cook Islands requested and received an assessment from the IMF (they were also assessed as part of a mutual evaluation by the Asian FATF-style regional body), with the staff report noting that the authorities “have strengthened the AML/CFT legal and institutional framework mainly in response to the FATF’s listing of the Cook Islands as a non-cooperative” but that “the efforts remain uneven,” noting that the FATF had no removed the jurisdictions from the list. While the IMF provided free technical assistance to the Cook Islands, they remained on the NCCT list until 2005. If one theory was that involving the IMF in assessing AML compliance would help get OFCs off the NCCT list it did not appear to be playing out.

There was an unanticipated affect on the onshore jurisdictions resulting from the involvement of the IMF in the AML project. In agreeing to allow the FATF and FATF-style regional bodies to produce ROSCs, the IMF/Bank insisted that they ensure uniformity through review of the former’s assessments. This did not go entirely well for the FATF and FATF-style regional bodies, where a major review found a high degree of variability in the quality and consistency of reports prepared by [the FATF and FATF-style regional bodies] as well as within the same assessor group. While a large majority of reports were of high- or medium quality with respect to key components of the assessments, the treatment of ratings gave rise to greater problems. A number of initiatives have been taken or are underway to improve the quality and consistency of assessments by all assessor bodies, including: the standardization of documentation, the strengthening of peer/internal reviews, and the intensification of assessor training no worse than onshore jurisdictions.

According to a member of one FATF member, one result of this review was that “the introduction of the methodology document killed some of the ‘I’ll scratch your back if you scratch mine attitude’; this quality review will kill off more.”

E. The Ongoing IMF Offshore Center Assessment Program


IMF staff’s review of the OFC program in 2003 generally gave OFCs high marks in both supervision and in anti-money laundering, noting that they “compared favorably” with onshore jurisdictions of similar wealth. The review again found no serious systemic risk. The review the following year actually found that compliance levels for OFCs were, on average, more favorable than those for other jurisdictions assessed by the IMF in its financial sector work. Not surprisingly, the IMF’s OFC program began to wind down, with fewer assessments and with AML assessments increasingly undertaken by FATF-style regional bodies. By early 2005, 41 of the 44 OFC jurisdictions had been assessed under the first phase of the OFC program. The second phase was to focus on monitoring compliance though assessment updates every 4 to 5 years with a focus on providing technical assistance to less wealthy jurisdictions to help improve their compliance. Finally, in 2008 the Offshore Center Program was merged with the FSAP program, treating offshore centers, in essence, like their onshore counterparts.

III. Successes and Failures: The System and TRN Characteristics

A. Deconstructing the System

While onshore centers achieved much of what they claimed they wanted with respect to each of the threeres of complaint, the process and results were different. Offshore centers, by agreeing to provide taxpayer information to onshore centers (and because many signed on to the Savings Tax Directive) ceased to be an easy location for onshore residents to commit tax evasion. That being said, the onshore jurisdictions were by no means fully satisfied; offshore centers could still make income tax evasion easier to determined tax-evading onshore residents. With respect to prudential regulation, the story was quite different. Offshore centers not only adopted and implemented the financial regulatory standards of onshore jurisdictions, they did a better job than did onshore countries. Much the same can be said of anti-money laundering standards. The processes, however, were significantly different.

1. Income Taxation. —With respect to income taxation, there was no real trans-national regulatory network and no generally accepted standard. Onshore centers sought to use the OECD to develop a generally accepted standard and to assess compliance with that standard through its harmful tax practices effort. Onshore centers no doubt would have preferred that onshore centers accept the ‘standard’ through peer-pressure or persuasion. As it turned out, the offshore centers (as well as other jurisdictions) were not at all convinced that the ‘standard’ actually was a best practice; they neither accepted that income taxation was the best way to raise revenue not believed that they should give up the benefits of offering tax avoidance or evasion possibilities to

onshore residents. They also did not accept that the OECD’s assessment process was legitimate. The OECD members’ fall-back position was to use the hard power of coordinated action by their local tax authorities against their own residents who did business with offshore centers. This resulted in an even more significant outcry against the alleged illegitimacy of the entire OECD process. Nevertheless, the threat of hard power did result in OFCs making some changes, although not exactly what the onshore centers wanted.

The first departure from the paradigm TRN process was the absence of a generally accepted standard. There were not only good economic arguments against the income tax in general, there were, at least from the perspective of offshore jurisdictions, very good arguments as to why they should not adopt an income tax, including that other taxes, such as import duties, were more appropriate for their particular economies. As the IMF noted, there was no international obligation for one member to adopt policies that were injurious to themselves to benefit other members. With no genuine agreement on a standard it was impossible to ‘pretend’ there was. One can argue that the onshore centers tried to use the OECD to help legitimize the ‘standard’ by formally adopting it the way a TRN might, but the effort failed. Unlike TRNs such as the Basel Committee, the OECD was not a group of technical experts but rather a club of states. To make matters even worse, the OECD shared the undesirable TRN quality of being a select club, consisting only of wealthy onshore jurisdictions. Onshore jurisdictions turned to the IMF to remedy some of these deficiencies, but the IMF refused to participate—again because staff did not accept the underlying argument that the ‘standards’ were ‘best practices’ appropriate for all jurisdictions. To make matters even worse, the ‘standard’ review and compliance assessment process were also conducted by the OECD, further depressing the perception of legitimacy. At the end of this process the only tool available to the onshore jurisdictions to reach compliance was the hard power of local regulatory authorities.

2. Prudential Regulation. —With respect to prudential regulation, there was a real transnational regulatory network—The Basel Committee—and a generally accepted standard. Unlike the absence of an income tax, poor prudential regulation in one jurisdiction actually could cause problems for all jurisdictions, including offshore centers. There were some potential problems with the process in that the Basel Committee consisted of only a small number of onshore regulators, but nevertheless the Offshore Group of Banking Supervisors generally accepted that Basel Core Principles really were an appropriate standard. It was here that the process deviated from the paradigm. Following the Asian Financial Crisis, onshore centers sought to cast blame banking and other financial failures on offshore centers.

It was here that the IMF was enlisted to, among other things, add legitimacy to the process. The IMF added a few positive TRN-like aspects, but more importantly (given the participation of the Basel Committee) corrected some typical TRN deficiencies. Most states were members of the IMF, resulting in broader representation (sometimes indirectly and imperfectly, such as with British Offshore Dependencies). IMF staff acted with relatively independence from member states and had significant independent technical knowledge. The IMF provided a review of the standards and a way of assessing compliance with those standards separate from the Basel Committee or any member states. In particular, the assessment process was designed to be as objective as possible, providing significant procedural protections for complying jurisdictions. The process determined that OFCs were largely in compliance with standard, making it much more difficult for onshore jurisdictions to implement (via their regulators) ‘countermeasures’ against residents doing business with offshore centers. To the
extent that onshore jurisdictions were trying to use the Basel Core Principles as a back-door to forcing greater compliance with the failed income tax ‘standards,’ this also failed.

3. **Anti-Money Laundering.**—With respect to anti-money laundering and terrorism financing, the system evolved as a kind of combination of the previous two. The G-7 began the FATF as a kind of TRN. While the FATF was technically a state membership task force, states largely were represented by domestic regulatory authorities as well as by domestic law enforcement. The anti-money laundering standards (and later anti-terrorism financing standards) developed by domestic authorities and endorsed by the FATF were generally accepted as best practices by offshore centers via the OGBS and the CFATF and later other relevant FATF-style regional bodies. Unlike domestic bank failures, however, domestic money laundering was far less of a threat to offshore centers in that criminals were committing their crimes onshore. Perhaps as a result many offshore centers were less interested in suffering the direct and indirect costs (including losing banking clients who were relying on bank secrecy to evade domestic income taxation) of enforcing the standards. As with the OECD’s harmful tax practices project, the FATF responded with its non-cooperating countries and territories project. However, offshore centers again objected to the assessment process as illegitimate, in part because the assessments did not use the FATF 40 as the standard and because the methodology for assessment was particularly subjective.

Again the IMF was enlisted to add legitimacy to the process. The IMF added a key procedural benefit by creating a detailed assessment methodology resulting in a far more objective assessment process. Also, by agreeing to participate the FATF had to agree to abandon the NCCT process.

As with its assessment of OFC’s compliance with Basel Core Principles the IMF determined that OFCs were largely in compliance with the FATF 40 + 9, making it much more difficult for onshore jurisdictions to implement countermeasures. To the extent that onshore jurisdictions were trying to use the FATF 40 + 9 as a back-door to forcing greater compliance with the failed income tax ‘standards,’ this also failed.

**B. Some Proposed Modifications to TRN Theory**

The experience of offshore centers with proposed global standards in income taxation, prudential regulation, and anti-money laundering generally confirms the important role played by trans-national regulatory networks. States not only acted alone in the international system, but through their various domestic governmental institutions, including tax and financial regulatory agencies (and, where relevant, legislatures and law enforcement). The Basel Committee on Banking Supervision played a particularly important role. The Basel Committee, through application of the collective expertise of its members and through the building of consensus and other ‘soft power’ worked successfully to convince all regulators that their Basel Core Principles were in fact best practices. Also as predicted by theory, the Basel Committee still had some legitimacy issues, including its limited membership and the fact that there was no other TRN independent of the Basel group with sufficient expertise to review the standards or to undertake objective assessments of compliance.

The experience also validates the proposed theory that certain non-TRNs with TRN characteristics can combine with TRNs to create a far more legitimate and effective system for creating and spreading the effect of global standards. The IMF was able to play this a role by supplying some of the helpful features missing from the Basel Committee. The IMF had a near
universal membership. The fact that IMF members were states and not local expert regulators was mitigated by the relative independence of a highly expert staff. The IMF supplied both an independent review of the standards and a relatively neutral and subjective method for assessment of compliance.

Thus, an organization with beneficial TRN and non-TRN characteristics may help mitigate the predicated deficiencies of a TRN; together they may advance the adoption of best practices.

The combination of the Basel Committee and IMF also helped protect offshore centers from the predations of onshore centers. Because of the transparent legitimacy of the system, onshore regulators were constrained from acting against resident financial institutions that did business with financial institutions in offshore centers.

Thus, the combination of an organization with beneficial TRN and non-TRN characteristics may protect relatively weak states from the self-interested actions of the strong.

The OECD and FATF had a more difficult time, demonstrating the problems of operating without the legitimacy of a TRN and/or an organization with TRN (and certain non-TRN) characteristics. The OECD did not have enough positive TRN characteristics to achieve legitimacy. A failure to bring the IMF and its attributes further failed to establish adequate legitimacy. While OECD member states and their tax authorities managed to achieve much of what they wanted, they did not achieve everything and the process was messy. The FATF did not have enough positive TRN characteristics to achieve enough legitimacy. It was, however, able to involve the IMF, whose beneficial TRN and non-TRN characteristics helped once again to create a legitimate system of review and assessment, advancing best practices and protecting weak states from the actions of the strong.

The OFC experience suggests two additional observations. Outside observers accept that the substantive standards of TRNs are accepted as best practices because observers (largely) agree that they are best. They agree in part because observers accept the skill of the technicians, but they also agree because the standards are at least relatively good if not best practices, which is a function of the actual skills. Had the IMF not agree to adopt the OECD’s standards in part because they were not actually best practices, at least when viewed from the perspective of non-OECD countries, including OFCs. Had the IMF agreed to adopt them, it would have been through political influence of member states or some other means that would render meaningless its beneficial TRN (and beneficial non-TRN) characteristics.

Finally, ultimately it is the hard power of domestic authorities that backs up the soft power of persuasion. TRNs and non-TRNs backup this power by providing legitimate standards and legitimate compliance assessments. The soft power of persuasion and the hard power of regulators always go together.

C. Recent Developments regarding OFCs

Recent news suggests that many key onshore centers are once again ratcheting up at least their rhetoric against OFCs. The Stop Tax Haven Abuse Act, originally introduced by Senators Carl Levin, Barak Obama, and others in 2007, was reintroduced this year.\(^\text{255}\) During his campaign, President Obama blasted ‘tax havens,’ stating that “[t]here’s a building in the Cayman Islands that houses supposedly 12,000 US-based corporations….That’s either the biggest

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building in the world or the biggest tax scam in the world, and we know which one it is.”

In a manner resembling the way many onshore countries tried to blame OFCs for the Asian financial crisis, U.K. Prime Minister Gordon Brown, recently tried to shift at least some blame OFCs for the current financial meltdown. French and German leaders have also made similar comments, even though no offshore bank has yet failed or been implicated in an onshore bank’s failure. No doubt criticism of offshore centers anti-money laundering efforts will also follow.

It obviously makes some significant political sense for leaders whose countries are in the depth of serious financial problems to blame others. OFCs tend to be small and weak and therefore good targets. It may be that the Basel Committee and the IMF operating together are the best protection OFCs have to the exercise of power by onshore financial regulators. However, the absence of a globally accepted income tax standard and a TRN or organization with sufficient TRN characteristics may work to the disadvantage of OFCs.

D. The Use and Abuse of Standards for Law

The title of this chapter is ‘The Use and Abuse of Standards for Law.’ With respect to the OFC experience with prudential regulation and anti-money laundering rules, the use of standards for ‘law’ (using the world law here to mean a rule that is, practically speaking, not optional), standards are well ‘used.’ The combination of the Basel Committee/FATF and the IMF, with the former using relatively independent expertise to create the standards and the IMF using more representative if less expert skill to review and assess compliance, resulted in a (relatively) good result, both in terms of substance and procedural fairness. The hard power of local regulators was guided, and restrained, by the process. It is relatively free from the often problematic origins of traditional international law, guided as it is by state’s views of principle or ideology (both of which may not be guided by technical expertise applied to solve technical problems) and state self-interest (which can overwhelm both technical considerations and the interests of weak states).

This Article views the larger onshore centers attempt to use the OECD to create and enforce (at least arguably) illegitimate income tax rules was an attempt to abuse standards as law. In fact, the OECD failed to create a generally accepted standard. While OECD members were able to force much of its agenda on OFCs through the coordinated threat of imposing the hard power of domestic tax authorities, the apparently illegitimacy of the system worked to negate its effectiveness. Brute force has always been available to powerful states to force change on weaker states; the failed attempt to create an income tax standard did not change that fact, though it may very well have mitigated its effectiveness.

Another way of viewing the use (and failure of the abuse) of standards for law is the triumph of objectivity. The application of technical expertise to solve technical problems is designed to be objective (based on facts) and not subjective (based on viewpoint). The standards are reviewed by an objective process. They are then generally accepted through objective review by domestic sub-state actors. The assessment of compliance is accomplished by an objective process. Ratings of compliance can then be used by local sub-state actors to guide their application of hard power.

What then is the answer to the question posed by Nietzsche: does the objectivity implied in use of standards for law originate in a heightened need and demand for justice, or does objectivity just create the appearance of such need? A comparison of the serious criticism levied on the false application of objectivity in the income tax area with the general acceptance of the real application of objectivity in the other areas argues for a tentative ‘yes’. The validity of this tentative ‘yes’ may be tested during the current period of international recession. No doubt OFCs are hoping that it is not merely a ‘detrimental and too flattering bias.’

APPENDIX: FSF, OECD, AND FATF LISTS

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