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The Unknown Future of Beneficial Ownership Requirements and Their Impact on Commercial Real Estate

Financial institutions have an extensive role in fighting financial crime through numerous regulatory requirements, including Know-Your-Customer (KYC), Anti-Money Laundering (AML), Customer Identification Program (CIP), and Beneficial Ownership. Moreover, these requirements are continually expanding and are certain to change in the future. The multiple layers of these requirements, however, can also impose substantial compliance and operational burdens on banks and their customers, particularly when customers regularly utilize multiple entities.

In the commercial real estate (CRE) world, many legitimate reasons exist to use multiple special purpose entities (SPEs) across investments, such as for bankruptcy remoteness, tax planning, risk management, etc. The Beneficial Ownership information required for each SPE may be the same, and both banks and their customers may desire to streamline the delivery of required information across entities. As banks and their customers adjust to new requirements, however, they will need to balance compliance with commercial objectives. To assist in this process, this article examines the history, current state, and potential changes of identification requirements, particularly with respect to Beneficial Ownership information at the center of more recent proposals, and offers some tips to the CRE industry in planning for the unknown future.

A Look Back

The KYC requirements under the original Bank Secrecy Act (BSA) passed in 1970 were transaction-based and mandated that banks file reports under five discrete scenarios involving cash, monetary instruments, and foreign banks. The most open-ended requirement related to filing a Suspicious Activity Report (SAR) when a national bank "detect[s] a known or suspected violation of Federal law or a suspicious transaction related to a money laundering activity or a violation of the Bank Secrecy Act".[i]

Enacted shortly after the September 11, 2001 terrorist attacks, the USA Patriot Act created a more comprehensive KYC regime. This act shifted the approach from transaction-based to a regime based on customer identification with an added focus on terrorism financing. Among the Patriot Act's many provisions, it required the Treasury Secretary to "prescribe minimum standards regarding the identity of the customer that shall apply in connection with the opening of an account at a financial institution".[ii] Such CIP minimum standards had to require financial institutions to implement reasonable procedures for verifying identities, maintaining records, and consulting lists of known or suspected terrorists or terrorist organizations. Combined with the law's requirement that financial institutions develop AML programs, internal policies, procedures, and controls, the Patriot Act effectively brought every bank customer, account, loan, or other transaction into the fight against money-laundering and terrorism financing.

In the years following the Patriot Act, perhaps the most significant driver of change related to KYC requirements in the CRE industry was not new regulations, but rather continual revisions of banks' policies and procedures. The Patriot Act and corresponding regulations did not establish clear-cut tests, but rather minimum standards, for acceptable KYC compliance programs. As a result, banks often developed programs, policies, and procedures that were more stringent than might otherwise be necessary to satisfy the minimum standards.

The banking industry's willingness to exceed minimum standards can be explained in part by the size of the fines levied by the federal government where financial institutions' KYC and AML programs were deemed insufficient. According to one study, US regulators and the Department of Justice assessed $23.56 billion in fines covering 122 penalties during the period of 2008-2018 for AML and related violations, as well as transaction reporting failures.[iii] Most notably for the purpose of this article, the regulators assessed HSBC with a $1.9 billion fine in 2012 primarily because it "failed to maintain an effective program against money laundering and failed to conduct basic due diligence on some of its account holders."[iv] One result of such penalties is that they can drive a financial institution to tighten its AML and KYC policies and procedures so as to protect against charges that it did not maintain effective programs.

Following the Patriot Act's KYC requirements, a common practice in the CRE industry was to obtain AML-related representations and covenants from counterparties to a transaction. Loan documents, purchase and sale agreements, and other real estate transaction documents came to include what would be commonly referred to in practice as "OFAC provisions", named after the Office of Foreign Assets Control (OFAC) in the Department of Treasury. OFAC provisions would, in effect, require a party to state that it did not and would not violate applicable AML laws, and that they did not and would not appear on OFAC's list of known or suspected terrorists. Although OFAC provisions are still relevant for use in real estate agreements, the continual expansion of KYC requirements, including as a result of recent developments, has meant that a financial institution's reliance solely on OFAC provisions is not enough to satisfy regulatory and internal compliance requirements.

Recent Developments

The most significant new regulation in recent years has been the Treasury Department's Financial Crimes Enforcement Network (FinCEN)'s Customer Due

Diligence (CDD) regulations promulgated in 2016 with a compliance deadline of May 2018. The primary purpose of the CDD requirements was to close a perceived weakness where financial institutions had not been "required to know the identity of the individuals who own or control their legal entity customers (also known as beneficial owners)", which "enable[d] criminals, kleptocrats, and others looking to hide ill-gotten proceeds to access the financial system anonymously".[v] This regulation also expressly required enhanced due diligence and risk-based assessments depending on the nature and purpose of customer relationships.

The CDD regulations direct covered financial institutions to obtain personal information, including name, address, date of birth, social security number (US citizens) or passport information (foreign persons), and address of both:

(a) each "individual, if any, who owns, directly or indirectly, 25 percent or more of the equity interests" of an entity that is a customer of the financial institution (the ownership prong), and;

(b) an "individual with significant responsibility for managing the legal entity customer" (the control prong).[vi]

Similar to as noted above, the CDD regulations permit financial institutions to develop policies that exceed minimum requirements for some or all of their customers. For example, banks could reduce the threshold of the ownership prong from 25% to 10% direct or indirect ownership in an entity. Further, the more stringent information requirements could be applied on a case-by-case basis following a risk-based assessment of any given transaction or more broadly to a given class or type of customer.

FinCEN's regulations indirectly require customers to comply with the Beneficial Ownership requirements since they effectively could not do business with a financial institution without providing the required information. The regulatory requirement and burden of collecting the information still falls directly on the financial institutions, though, as does the risk of penalty for non-compliance.

Beneficial Ownership Reform Legislation

Two pieces of legislation proposed in 2019 looked to shift reporting burden to the business entities themselves. The Corporate Transparency Act (CTA), which passed the House of Representatives 249-173 in October 2019, narrowly focuses on the Beneficial Ownership issue. In the Senate, the Improving Laundering Laws and Increasing Comprehensive Information Tracking of Criminal Activity in Shell Holdings Act (the ILLICIT CASH Act) is a wide-ranging, bipartisan bill designed to modernize AML requirements and enforcement. In each bill, business entities themselves would be required to disclose Beneficial Ownership information to FinCEN directly, including updating information to reflect any changes in beneficial ownership information.

With some variation, each bill would effectively codify the current regulatory definition of "beneficial owner" to include both 25% direct or indirect owners and individuals exercising significant control over the company. The CTA adds a third prong to the definition of "beneficial owner" to include anyone who "receives substantial economic benefits from the assets" of a covered company, which would be defined more precisely in rules promulgated by the Secretary of the Treasury. The personal information requirements under the CTA includes each beneficial owner's full legal name, date of birth, current residential or business street address, and a unique identifying number from a non-expired passport, personal identification card, or driver's license. Specific provisions address the information requirements for foreign beneficial owners. Entities would be required to retain the relevant Beneficial Ownership information for five years after the applicable entity terminates.

Since the CTA is geared to fight financial crimes, it provides for enforcement agencies to obtain the Beneficial Ownership information and for criminal and civil penalties for anyone who knowingly or willfully (but not negligently) violates the act's disclosure requirements. Both bills also provide that Beneficial Ownership information may be furnished to the financial institutions following "a request made by a financial institution, with customer consent, as part of the institution's compliance with due diligence requirements imposed under" applicable law.[vii] As a result, the Beneficial Ownership information under these bills would provide a means for banks to access required information without having to obtain it directly from the customer. Accordingly, financial institutions and bank-industry groups have been generally supportive of these legislative efforts to shift responsibility onto legal entities themselves.

Gaps and differences exist between the information that an entity would be required to provide under the CTA or ILLICIT CASH Act and what a bank would be required to obtain for opening an account under the current CDD regulations. Most notably, in terms of personal identification of beneficial owners, the CTA specifies providing a passport or driver's license number as compared to the disclosure of an individual's social security number required under current Beneficial Ownership regulations. In addition, certain entities are excluded from having to provide information under the CTA, such as regulated entities like broker-dealers or investment companies; or entities with 20 or more employees, a minimum of $5,000,000 in gross taxable income, and an operating presence in the U.S. Further, as currently drafted, the CTA applies only to corporations and limited liability companies, but not to partnerships, trusts, or other entities.[viii]

Gaps like these could be closed either through revisions to legislation (i.e., CTA or ILLICIT CASH Act) or through subsequent implementing regulations. Even under new legislative regimes, however, financial institutions would remain responsible for ensuring overall compliance with their own FinCEN requirements, though they may be relieved of the initial step of data collection from customers. While the Senate has yet to act on either bill (as of December 2, 2019), these pieces of legislation demonstrate that lawmakers may view the current regulatory regime as insufficient to fight financial crimes, so the status quo likely will change again in the future.

The Impact on Commercial Real Estate Finance Transactions

One of the most immediate impacts of the FinCEN CDD regulations was to force financial institutions to ramp up and devote significant time and resources to their AML compliance programs. As a result, their customers also have had and continue to have to devote resources to responding to their bank's requests for CDD, and in some cases, enhanced information. All this leads to the final question for consideration: what can parties in the CRE finance space do now to address the unknown future of KYC and Beneficial Ownership requirements? Here are some suggestions:

- Beware of the broad covenant: Lenders may be inclined to include a broad-based covenant obligating the borrower to provide information and documents as may be required by the lender to meet its CDD requirements and internal policies. Such a covenant may seem as a way to implement the bank's regulatory requirements. At the time of origination of the loan, however, neither the bank nor the borrower can know what the regulatory requirements or bank's implementing policies will be over the course of a three to seven year loan as is common in CRE finance. As a result, a borrower could be at risk for default for a breach of the covenant for not being able to deliver information that was not contemplated at the time of execution. From the lender's perspective, even if such a breach would be seen as a minor technical default, it would face the risk of having to carry a defaulting loan on its books. So, rather than having a general information covenant, lenders and borrowers should explore other

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ways to address KYC and Beneficial Ownership requirements, such as using conditions for funding rather than covenants, or discrete and defined reporting obligations instead of broad provisions.

- Anticipating Information Needs: As noted above, sponsors and investors in real estate transactions need to be prepared to provide Beneficial Ownership and other information, either to allow financial institutions to comply with their current requirements or to provide to FinCEN should CTA or ILLICIT CASH Act become law. Thus, sponsors and investors will need to develop approaches and agreements about how to handle this requirement, and should consider and address within their investment documents issues like:
  - Procedures and conditions for obtaining and disclosing personal information about investors either with or without prior consent; and
  - Remedies for cases in which an investor does not provide additional, required information, such as potentially withholding distributions, removing the investor from the investment, or obtaining indemnities from the investor for failing to provide required information.

These are but two of the issues to address given the present and unknown future of Beneficial Ownership regulations. What is certain, though, is the necessity of fighting financial crimes will have substantive commercial implications in the CRE industry in the years to come.

[i] 12 CFR §21.11, available at https://www.law.cornell.edu/cfr/text/12/21.11 (last visited November 14, 2019).

[ii] USA Patriot Act §326(a)(l)(1), available at https://www.govinfo.gov/content/pkg/BILLS-107hr3162enr/pdf/BILLS-107hr3162enr.pdf (last visited November 14, 2019). The Department of Treasury in the implementing regulations subsequently defined "account" to mean "a formal banking relationship established to provide or engage in services, dealings, or other financial transactions including a deposit account, a transaction or asset account, a credit account, or other extension of credit" (68 FR 25090, 25109).

[iii] "A Fine Mess We're In: AML/KYC/Sanction Fines." Fenergo. 2018. Available at https://www.fenergo.com/aml-kyc-sanction-fines (last accessed on October 17, 2019).

[iv] Aruna Viswanatha and Brett Wolf. "HSBC to Pay $1.9 Billion U.S. Fine in Money-Laundering Case." Available at https://www.reuters.com/article/us-hsbc-probe/hsbc-to-pay-1-9-billion-u-s-fine-in-money-laundering-case-idUSBRE8BA05M20121211 (last accessed on October 15, 2019).

[v] 81 FR 29398, available at https://www.govinfo.gov/content/pkg/FR-2016-05-11/pdf/2016-10567.pdf (last visited November 14, 2019). A kleptocrat is a governmental leader who makes himself or herself rich and powerful at the expense of the governed people. Famous recent historical examples Jean-Claude ("Baby Doc") Duvalier of Haiti, Slobodan Milosevic of Serbia/Yugoslavia, and Ferdinand Marcos of the Philippines.

[vi] 31 CFR §1010.230(d)(1)-(2) , available at https://www.law.cornell.edu/cfr/text/31/1010.230 (last visited November 14, 2019).

[vii] CTA §5333(a)(5)(B)(iii), available at https://www.congress.gov/bill/116th-congress/house-bill/2513/text (last visited November 14, 2019).

[viii] The CTA, as currently drafted, directs the Comptroller General of the United States to conduct a study evaluating the impact of not including partnerships, trusts, or other legal entities within the scope of the CTA.

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