III. Stricter Anti-Money Laundering Rules for Financial Institutions

A. Introduction

On May 11, 2016, U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule under the Bank Secrecy Act (BSA) mandating financial institutions to strengthen customer due diligence requirements.[1] The Rule compels financial institutions to identify and verify the identity of "beneficial owners of legal entity customers."[2] Originally proposed approximately two years ago, the Customer Due Diligence Rule (Rule) was announced a month after the unprecedented leak of 11.5 million confidential files of the Panamanian law firm, Mossack Fonseca (Panama Papers).[3] The Obama Administration described the Rule as a way to "increase financial transparency and give financial institutions and law enforcement the ability to identify the assets of criminals and national security threats."[4] FinCEN adopted the Rule with the purpose of clarifying and strengthening the anti-money laundering (AML) requirements for banks, brokers, or dealers in securities, mutual funds, and futures commission merchants and brokers in commodities.[5] At its core, the Rule contains explicit customer due diligence requirements and includes new requirements for financial institutions to verify

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[1] Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,398 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, and 1026).

[2] *See id*.

[3] Alan C. Porter & Tyler Kirk, *FinCEN Adopts New Customer Due Diligence Requirement for Financial Institutions*, K&L GATES (July 26, 2016), http://www.klgates.com/fincen-adopts-new-customer-due-diligence-requirements-for-financial-institutions-07-26-2016/ [https://perma.cc/ZFR7-XR3E].

[4] Tanya Somanader, *President Obama's Efforts on Financial Transparency and Anti-Corruption: What You Need to Know*, WHITE HOUSE BLOG (May 6, 2016, 9:24 AM), https://www.whitehouse.gov/blog/2016/05/06/president-obamas-efforts-promote-financial-transparency-and-combat-corruption-what [http://perma.cc/5NY7-XBJH].

[5] Porter & Kirk, *supra* note 3, at 1 (stating the Customer Due Diligence Rule serves the purpose of clarifying and strengthening the AML requirement for banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities).

beneficial owners of legal entity customers.[6] The deadline for compliance is May 11, 2018.[7]

This article explains the regulatory framework governing money laundering, and the Rule and its impact on financial institutions. First, Section B discusses the background of the AML regulatory scheme. Section C provides an overview of the Rule. Lastly, Section D discusses the impact of the Rule on financial institutions.

B. Background

The AML regulatory regime under the BSA began as recordkeeping and reporting requirements for banks and thrifts.[8] Since its initial passage in 1970, the BSA has been transformed to combat global terrorism and new money laundering schemes.[9] BSA and AML regulations establish compliance standards to prevent crimes such as money laundering by requiring "at a minimum— (A) the development of internal policies, procedures, and controls; (B) the designation of a compliance officer; (C) an ongoing employee training program; and (D) an independent audit function to test programs."[10] The AML regulatory regime aims to prevent criminals from co-opting the financial system.[11] Particularly, in the period following the terrorist attacks on September 11, 2001, U.S. financial regulatory agencies have focused on ending the use of financial institutions by criminal organizations and terrorist groups.[12] As a result, FinCEN has been pushing for stricter AML regulation and compliance.[13] AML coverage

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[6] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. at 29,398.

[7] *See id.*

[8] Porter & Kirk, *supra* note 3, at 1.

[9] Adam S. Coto, *Customer Due Diligence: FinCEN and the Beneficial Ownership Requirement for Legal Entity Customers*, 20 N.C. BANKING INST. 145 (2016).

[10] Bank Secrecy Act § 205, 31 U.S.C. § 5318(h) (1970).

[11] Coto, *supra* note 9, at 145.

[12] William M. Sullivan Jr. & Fabio Leonardi, *A New Frontier for Bank Secrecy Act Prosecutions*, LAW360 (July 14, 2016, 12:27 PM), http://www.law360.com/articles/817470/a-new-frontier-for-bank-secrecy-act-prosecutions [https://perma.cc/A9SC-JN28].

[13] *See id.* ("[T]he U.S. Department of Justice and the U.S. Department of the Treasury's Financial Crimes Enforcement Network have been increasingly

has now expanded to include banks, thrifts, broker-dealers, and mutual funds.[14] The Rule is part of the trend toward stricter AML rules, aimed at limiting the ability of criminals to use financial institutions in illicit activities.[15]

The recent release of the Panama Papers provided important details regarding the use of overseas shell corporations to launder illicit money through legitimate financial institutions.[16] An anonymous whistleblower released the Panama Papers to a German newspaper, and journalists from over forty countries collaboratively analyzed and released the material to the public.[17] The leak disclosed the identities of the true owners of approximately 214,000 shell companies, collectively worth billions of dollars.[18] Numerous governments and the media are now investigating whether these shell companies were used to hide illicit funds, launder money, receive bribes, commit crimes, and/or evade taxes at the highest levels of government and society.[19] According to outgoing FinCEN Director Jennifer Shasky Calvery, prior to the Rule, "law enforcement agencies frequently found themselves at a 'dead end' when they ran up against a shell company" due to difficulties in tracking down the true owners of these shell companies.[20] The Rule's purpose is to alleviate this problem.[21] The Rule would allow law enforcement and government agencies to locate

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scrutinizing anti-money laundering compliance efforts and pursuing domestic and foreign banks for violations of the Bank Secrecy Act.").

[14] Porter & Kirk, *supra* note 3, at 1.

[15] *See* Coto, *supra* note 9, at 145.

[16] *See* Jon Barooshian, *What the Panama Papers Should Teach Companies about Money Laundering*, CORP. COUNS. (June 30, 2016), http://www.corpcounsel.com/id=1202761437525/What-the-Panama-Papers-Should-Teach-Companies-about-Money-Laundering?slreturn=20160811204102 [https://perma.cc/9PPZ-7J86].

[17] *Id.*

[18] *Id.*

[19] Mark A. Rush et al., *Are Your Company's Legal, Due-Diligence, De-risking, or Compliance Obligations Impacted by the "Panama Papers"?*, K&L GATES (2016), http://www.klgates.com/are-your-companys-legal-due-diligence-de-risking-or-compliance-obligations-impacted-by-the-panama-papers-04-08-2016/ [https://perma.cc/L7CJ-F8G2].

[20] Evan Weinberger, *FinCEN Chief Defends Shell Co. Ownership ID Rule*, LAW360 (May 24, 2016, 1:24 PM), http://www.law360.com/articles/799475/fincen-chief-defends-shell-co-ownership-id-rule [https://perma.cc/GYR4-E7Y2].

[21] *See id.*

individuals linked to sham companies suspected to be a front for a criminal or terrorist group, and ultimately find owners of illicit shell corporations.[22]

C. Rule Overview

The Rule applies to banks, brokers, or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities (collectively, covered financial institutions).[23] The Rule took effect July, 11 2016.[24] Covered financial institutions must comply by May 11, 2018, two years from publication.[25]

FinCEN lists the following four core elements of customer due diligence, all of which should be explicitly required for covered financial institutions: (1) customer identification and verification, (2) beneficial ownership identification and verification, (3) understanding the nature and purpose of customer relationships to develop a customer risk profile, and (4) ongoing monitoring for reporting suspicious transactions and maintaining and updating customer information.[26] The first element is already required by an existing AML rule,[27] while the third and fourth elements are implicitly required by current reporting requirements.[28] The second element, beneficial ownership identification and verification, is the focus of the Rule.[29]

1. Beneficial Ownership

Prior to the Rule, AML regulation did not require financial institutions to disclose their legal entity customers' ownership information.[30] The Rule now requires covered financial institutions to maintain written procedures that identify and verify beneficial owners

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[22] *Id.*
[23] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,398 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, and 1026).
[24] *Id.*
[25] *See id.*
[26] *See id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] Porter & Kirk, *supra* note 3, at 2.

of legal entity customers that open new accounts.[31] Financial institutions must also obtain certification from individuals opening new accounts on behalf of a legal entity customer that "the beneficial ownership information supplied is true and accurate to the best of the individual's knowledge."[32] Financial institutions are required to record the beneficial ownership information and keep the record for a period of five years.[33] The Rule defines a "beneficial owner" as: (1) someone who "directly or indirectly" owns at least 25 percent of the entity's equity interest and (2) "someone with significant responsibility to control, manage, or direct a legal entity customer."[34] According to FinCEN, this two-prong definition requiring entity's to name both equity holders and directors "would allow law enforcement to track down people behind the money."[35]

D. Impact

The Rule's beneficial ownership requirement addresses the issue of legal entity customers opening accounts with the purpose of avoiding disclosure of ownership to hide illicit activities.[36] The Rule carries the goal of reducing illicit activity by providing law enforcement with easier access to beneficial ownership information.[37]

1. Cost-Benefit Analysis

This mission comes with a hefty price tag. The U.S. Treasury projects that the cost of compliance with the Rule will range from $1.15 billion to $2.15 billion[38] over the next ten years.[39] The Treasury estimates that there are $300 billion illicit proceeds generated through financial crimes every year.[40] As a result, FinCEN relied on a breakeven analysis to assess the relative costs and benefits of the

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[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. at 29,451.
[35] Weinberger, *supra* note 20.
[36] *See* Coto, *supra* note 9, at 146.
[37] *Id.* at 161.
[38] This cost was calculated using a 7 percent discount rate. Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. at 29,399.
[39] *Id.*
[40] *See id.*

Rule.[41] For the Rule to produce a net positive effect, FinCEN concluded that the Rule would need to reduce illicit activity by 0.6 percent.[42] The Treasury believes that the rule will reduce illicit activity by more than the 0.6 percent needed to break even.[43] However, most of the estimated cost is front-loaded, burdening the financial system.[44]

2. Criticism

Critics of the Rule, including former Michigan Senator Carl Levin, have said that those wishing to hide their identities and illicit cash will still easily evade the Rule.[45] Accordingly, these critics have been advocating reducing the ownership threshold down from 25 to 10 percent, which is still higher than 5 percent ownership threshold for reporting beneficial ownership status required by the Securities and Exchange Commission.[46] FinCEN also received complaints that the Rule only requires financial institutions to collect the identities of personnel with "significant managerial control," creating a loophole that allows financial institutions to appoint functionaries that are in day-to-day control.[47] Levin expressed concern that the Rule does not go far enough to prevent "terrorists, money launderers, tax evaders and other wrongdoers" from hiding their identities while misusing U.S. financial institutions.[48]

Other critics, ranging from the International Monetary Fund to Oxfam, worry the current enforcement regime goes too far and places too much pressure on U.S. financial institutions.[49] Critics are

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[41] *Id*. at 29,426.
[42] *Id*. at 29,399.
[43] *Id.*
[44] *See* Coto, *supra* note 9, at 161.
[45] Weinberger, *supra* note 20.
[46] *Id.*
[47] *Id.*
[48] Evan Weinberger, *Obama's Moves To Eliminate Shell Companies Easy To Evade*, LAW360 (May 6, 2016, 7:04 PM), http://www.law360.com/articles/793365/obama-s-moves-to-eliminate-shell-companies-easy-to-evade [https://perma.cc/P7XD-EJUW] ("'By allowing managers instead of the real owners to be named, the new rule will enable terrorists, money launderers, tax evaders and other wrongdoers to hide their identities while misusing U.S. financial institutions,' the former senator said in a statement.").
[49] *See* Evan Weinberger, *Feds Seek To Quell Banks' Anti Money Laundering Fears*, LAW360 (Aug. 30 2016, 6:34 PM), http://www.law360.com/

concerned that as a result of this Rule, U.S. banks will engage in the process of de-risking, "essentially going through their books" to find and eliminate customers that "present the largest chance of resulting in a rebuke from regulators."[50] De-risking will likely affect foreign banks that rely on their relationship with U.S. banks to transact in the States.[51] These foreign banks are often located in developing nations, where AML regulation standards may be low.[52] U.S. banks could decide that this low level of AML regulation might be too risky and end correspondent banking relationships with these foreign banks.[53]

3. Government Response

On August 30, 2016, the U.S. Department of the Treasury, in conjunction with the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the National Credit Union Administration released a fact sheet outlining what they expect from banks in terms of risk evaluation posed by foreign banks with whom they conduct business.[54] The fact sheet is intended to ameliorate financial institutions' worries and minimize potential de-risking.[55] The fact sheet dispels myths about FinCEN regulations in an effort to convince banks not to drop existing relationships.[56] The fact sheet emphasizes that under existing U.S. regulations, there is no general requirement for U.S. depository institutions to conduct due diligence on a foreign financial institution's customers.[57] Additionally, the Treasury does not utilize a zero

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articles/834529/feds-seek-to-quell-banks-anti-money-laundering-fears [https://perma.cc/YB3C-SVPQ].

[50] Evan Weinberger, *Banks To Stay On Edge Despite Feds' Laundering Assurances*, LAW360 (Aug. 31, 2016, 9:04 PM), http://www.law360.com/articles/834892/banks-to-stay-on-edge-despite-feds-laundering-assurances [https://perma.cc/JFE8-WYQW].

[51] *See id.*

[52] *Id.*

[53] *Id.*

[54] Weinberger, *supra* note 49.

[55] *Id.*

[56] Weinberger, *supra* note 50.

[57] U.S. DEP'T OF THE TREASURY & FED. BANKING AGENCIES, JOINT FACT SHEET ON FOREIGN CORRESPONDENT BANKING: APPROACH TO BSA/AML AND OFAC SANCTIONS SUPERVISION AND ENFORCEMENT 1 (2016), https://www.treasury.gov/press-center/press-

tolerance policy but "continue[s] to use their authorities—in a proportionate and appropriate manner—to safeguard our financial system against abuse."[58]

4. Implication for Financial Institutions

The Rule sets the beneficial ownership level at 25 percent,[59] which appears to be a fairly "manageable" level for financial institutions.[60] Consequently, legal entity customer might not be required to the Rule's disclosure requirements, where they do not meet the ownership threshold.[61] Furthermore, in the absence of red flags, there is no duty to investigate whether beneficial owners are attempting to avoid the reporting requirements.[62]

The Rule's two-prong definition requires all entities to disclose at least one person under the control requirement. This person can be an executive officer or senior manager, or anyone who regularly performs similar functions.[63] Thus, all financial institutions must designate at least one person as the controlling individual for each legal entity customer.

The Rule explicitly requires financial institutions to utilize risk-evaluating procedures to reasonably detect and prevent fraud and abuse, a process many institutions already implement.[64] According to Lourdes Gonzales, Assistant Chief Counsel of the Securities and Exchange Commission's division of trading and markets, these customer due diligence rules "will require financial institutions to

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releases/Documents/Foreign%20Correspondent%20Banking%20Fact%20Sheet.pdf [https://perma.cc/EAH6-NAHH].

[58] *Id.* at 4.

[59] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,451 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, and 1026).

[60] Weinberger, *supra* note 48, at 2 (remarking banks seemed pleased that FinCEN allowed for a manageable level for beneficial ownership).

[61] Porter & Kirk, *supra* note 3, at 3.

[62] *Id.*

[63] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. at 29,452.

[64] Porter & Kirk, *supra* note 3, at 5 ("The rule's aim is to enhance the effectiveness of AML compliance programs by explicitly requiring what many financial institutions, in the exercise of prudent business practices, have been doing for some time—implementing risk-based procedures reasonably designed to detect and respond to red flags.").

understand their relationships more closely and to develop customer risk profiles."[65] The Rule requires financial institutions "to review and supplement existing customer identification programs, coordinate with third parties, and modify systems and processes to meet the new requirements."[66] Although financial institutions have two years to come into compliance,[67] implementation of necessary changes, along with documentation, could take considerable time.[68] Thus, financial institutions should focus on taking reasonable measures to reach compliance as soon as possible, especially given financial regulator's increased attention and prosecution of AML compliance violations.[69]

E. Conclusion

The adoption of the Rule coincided with the release of the Panama Papers and an increased scrutiny on financial institutions' compliance with AML practices.[70] The Rule requires financial institutions to identify and verify individuals with 25 percent more equity in a legal entity customers as well as individuals controlling or managing the legal entity customers.[71] FinCEN and other financial regulators continue to take threats posed by Treasury and the FBAs take the threats posed by criminals, money-launderers, and terrorist

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[65] Liz Skinner, *Advisers to face stricter anti-money-laundering rules*, INV. NEWS (May 24, 2016), http://www.investmentnews.com/article/20160524/FREE/160529974/advisers-to-face-stricter-anti-money-laundering-rules [https://perma.cc/ML3P-6RA2].

[66] Porter & Kirk, *supra* note 3, at 5.

[67] *See id.*

[68] *Id.*

[69] Sullivan & Leonardi, *supra* note 12, at 3 ("[F]inancial institutions involved in trade-finance activities, such as issuing letters of credit, providing trade-supporting loans to exporters or importers, or engaging in documentary collection, trade credit insurance, factoring or forfaiting, should consider implementing TBML compliance programs to assess and mitigate money laundering and terrorist financing risks arising from trade-related activities.").

[70] *See* Porter & Kirk, *supra* note 3, at 5.

[71] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,451–52 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, and 1026).

financers very seriously, and implement rules in proportionate manner.[72]

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[72] *See* U.S. DEP'T OF TREAS. & FED. BANKING AGENCIES, *supra* note 57, at 4 ("Treasury and the FBAs take the threats posed by criminals, money-launderers, and terrorist financers very seriously.").
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