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IMPLEMENTATION OF FINCEN'S CUSTOMER DUE DILIGENCE RULE— FINANCIAL INSTITUTION PERSPECTIVE

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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IMPLEMENTATION OF FINCEN'S CUSTOMER DUE DILIGENCE RULE— FINANCIAL INSTITUTION PERSPECTIVE

Friday, April 27, 2018

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Blaine Luetkemeyer [chairman of the subcommittee] presiding.

Present: Representatives Luetkemeyer, Rothfus, Posey, Ross, Pittenger, Barr, Tipton, Williams, Love, Loudermilk, Tenney, Clay, Maloney, Heck, Crist, and Waters.

Also present: Representatives Pearce and Hill.

Chairman LUETKEMEYER. The meeting will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is entitled, "Implementation of FinCEN's Customer Due Diligence Rule—Financial Institution Perspective."

I would like to thank the witnesses for appearing today. We appreciate your participation and look forward to your discussion.

In the interest of time, the Ranking Member and I have agreed to forego opening statements and move directly to witness testimony.

Today we welcome the testimony of Mr. Greg Baer, President of The Clearing House Association; Mr. Carlton Greene, Partner, Crowell & Moring; Mr. Gary Kalman, Executive Director of the FACT Coalition; and Ms. Dalia Martinez, Executive Vice President, International Bank of Commerce, on behalf of the Mid-Size Bank Coalition of America.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written statements will be made part of the record.

A little bit on the lighting system. Green means go, yellow means you have a minute to wrap up, and red means you should be closing up and moving on.

We do have votes in the 10:30 to 11 o'clock range, somewhere in there. We hope to be able to get as far down the road as we can. That is why we have done away with opening statements.

Depending on how many participants we have in the committee today, we will continue after votes, if we need to. So hopefully, we will get a lot done between now and then.

With that, Mr. Baer, you are recognized for 5 minutes.

STATEMENT OF GREG BAER

Mr. BAER. Thank you.

Chairman Luetkemeyer, Ranking Member Maloney, and members of the subcommittee, thanks for the opportunity to testify today on FinCEN's CDD (Financial Crimes Enforcement Network Customer Due Diligence) Rule. It is a particular pleasure to testify before you, Mr. Chairman and the Ranking Member, with whom it has been a true pleasure working with you and your staff on these issues now for some time.

The Clearing House believes that the FinCEN CDD Rule and its beneficial ownership requirement can provide law enforcement with useful information as it seeks to learn more about suspect companies. We particularly appreciate FinCEN's decision to grant financial institutions some flexibility in how they collect and certify beneficial ownership information, which was the product of a laudable notice and comment process by FinCEN.

We do, however, have one primary concern with the final rule and broader concerns about guidance used to interpret it and the examination process that is expected to enforce it.

As for the rule, it requires covered financial institutions to reconfirm the beneficial owners of a customer each time the customer opens an account. This requirement is burdensome for customers that routinely open multiple accounts on the same day or within a short period of time. For example, title companies can open multiple accounts daily to assist in closing real estate transactions, and large companies frequently open accounts for many reasons.

The cost in customer inconvenience of reconfirming ownership with each new account do not appear to come with any corresponding benefit, as there generally is no reason to believe that the opening of a new account is evidence that the ownership of the customer has changed.

The new account requirement is complicated further by guidance released by FinCEN on April 3 in the form of FAQs. While the Clearing House generally appreciates FinCEN's efforts to provide additional guidance, unfortunately, in some areas, the guidance has expanded rather than interpreted the final rule in unexpected ways.

Most significantly, FAQ 12 states that even the rollover or auto renewal of an account, for example, a deposit or a loan, constitutes a new account. Again, there is no reason to believe that the rollover of a 1 month CD is evidence of a change in ownership in the customer.

Since adoption of the CDD Rule in 2016, financial institutions have invested millions and rebuilt their internal systems, which would need to be significantly modified to accommodate this direction which came only 1 month before the go live date.

The FAQ 12 guidance is even more troubling, given that these products include contractual provisions that require financial institutions to auto renew for customers without interruption. There-

fore, on May 11, financial institutions will be forced to choose between breaching their contracts with customers or following the FAQ.

We note that FinCEN in its FAQs has attempted to resolve this issue by providing that, during the initial certification of beneficial ownership, the customer can simply agree to notify of any future change. We hope and expect that FinCEN will revisit the question of existing accounts where that agreement has not already been obtained. However, even as FinCEN considers this issue, we are quite concerned that examiners at the regulatory agencies will treat guidance as a binding rule and cite banks for violations of law for honoring their contracts in their traditional zero tolerance approach to AML (anti-money laundering) compliance.

Of course, new beneficial ownership requirements for banks highlight the need for broader legislation to prohibit the formation of anonymous companies, as many criminals launder money by forming LLCs and using them to hold real estate or other valuables, all without even touching the banking system. For this reason, we continue to support your legislation ending anonymous ownership of U.S. companies.

With respect to implementation of the CDD Rule, we believe that FinCEN compliance examinations—BSA (Bank Secrecy Act) compliance examinations should follow FinCEN's rule and not seek to amend or interpret it, either at the agency level or through ad hoc examiner judgment. For example, public reports have indicated that the banking agencies have considered directing institutions to collect beneficial ownership at a 10 percent equity threshold in some cases. However, FinCEN was very clear in its rule that the standard is 25 percent.

More broadly, my written testimony describes the profound dysfunction in the current AML regime where banks are judged on SARs (suspicious activity reports) they don't file, rather than the value of the ones they do, where no priorities are set and where the hallmarks of the regime are box checking and compliance for compliance's sake.

The result is a system that is doing far less to assist law enforcement and national security than it could, and a system with extraordinary collateral costs, everything from pushing LMI customers out of the banking system and into the hands of check cashers and payday lenders, to forcing global banks to exit certain countries or regions at risk of sanction.

In the now 2 years since we began raising these issues, it has been gratifying to see the building of a broad bipartisan consensus that major changes are necessary to the system. But I am sad to report that, by all accounts, nothing much has changed in the banking agencies' examination and enforcement of the regime. Hearings like this and the draft legislation under consideration are important steps in turning this consensus into real reform.

Thank you very much.

[The prepared statement of Mr. Baer can be found on page 30 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Baer.

Mr. Greene, you are recognized for 5 minutes.

STATEMENT OF CARLTON GREENE

Mr. GREENE. Thank you, Mr. Chairman. I appreciate the opportunity to address the subcommittee.

My name is Carlton Greene. I am a Partner at Crowell & Moring. I am formerly the Chief Counsel of FinCEN. Before that, I served a number of years at Treasury working for the Office of Foreign Assets Control on sanctions activities against—U.S. sanctions regimes against Iran, North Korea, transnational criminal organizations, and terrorist actors.

So since leaving FinCEN, I have been now 2 years in private practice working in the economic sanctions and anti-money laundering areas, primarily for financial industry clients. And I think it has given me a balanced view on the critical mission that FinCEN plays, but also the enormous efforts that private industry puts into complying with the Bank Secrecy Act, the burdens associated with it, how seriously that they take it, and how much they work every day to try and comply with it, much of which is not seen by regulators.

There are just a few points I wanted to make today. One is that I think the CDD Rule represents a very important advance in the information available to FinCEN. Information on beneficial owners, I think, will allow FinCEN to draw all kinds of connections that were not previously available to it in the fight to detect and deter financial crime. I think that is critical information.

I think that FinCEN deserves credit for having gotten this rule across the line. This is a rule that has been 10 years in the making. FinCEN conducted extensive public outreach associated with the rule. It incorporated a lot of the comments that industry provided. It showed a willingness to engage with folks and have a real back-and-forth dialog.

I also think that the FAQs that FinCEN put out, again, show considerable responsiveness to the concerns that industry raised about the rule and the questions that they had about the rule.

I think that kind of partnership bodes well for the future of the rule and its implementation.

On the banking side, I think that banks and other covered financial institutions, likewise, put an enormous amount of effort into informing FinCEN's work on the rule, helping it to understand what kind of ideas would impose impossible burdens on the industry or otherwise wouldn't generate the kind of benefits FinCEN was hoping for.

I know that the CDD Rule comes on top of the many burdens that these institutions already face. And I know firsthand, from my experience in private practice, how much time, effort, expense goes into maintaining AML compliance programs, much of which is never seen by regulators.

I know also that the professionalism with which every financial institution I have dealt with has approached this issue. So I think there is a lot of credit to be given on both ends.

A few points about the rule itself and about the future of the AML regime. I think the FAQs, although they provide important interpretive guidance and have solved a number of the problems raised by industry about the rule, there are a number of compli-

ance questions that still remain out there, and I have given a list of several of these in my testimony.

My hope is that FinCEN will continue to work closely with the regulating community to address these questions to provide public guidance where possible on them, but always to listen and offer its thoughts on the approach to these so that industry knows the way to go forward and that implementation is reasonable and possible.

I also hope that in the early years of implementing the rule, that they will be lenient about enforcement, understanding the inevitable but unexpected obstacles that will arise.

The second point I wanted to raise is a broader issue about AML regulation and relates to FinCEN's relationships with the prudential banking regulators. One of the concerns I have, and I think I share with Mr. Baer, is that because FinCEN has delegated examination authority to the Federal banking regulators—the Federal functional regulators, I should say, more broadly, and because these agencies have their own—use their own independent authorities to enforce Bank Secrecy Act obligations, I think there is some risk there that there will be divergent interpretations of the Bank Secrecy Act or that enforcement priorities across all these different agencies will not necessarily line up with those that most advance FinCEN's mission of detecting and deterring financial crime.

FinCEN, I think, is uniquely positioned in that it has access to financial threat information and it also understands the regulatory process. And I think it is uniquely positioned to balance those two together to ensure that enforcement is calibrated to the actual needs to address financial threats. In the absence of that dual knowledge, I think there is a potential for overly formalistic enforcement of the Bank Secrecy Act.

I am happy to comment further if needed. Thank you.

[The prepared statement of Mr. Greene can be found on page 42 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Greene. I appreciate your testimony.

Mr. Kalman, you are recognized for 5 minutes.

STATEMENT OF GARY KALMAN

Mr. KALMAN. Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee, thank you for the opportunity to appear before you.

On behalf of the Financial Accountability and Corporate Transparency (FACT) Coalition, I appreciate the opportunity to discuss FinCEN's Customer Due Diligence Rule and the importance of collecting beneficial ownership information.

This remains a critical element in the larger effort to address grand corruption and the nexus between secrecy jurisdictions, crime, corruption, human rights, and national security. FACT Coalition is a nonpartisan alliance of more than 100 State, national, and international organizations working to combat the harmful impacts of corrupt financial practices.

Before addressing the particulars of the CDD Rule, I thought it was important to review why the collection of this information matters. As detailed further in my written testimony, the rule is a

positive step forward, but falls short of what is needed to protect the integrity of our financial system.

Anonymous companies have become the vehicle of choice for drug cartels, organized crime, corrupt foreign officials, and others who need to launder money. These entities are able to profit from these funds, prop up their regimes, and engage in a host of harmful actions.

A few quick examples. A Moldovan gang used anonymous companies from Kansas, Missouri, and Ohio to trick victims from overseas in a $6 million human trafficking scheme. Traffickers in counterfeit and other illicit goods and services often hide behind corporate entities to make it more difficult for legitimate businesses to honestly engage in global commerce.

As Congress considers new sanctions to counter North Korean threats, the committee should take note of a U.S. Department of Justice case charging a Chinese national and several colleagues with violating U.S. sanctions laws by working with a blacklisted North Korean bank to set up shell companies in Hong Kong and elsewhere to hide the business they were doing with North Korean companies that helped them to develop nuclear weapons.

We agree on the need for the CDD Rule as a step toward a comprehensive approach to prevent the abuse of anonymous companies and launder money through our financial system.

The rule was published in 2016. Financial institutions have had 2 years to prepare for the implementation of the rule. Many U.S. financial institutions already routinely collect beneficial ownership information as part of their know-your-customer obligations. We do not see a need for the delay in the implementation of the rule. We have no position on whether or not, if there are good-faith efforts that have been made by financial institutions, to have reasonable accommodation on enforcement actions.

The Coalition does have a concern about the rule's definition of beneficial owner. The rule does exclude the concept of entitlement to funds, thereby enabling a corporate officer to be deemed the beneficial owner of a corporation. That officer has no ownership rule or entitlement to the corporation's funds.

The Coalition favors a consensus definition that was already approved overwhelmingly by Congress in last year's National Defense Authorization Act. In the NDAA of Fiscal Year 2018, a provision was included to require the Department of Defense to collect beneficial ownership information when leasing high-security office space. That definition, with its focus on natural persons who ultimately control or benefit from a legal entity, is important to prevent the shell games in which one company owns another, which in turn owns another and so on, all to obfuscate the name of the individuals who exercise ultimate control.

The rule is only one part of an overall strategy to address the abuse of anonymous companies. Bad actors have established U.S. companies to purchase real estate, aircraft, and other large ticket items with cash. Companies have been created in the U.S. only to route money from one jurisdiction to another, bypassing the U.S. banking system.

While financial institutions represent the largest gatekeeper to the U.S. financial system, they are not the only gatekeepers. And as such, Congress should be looking beyond the rule.

There are at least two proposals currently pending in the House Financial Services Committee to strengthen corporate transparency by improving beneficial ownership disclosures.

We thank Chairman Luetkemeyer for his leadership, along with Chairman Pearce, for sponsoring the Counterterrorism and Illicit Finance Act; and Representatives Pete King and Carolyn Maloney for cosponsoring the Corporate Transparency Act. Both proposals require companies to name the beneficial owners at the time of formation and both include language consistent with last year's NDAA.

The CDD Rule, the NDAA provision, and Treasury's geographic targeting orders are all important steps. But they are not a substitute for a consistent national standard that levels the playing field for all States and corporate entities.

Thank you, and I look forward to any questions.

[The prepared statement of Mr. Kalman can be found on page 45 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Kalman.

Ms. Martinez, you are recognized for 5 minutes. Welcome.

STATEMENT OF DALIA MARTINEZ

Ms. MARTINEZ. Chairman Luetkemeyer and members of the subcommittee, I am honored to have this opportunity to present testimony today.

I am Dalia F. Martinez, Executive Vice President and Corporate Bank Secrecy Act Officer for International Bank of Commerce. IBC Bank-Laredo is a member of International Bancshares Corporation, a $12.2 billion multibank financial holding company in Laredo, Texas. We have 192 branches and more than 294 ATMs serving 90 communities in Texas and Oklahoma.

I am speaking to you today representing the Mid-Size Bank Coalition of America (MBCA), the voice of 88 community banks with headquarters in 34 States. MBCA banks are primarily between $10 billion and $50 billion in assets, with more than 10,000 branches in all 50 States with deposits of $1.2 trillion. MBCA banks represent, service, and support millions of customers.

I have held the position of BSA Officer at IBC for more than 27 years. BSA compliance is a top priority for us, and I have seen firsthand how BSA regulations have evolved, the burden they have placed on our bank, and how these regulations have sometimes ended up harming, rather than helping, our most important asset, our customers.

I would like to focus on four points in my testimony today. First, compliance with the CDD Rule is very expensive and burdensome. IBC has spent 2,912 hours in design and testing, 7,859 hours in training 2,142 employees and officers preparing to comply with this regulation. These expenditures are on top of the $5 million a year we currently spend to comply with existing BSA/AML regulations.

Every hour a bank employee spends on regulatory compliance is an hour that employee is not able to spend on what we value most: Helping our customers achieve financial success.

Second, the CDD Rule has many gray areas that are difficult to implement. Let me provide you an example that illustrates this. Bank frontline employees who are typically not schooled in complicated business structures are required to capture beneficial ownership information when an account is opened. But the individual opening the account on behalf of the company is usually a control person at the company and not the actual business owner. While in some cases the control person may have knowledge of the ownership structure of the company, they often will not have the identification required for the CDD requirement. This may result in accounts being turned away and delays in opening accounts.

Third, the rule puts a burden on banks to ensure the information the customer provides is accurate. But banks are not given the tools they need to make that determination. Banks can rely on the information that customers disclose about the ownership structure of the company, only so long as the financial institution does not have knowledge of facts that would reasonably call into question the reliability of the information. However, FinCEN does not define having knowledge.

Financial institutions have millions of records. Are we to comb through all our records to ensure information provided on a beneficial ownership attestation does not conflict with a document that already exists within the bank?

Unlike some countries, the United States does not maintain a national database of business ownership information that a financial institution can rely on. Tools and guidance from FinCEN designed to help banks verify customer information are needed.

Fourth, while FinCEN has provided some guidance to banks in the form of FAQs, some of the FAQs are not clear, and others create an even greater burden on banks and, ultimately, bank customers. One such example is with certificates of deposit that auto renew. These CDs are for a specific term and rate. Upon maturity, the CD renews and the customer never has to come to the bank, as renewal information is mailed to the customer.

FinCEN FAQs state that upon the first auto renewal of a CD established prior to May 11, 2018, the financial institution must obtain the beneficial ownership and CDD information. This means banks will need to contact their customers to try to obtain the beneficial ownership information.

From my 39 years in banking, I can tell you, customers do not update their phone records and email addresses with the bank on a regular basis. Therefore, we will mostly like have to rely on mail. If the customer does not respond to the bank's request, are we to return the funds to the customer or track exceptions?

Every time a bank makes an exception, the exception is tracked for BSA exam purposes and is subject to second-guessing after the fact. Again, this reality will lead to even more de-risking, which will harm bank customers, especially small business customers who are not exempt from any of these regulations.

In closing, on behalf of IBC and MBCA, I hope I have conveyed to you that regulatory costs and burdens imposed on banks affect our Nation's small businesses.

It is critically important that FinCEN provide clear and effective guidance; otherwise, our prudential regulators will be left to their

own interpretations, and ultimately, this will result in customers simply being driven out of the traditional banking system.

Thank you.

[The prepared statement of Ms. Martinez can be found on page 56 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Ms. Martinez.

With that, we will begin our questions. I will recognize myself for 5 minutes.

One of the concerns that we have had—and Chairman Pearce and I are working on a BSA/AML bill, and part of it is to get this beneficial ownership situation resolved.

One of the problems that we see is that the banks are being deputized to become law enforcement officers by this rule from Treasury, and it is costing literally millions and millions of dollars. One large bank I was talking to actually has over a thousand employees that do nothing but take care of BSA/AML, and now they are going to have to deal with this beneficial ownership situation.

So, Mr. Greene, you tell me that you have been involved with FinCEN for quite some time, and you like the rule, according to your testimony. Can you tell me, do you think FinCEN could be able to collect information by themselves? That is what we proposed in our bill. Is that going to work or not?

Mr. GREENE. Thank you, Mr. Chairman. If by that you mean if they were to collect beneficial ownership directly themselves—

Chairman LUETKEMEYER. Right.

Mr. GREENE. —and to make use of it. Yes, I think that is a possibility.

Chairman LUETKEMEYER. That is a viable solution. Is that what you are saying?

Mr. GREENE. It is potentially a viable solution, yes, sir. And I also think that speaks to a separate issue, which is that there is only so much that financial institutions are in a position to gather. Putting aside the burden, just as a practical matter, I think Mr. Baer mentions some of the circumstances that as useful and as important as the CDD Rule is, there are types of information—companies that will not be covered by it in terms of beneficial ownership information. And that would include, for example, an LLC that is established in Delaware but keeps its accounts overseas and directs its operations overseas. That would not be covered by the CDD Rule because it would not be banking with a U.S. financial institution.

Chairman LUETKEMEYER. I had my taxes filled out during the—about a month ago. And I asked my accountant, I had this—we had this situation, this problem. I said, is there another way that FinCEN could collect the information? And he said the IRS already has all this beneficial ownership information. And since IRS is within the Treasury Department, which is where FinCEN is, you would think you would be able to just give them a call and say, hey, can you give us this information with regards to the XYZ company.

Is that a viable solution?

Mr. GREENE. Thank you, Mr. Chairman. I have not—I will confess I have not looked at the specific beneficial ownership information available to the IRS. I do know that, in the past, there have

been legal impediments to using taxpayer information for purposes of financial threat analysis on the FinCEN side.

Chairman LUETKEMEYER. OK. So according to my accountant, they already have this information, because you have to file it when you file your tax returns. So if we could do something in the bill, for instance, to say something to the effect that we would allow FinCEN to have access if they have some sort of cause to be able to go looking for this information, would that be a viable solution?

Mr. GREENE. Certainly, I think that FinCEN could make very good use of any beneficial ownership information that might already be in the Government.

Chairman LUETKEMEYER. That would certainly streamline things, wouldn't it?

Ms. Martinez, you were adamant in your discussion here and your testimony a minute ago with regards to concerns you had about, and to me it is a real problem, with regards to de-risking. And some of the banks, that they just, in order to get rid of this problem, may just not take these kinds of customers on.

Would you like to elaborate a little bit on the de-risking problem here? We see this throughout all sorts of other things going on right now, and seems like we are compounding the problem here with this rule.

Ms. MARTINEZ. Thank you, Chairman. Yes, that is very true. The issue of de-risking is very real in all financial institutions, and it is primarily a result of the fact that there is not definitive guidance. And so individual examiners, from exam to exam, may change their position on how they evaluate certain types of accounts and the requirements that they ask the banks to follow for documenting risk on these types of customers.

So at some point, it just becomes too burdensome to continue to ask for information from the customer, or the customer just gives up because we are asking for too much information. And so we de-risk that account or group of accounts, and that customer goes to another financial institution and starts all over again.

I don't think that helps our goal here of trying to combat money laundering.

Chairman LUETKEMEYER. My time is about up. I just want to ask you for one more quick comment. You also talked about the problem with the lack of clarity with regards to the guidelines. Would you like to just take a couple of moments and elaborate on that as well?

Ms. MARTINEZ. Well, I will talk about the 25 percent beneficial rule. In FinCEN's FAQs, they talk about that the banks can use another threshold, a lower threshold, for accounts that they deem higher risk. I think that is very dangerous that we don't have a bright line, because that will leave the examiners open to interpretation.

Chairman LUETKEMEYER. Thank you very much.

With that, I will go to the Ranking Member, Mr. Clay from Missouri, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman. Let me thank the witnesses for being here.

Mr. Kalman, to what extent does FinCEN's final CDD Rule address the deficiencies that have been cited by the Financial Action

Task Force as part of its periodic reviews of our Nation's anti-money laundering and counter-terrorist financing framework?

Mr. KALMAN. Thank you for the question. It addresses some of it. In fact, the Financial Accounting Task Force has issued several reports—two—I think one in 2006 and one in 2016, calling out some deficiencies in our anti-money laundering regime. They actually did say that we had some very strong rules, but where we were lacking was in the collection of beneficial ownership information and in requiring due diligence requirements upon the gatekeepers to the financial system. That wasn't just the banks, that was real estate industry, accounting industry, and some others.

So this addresses a piece of the puzzle to positive steps forward, we would argue, but it is not complete.

Mr. CLAY. During FinCEN's rulemaking process, some commenters questioned whether the requirement to collect and verify beneficial ownership information would be more appropriately placed on State governments responsible for the formation and registration of legal entities and/or, alternatively, on a Federal entity such as the IRS or FinCEN.

Can you discuss why it is important to require financial institutions to collect and verify the beneficial ownership information of their legal entity customers, and separately, to also require States, FinCEN or some other Federal entity, to collect this information as part of the company formation process?

Mr. KALMAN. So actually, as Mr. Greene alluded to, I think there are two different purposes for the different entities to collect. So one—as a matter of fact, there is a quote that I had found when I was preparing for the testimony, from Jennifer Shasky, formerly of FinCEN. It said the two initiatives, the CDD Rule and beneficial ownership draft legislation, dovetailed together. The CDD Rule focuses on financial institutions knowing who the legal entity customers are regardless of where the entities are formed. And then the proposed legislation focuses on making sure the legal entities are formed in the United States, are more transparent to law enforcement regardless of where the conduct of the financial activity is.

So there are two separate things; we would argue, both are important if we are really going to plug the holes.

Mr. CLAY. I see. In what way does the CDD Rule complement proposals pending consideration before this committee to require the collection of beneficial ownership and information as part of the company formation process? How does it complement it?

Mr. KALMAN. Again, if law enforcement is to get a full picture and know both where the legal activity is taking place and at the State level, we think that both are necessary for law enforcement to have the full picture. And so we do very strongly support the proposals in the committee, Mr. Luetkemeyer's proposal with Mr. Pearce, Mrs. Maloney's proposal, and we think both are necessary if you are actually going to look at the full picture and make sure that there are not loopholes through which the criminals can slip.

Mr. CLAY. Now, has law enforcement complained about the process or do they find it to be effective?

Ms. Martinez, does law enforcement find this process to be effective or not?

Ms. MARTINEZ. I can only share with you anecdotal information from law enforcement or FinCEN, and I can also share with you my own personal experience.

I can tell you that of the thousands of SARs that we file, I can tell you there are less—I have an example of less than half a dozen cases that I know of that had actually turned into some sort of a prosecution. I am not saying the information is not helpful. It possibly is. However, there is insufficient transparency from FinCEN to the financial institutions as to how helpful that information actually is.

Mr. CLAY. So you don't get a response back once the information is turned in?

Ms. MARTINEZ. Very, very, very rarely.

Mr. CLAY. I see. My time is about up.

Mr. Chairman, thank you. I yield back.

Chairman LUETKEMEYER. OK. We next go with Mr. Tipton from Colorado, is recognized for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. I thank the panel for being here today.

I believe that the Customer Due Diligence Rule is well intentioned. In my district in Colorado, which has a high amount of drug cartel activity, its effects will be felt.

Being able to share some of that beneficial ownership information with law enforcement will help some of the—and effectively combat bad actors in Colorado and across the country, which will in turn make some of our communities safer.

That being said, I also believe that the rule needs to be implemented in the commonsense, harmonized manner that takes into account the burden of collecting the information and sharing it with law enforcement and what that will have in terms of impact on our financial institutions.

Mr. Baer, I would like to start with you. You mentioned in your testimony that recent guidance from FinCEN detracts from the clarity and predictability of the CDD Rule. Would you briefly discuss what clarity, predictability in these kinds of rulemakings is important for our financial institutions?

Mr. BAER. Sure. Thank you, Congressman. I think just to start in a most general manner, I think clarity is really important not just only in the rules in general across any type of regulation, but particularly in this area where we have this very odd construct where FinCEN is the rule writer but has delegated, and I would argue, abdicated responsibility for the examination of the institutions subject to those rules.

So as I think several of the witnesses have alluded to, enforcement really comes through an examination process through the banking agencies and other Federal financial regulators. They are not regularly in touch with FinCEN, FinCEN does not set priorities for them, as any other law enforcement or intelligence agency would, for those who are deputized for carrying out the activity on the ground.

So that is why in this area we are quite concerned to the extent that there are any gaps or vagueness in FinCEN's rules or guidance, because that will be resolved, unfortunately, through a series of examinations with examiners having different opinions, poten-

tially agencies having different opinions, and all with banks being at extraordinarily reputational enforcement risk to the extent that they get anything wrong.

So, an example a couple of us talked about with the auto renewals of CDs, it is effectively impossible for banks in a 1-month period to produce a system where they are reconfirming a customer account on a rollover of a CD. So they now effectively are going to have to be inconsistent with that guidance, which is not a rule, but really to honor their contracts. But we don't know what the banking agencies are going to do on the ground when they examine them.

Mr. TIPTON. So it would be fair to be able to say that the covered entities really don't have a clear understanding of what areas to be able to focus on to ensure that they can comply with a CDD Rule?

Mr. BAER. I think in some areas they do, but I think there are certainly other areas where they do not.

Mr. TIPTON. Do you have a comment on that, Ms. Martinez?

Ms. MARTINEZ. I think the regulation is pretty simple, but the execution of the regulation is very complicated. And so I think that the current FAQs that are out there, while they are helpful, they are insufficient.

Mr. TIPTON. A consistent theme that we touch on in this committee is the need for harmonization between the regulators and the rulemaking. As FinCEN is not the supervisory or examining agency which you have spoken to in your testimony, when it comes to reviewing BSA and AML compliance, do you think that the Federal banking regulators are familiar with the CDD to conduct fair and effective BSA reviews?

Mr. BAER. I think certainly their task has been somewhat complicated through the recent FAQs which have opened up some new issues. I think really time is going to have to tell, I think as Ms. Martinez indicated, as they fan out to examine the thousands of institutions subject to this rule, we don't know what approach they are going to take. I mean, clearly, there are issues yet to be resolved, and I think FinCEN has every intention of attempting to be helpful, perhaps providing further guidance, but they ultimately are not the ones who decide whether they are going to give a bank an MRA or formally or informally sanction it for perhaps a technical violation of this guidance.

Mr. TIPTON. I would like to follow up on a comment Ms. Martinez had mentioned in regards to having a bright line. You need to know exactly what you are going to be dealing with.

Community bankers in my State of Colorado, they raised a concern that the rule is going to have a negative effect on their volume of business when we are talking about having to re-verify a customer that is just having a CD rollover. So what are some of the real impacts that you will see in that area?

Ms. MARTINEZ. Well, the problem is that there is one unanswered question. FinCEN says that the information should be gathered at account opening. FAQs now say that a CD rollover is considered a new account opening. And so if we are to gather that information at account opening, if the customer is not present, as I described is the case with CD rollover accounts, then how are we

to obtain that information, other than by mail or some other method?

So if the customer is not present, then the account technically can't be opened, I am assuming. I am not sure because FinCEN hasn't been clear about that.

Mr. TIPTON. Thank you for your testimony.

My time has expired. Thank you, Mr. Chairman.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we go to the gentlelady from New York. Mrs. Maloney is recognized for 5 minutes.

Mrs. MALONEY. I want to thank the Chair and the Ranking Member and all the panelists for addressing this incredibly important issue. It is one that I have been working on for over 10 years.

The problem that we are trying to address is simple. Criminals and terrorists, terrorist financing, have always used anonymous shell companies to finance their operations, because they never have to disclose who actually owns them. And there is no way for law enforcement to figure out if a transaction conducted by a shell company was actually done by a criminal organization.

It was actually in response to law enforcement in New York City who came to me with the need to crack down on this, because they would go right up to the LLC and then they couldn't get anymore information.

The solution is really a simple one. Companies should have to disclose their beneficial owners at the time they are formed. But because no State requires companies to disclose their beneficial ownership, FinCEN passed a rule in 2016 that requires banks to identify the beneficial owners of any companies that open accounts with them.

FinCEN's Customer Due Diligence Rule is very important because it is the first step toward cracking down on these anonymous shell companies, and it will ensure that criminals and terrorists aren't using our financial system to operate their schemes. But the FinCEN rule by itself is not the solution.

Ideally, companies would be disclosing their beneficial owners when they are formed, and then financial institutions would have access to this beneficial ownership information so that they can assure themselves that companies that open accounts with them are not criminals or money launderers.

I would like first to ask Gary Kalman—and we have worked together on beneficial ownership for years, and I want to thank you and the FACT Coalition for your constant focus on this.

You noted in your testimony that you believe the FinCEN rule is important, but it is not sufficient in itself.

If Congress were to pass a beneficial ownership bill, like the bill I have introduced, would that complement the FinCEN rule or would it replace the FinCEN rule?

Mr. KALMAN. Thank you for the question, Mrs. Maloney, and thank you for your leadership as well on this issue. We think that it complements the rule. It is not a replacement. We think that the legislation you have introduced will cover companies that bypass the financial system and avoid banks so you are having much broader coverage.

One thing I would also add which I didn't say before is we actually also think that it is helpful, and folks on this panel can correct me if they disagree, but I think they will say that this is a help with financial institutions, realtors that may be—if we give access to other gatekeepers to the financial system, then this helps the entire system function and gives law enforcement the information and the tools that they need.

So we actually think it is not only good for cracking down on bad behavior and illegal and illicit activity, but we also think that it serves as a help to the other institutions we are asking to help us with cracking down on this.

Mrs. MALONEY. And that leads to my next question which I would like to direct to Mr. Baer. You noted in your testimony that the FinCEN rule is burdensome for banks because it puts all the onus on the banks to collect beneficial ownership information.

And I agree with that statement, particularly mid-sized smaller banks, they are having tremendous trouble gathering this information. The responsibility shouldn't all be on the banks. Banks are required to know their customers, but it shouldn't have to be this hard to find out actually who they are. Would passing my Corporate Transparency Act help alleviate this burden on banks?

Mr. BAER. Congresswoman, yes, absolutely. I think it just makes common sense. It makes much more sense.

Mrs. MALONEY. How much regulatory relief would passing my bill mean to banks?

Mr. BAER. I think substantial. And it is funny, it is just so much simpler as a commonsense matter to say at the outset when you form your company who owns it, and then each bank can rely on that information, every bank doesn't have to redo that work.

Mrs. MALONEY. And finally, if Congress does pass a beneficial ownership bill, should the definition of a beneficial owner in the bill be exactly the same as the definition in the FinCEN rule? Or should the bill's definition be broader than FinCEN's definition in order to ensure that all the beneficial ownership information is compiled?

Mr. Baer, quickly. I am out of time.

Mr. BAER. I think ideally they would be consistent. The one bad outcome would be if the CDD Rule were broader, because then compliance with the beneficial ownership legislation would not suffice for CDD. So some could argue perhaps it should be broader. But I think ultimately the best idea would be consistent.

Mrs. MALONEY. OK. Thank you.

Chairman LUETKEMEYER. The gentlelady's time has expired.

With that, we go to the gentleman from Georgia. Mr. Loudermilk is recognized for 5 minutes.

Mr. LOUDERMILK. Thank you, Mr. Chairman.

It is my understanding that financial regulators may expect institutions to collect beneficial ownership information at a lower equity interest threshold, and failure to do so may result in negative examination findings.

In fact, in their latest FAQs, FinCEN states that, and I will quote, financial institutions may reasonably conclude that collecting beneficial ownership information at a lower equity interest than 25 percent would not help mitigate the specific risk posed by

the customer or provide information useful to the financial institution in analyzing the risk. Rather, any additional heightened risk could be mitigated by other reasonable means, such as enhanced monitoring or collecting other information, including expected account activity in connection with the particular legal entity customer.

Mr. Baer, what risk posed by the customer may be mitigated by collecting beneficial ownership data at a lower threshold?

Mr. BAER. Thank you, Congressman. We strongly support a bright-line rule of 25 percent. We believe that is the clear intent not only of the CDD Rule, but also the guidance issued by FinCEN. And we believe, in just about every case, that is certainly sufficient to have people on the hook and searchable by law enforcement. If they are interested in a company and want to know who owns it, a 25 percent threshold, we believe, is sufficient.

There certainly may be cases where monitoring or investigation of a company leads you to believe, well, this is a case where people have below 25 percent ownership, but there is some reason to think maybe they are acting in concert, or something like that, where, yes, we would want to have reporting at a lower level. But we believe strongly that should be on a facts and circumstances basis, on a risk basis by an assessment by the financial institution and that that rule shouldn't get rewritten by guidance or interpretation.

Mr. LOUDERMILK. Right.

Ms. Martinez, do you have any thoughts on this?

Ms. MARTINEZ. I think that most of my colleagues would agree that financial institutions take this responsibility very seriously, and we are personally responsible for the programs in our bank. So when we see risk, then we want to address that risk. And I agree that we should have a 25 percent bright line. But it should be up to banks to decide if, on a risk-based approach, they should look at an account differently. I don't think that that should be left to examiners, because individual examiners have different types of customer groups that they just are concerned about, and so then they force banks into lowering thresholds that are not clearly defined by the regulation, and that hurts customers.

Mr. LOUDERMILK. OK. Mr. Baer, would lowering the threshold provide additional information that would otherwise be more useful to you in analyzing the risk?

Mr. BAER. Again, Congressman, I think generally the consensus, and certainly, I mean—I should emphasize FinCEN did a very rigorous and comprehensive notice and comment rulemaking on this, and I think ultimately they concluded, as I think most financial institutions concluded, that 25 percent threshold is appropriate, it strikes the right balance, and that is enough to know about the ownership of a company.

Again, there can always be cases where banks may have reason to investigate further, but we think that suffices for law enforcement purposes.

Mr. LOUDERMILK. One quick follow up. If a financial institution chooses to collect beneficial ownership information to the 10 percent level on some high-risk customers, they must then clearly distinguish to which high-risk customers a lower threshold would be

applied and choose how soon that information must be completed after the high-risk designation.

So what if the customer fails to comply or fails to comply in a timely manner? Will the financial institution close the account because the customer is not cooperative, even though the actual regulatory requirements for the collection of beneficial ownership information have not been met—or have been met?

Mr. BAER. I may defer to Ms. Martinez on this. My assumption is that if the customer would refuse to provide that information, in all likelihood you would file a SAR and then perhaps close the account.

Ms. MARTINEZ. You just described one of the primary reasons that banks de-risk.

Mr. LOUDERMILK. OK. Thank you.

I yield back, Mr. Chairman.

Chairman LUETKEMEYER. The gentleman from Georgia yields back.

With that, we go to the gentlelady from California, the Ranking Member of the full committee. I am going to recognize her for a point of personal privilege, and then we will recognize her after that for 5 minutes of questions. She is now ready to go.

Ms. WATERS. Thank you very much, Mr. Chairman and Ranking Member.

Before I begin the questions, I would like to first recognize the hard work of one of my staffers, Kirk Schwarzbach, as today is his last day, after more than 10 years on the committee. Kirk came to the committee in 2008 and started at the front desk. Today, he now manages a portfolio that spans monetary policy, currency and coins, various consumer protection issues, international development, and counter-terrorism and illicit finance.

Beyond being a brilliant individual, Kirk is also very friendly, warm and caring. His compassion to advocate good policy on behalf of Americans he may never meet is only surpassed by his dedication.

Kirk is not going far, as he is going to be joining the Congressional Affairs Office at the Federal Reserve. But certainly we are going to miss him.

Thank you, Kirk.

Chairman LUETKEMEYER. The gentlelady is now recognized for 5 minutes for questions.

Ms. WATERS. Thank you very much.

As you know, FinCEN began the process of developing its Customer Due Diligence Rule in March 2012, and it was more than 6 years ago when it issued an advance notice of a proposed rulemaking. After a 4-year rulemaking process in 2016, FinCEN finalized the CDD Rule and provided covered financial institutions a 2-year delay before they would have become compliant, which will be on May 11, 2018.

Do you believe that this 2-year delay was adequate with respect to giving banks time to put the necessary processes in place to collect this information? And this is for Mr. Kalman.

Mr. KALMAN. Thank you for the question. As I said in my testimony, we think that it is reasonable. Banks have had 2 years to

comply with the rule, and it is reasonable for the rule to go into effect. We don't see a need for delay.

I did also say, for banks that—if there are banks that have ignored the rule and didn't do anything, then they need to do so. But for those banks that did take good-faith efforts and there is some misinterpretation—not misinterpretation, that is the wrong word—if there are some banks that because of the FAQ that has created confusion feel that they are not in compliance, we don't take a position on a reasonable time-specific accommodation in terms of enforcement.

Ms. WATERS. OK. I am going to move on.

Mr. Kalman, also in your testimony, you emphasize how criminals can use shell companies to facilitate their illicit activity. How would CDD Rule and beneficial ownership legislation help curb the flow of illicit funds by criminals, kleptocrats, human traffickers, and terrorists?

For example, in 2013, prosecutors in New York charged 34 alleged members of Russian-American organized crime groups with a range of racketeering activities, which includes one group that was alleged to have moved millions of dollars in illicit funds to a network of shell companies in Cyprus and the United States. Would the CDD Rule or beneficial ownership legislation prevent this?

Mr. KALMAN. So in my written testimony, and let me highlight it here, I think it is a critically important issue for us to be raising here that this is not an administrative exercise, that this impacts real issues that threaten the financial system and individuals in our society. The issues range from, as you said, national security issues, kleptocrats hiding money. We also see it in the opioid epidemic, anonymous shell companies used to move illicit drugs, human trafficking examples. We recently had Polaris, one of the largest anti-human trafficking organizations join our coalition specifically because law enforcement can't follow the money.

There are numerous examples, and the legislation that you have cosponsored with Mrs. Maloney would crack down on this, and we think it would have a foundational impact on these issues and lead law enforcement to better be able to crack down on the wrongdoing.

Ms. WATERS. I am a bit curious. Cyprus comes up quite often when we are talking about shell companies or when we are talking about money laundering. Do you have or know or understand information about what is going on with Cyprus and its role in money laundering and shell companies?

Mr. KALMAN. There may be others that—Mr. Greene has more information on Cyprus. Let me say one thing that I do think is important because it has come up in numerous conversations, very quickly, that the issue is if we close down our system to this money laundering, won't they just go overseas to some of these other jurisdictions, whether it be Cyprus or the Cayman Islands or what have you.

I would like to say that the European Union and many of our allies have already moved to collect this information. If we voluntarily choose to move forward and do the same, the remaining nations, I have been told, would follow suit. Right now, those places like Cyprus, the Cayman Islands, BVI, what have you, all point to

the United States saying why should we do this if the United States doesn't?

So we do believe that if we take leadership in this, the rest of the world will follow and we can actually have a substantial impact globally.

Ms. WATERS. Does anyone else have something quickly to say about Cyprus?

Mr. GREENE. Yes. Thank you, Congresswoman. I would just say that I think Cyprus has been an attractive jurisdiction for a variety of actors because it is seen as a favorable jurisdiction for offshore banking and also one that protects the privacy of companies that are established there, sometimes referred to as bank secrecy jurisdictions. I think you can see that sometimes that can go awry, as has happened in the recent designation of FBME by FinCEN for 311 sanctions.

Ms. WATERS. Thank you. I yield back.

Chairman LUETKEMEYER. The gentlelady's time has expired.

With that, we go to the gentlelady from Utah. Mrs. Love is recognized for 5 minutes.

Mrs. LOVE. Thank you. Thank you so much for being here today.

I have heard a little bit of consternation about this rule from the banks in my State who don't think that they are best positioned or the best positioned entity to gather this due diligence, and they wonder why this due diligence isn't conducted by the various States, corporations, departments which register the business.

On the other hand, banks have already been forced to develop extensive FinCEN compliance procedures, and this would seem to just add new wrinkles to those existing procedures.

I would like to hear your thoughts on the relative merits of having banks conduct this particular form of due diligence. The burden has to fall somewhere, but I guess I am just trying to figure out why the banking institution has to be the place where it goes.

Mr. BAER. Thank you, Congresswoman. The CDD Rule is actually broader than just beneficial ownership. It involves an obligation to know the customer and monitor for suspicious activity, and to do that you actually have to know who are you monitoring.

So the question is when you start with who the beneficial owners are, is that something the bank should have to do and each bank do potentially for the same customer over time? Or is that something that just should be collected, as the legislation would intend, at the outset of the formation of that company?

I think banks would tell you they are not trying to avoid their CDD requirements, but it certainly would be much more efficient and probably more accurate if they could just draw on a database, I think the draft legislation envisions FinCEN, and just go to that database and say, OK, here are the beneficial owners of this company, and that is who I am going to monitor for suspicious activity.

Mrs. LOVE. Ms. Martinez, what kinds of resources does an institution need to devote to this additional rule, and how does this affect cost to the institutions?

Ms. MARTINEZ. So I talked about this in my opening statement. Just for IBC, we have spent 2,912 hours just designing and testing all of our programs and our policies. And it has taken us about

7,800 hours to train our employees on this new rule. And this is an ongoing effort because there is still not enough clarity.

Mrs. LOVE. Right.

Ms. MARTINEZ. I would like to address your point on why the burden is on the banks and not on the States.

I am in Laredo, Texas, which is on the border of the U.S. and Mexico. And I will just use Mexico as an example. I am not saying or advocating that this is what we should do, but just as an example of what Mexico does. And they have done this for many, many years.

Every state in Mexico is required to register businesses. And financial institutions can rely on that information. And that beneficial ownership information is at 1 percent and above.

Mrs. LOVE. OK.

Ms. MARTINEZ. And if there is a change to that company structure, there is a formal Federal process that the company has to go to to register those changes.

Mrs. LOVE. OK.

Ms. MARTINEZ. So I think we should be partners with the States and we shouldn't bear the entire burden.

Mrs. LOVE. Instead of trying to do two separate—OK. So what areas should FinCEN and the regulators be working on to address the—you talked about clear understanding. And that clearly is an issue.

So what do you think the areas should FinCEN focus on so that we can address that, first and foremost, because that, I can see already, using resources and trying to figure out what information, clear direction on what to do. So—

Ms. MARTINEZ. I think there are two that come to my mind right away. And the first one is this issue with the auto-renewable CDs.

So if you are a business customer and you bank with four different banks in your city, and you have four different CDs that all auto renew at a different time, you are going to be required by your financial institution to provide beneficial ownership information the first time that that CD renews after May the 1st. So four different beneficial ownership attestations will need to be provided.

So if you are a larger business and you have four certificates of deposit and four checking accounts, and then you have a change to your organizational structure, now you have to go to four different banks to make those changes. And that is a, I think, a burden on our small businesses that are not exempt by this regulation.

Mrs. LOVE. OK. Thank you.

And on the flip side, what actions should FinCEN and regulators take to ensure financial institutions aren't overcollecting information? I mean, you are thinking about different information that has to happen very quickly. You have different entities. How do we ensure that there is not overcollecting?

Ms. MARTINEZ. Well, I think that is a very good question, and I think we should all ask FinCEN that question. The problem is also that not only are all the financial institutions having to collect all this information, but it is not going to be used unless we receive a subpoena. And there is nothing to verify it against.

Yes, there is verification for identification of the beneficial owners, but there is no corporate document that banks have to verify

the percentage of ownership that the customer is attesting to. So how valuable will that information even be to law enforcement?

Mrs. LOVE. Very insightful. Thank you so much.

I yield back, Mr. Chairman.

Chairman LUETKEMEYER. The gentlelady's time has expired.

With that, we go to the gentleman from Washington. Mr. Heck, you are recognized for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

First, I would like to start off by saying in the 5 years and 4 months I have had the privilege and honor to sit on this committee, we have received testimony from an incredible number of interesting stakeholders, ranging from consumers seeking to protect consumers to those who are regulated.

In all that time, Ms. Martinez, I don't think I have ever seen testimony presented as strong and clear and supported as yours. You are a credit to your profession, and I just wanted to thank you for that.

I also want to say that when I talk to bankers back home about compliance, and I do all the time, I ask them, what is really frustrating you? What is getting you down? And every single one says BSA and AML. Every single one. And I have come to the conclusion, as somebody not from the industry, except I had a cup of coffee in it 40 years ago, that it really is borne of two factors.

And the first of which seems to be it is a one-way ratchet, and it is getting tighter and tighter. Requirements are always getting more difficult, and there isn't any countervailing effort within the regulatory context to seek to ease that, it seems to me, or to lighten BSA compliance in other ways.

And second is that it is, as alluded to here earlier, just, frankly, not very transparent.

The bankers in my district, as Ms. Martinez reflects, really believe in the mission of BSA, and nobody doubts that. And they put a lot of time and effort into complying with it. Thank you for documenting it again, Ms. Martinez. But they have no idea if they are helping. They really don't. Not a single one of my community bankers, not one, has ever told me that they have received a follow up from a law enforcement agency on a SAR or a CTR. Not one.

So the first problem, I think, about the one-way ratchet is at least partially on us. We contribute to this here in this institution, unfortunately. We have been ignoring this hue and cry and the recommendations that we back down some. Part of the evidence of that, to invoke the 800-pound elephant in this room, is that both chambers have passed packages of major regulatory relief. And we hear a lot from, back home, about the need to do this. Not one line, not one section, not one provision relating to BSA/AML. The number one complaint: Nothing is being done in it.

And I am not pretending like this is easy. It is a Gordian knot. My friend, Mr. Luetkemeyer, has been working on this for a couple of years. I know it is hard.

So the second problem is really what I want to quickly, since I have managed to speak for most of my time, get your thoughts on, and that is the issue of just how darned effective is the Bank Secrecy Act. How efficient is it? Is anyone reading SARs that are

filed? Does anyone review the CTRs, or are they just kept in a database to be used if there is a lead that comes up?

And if nobody is reading them, does it make more sense to just have the banks keep it and make it available should somebody need it? Or if people are reviewing the reports, for which I haven't received much evidence, indications otherwise, and acting on leads that they generate, what can we do to demonstrate to the people like Ms. Martinez that all of their time, effort, and money devoted to this is actually making a difference?

That is a big mouthful of questions. Mr. Greene, you win. 1 minute and 16 seconds.

Mr. GREENE. Thank you, Congressman. I appreciate the opportunity to answer this question having been inside FinCEN and seen the value of SAR reporting.

I think you touch on an issue that FinCEN, I know during my time there, was very concerned about, which was the lack of feedback about the value of SARs and their utility.

I can tell you from having seen inside of FinCEN, SARs are immensely useful, and so is a lot of the other reporting that is required under the Bank Secrecy Act.

I was particularly impressed by their use in combating terrorism and in informing investigations related to terrorist attacks, both abroad and also activities within the United States. And so I think they play a critical role.

But I think that there is some regulatory fatigue that has set in among the regulated financial institutions that have to comply with the Bank Secrecy Act, and they need to understand the value of those SARs, number one.

So it would be nice to have some method of feedback to industry to explain to people when a particular SAR has been useful, that would require some collaboration with law enforcement. But more broadly, I also think there needs to be some flexibility in the approach to enforcement of the BSA requirements so that we are really focusing on enforcing against parts of AML programs that really address the particular threats that the country is facing at any given moment.

Thank you.

Mr. HECK. Thank you sir.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we go to the gentleman from Texas. Mr. Williams is recognized for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman. And thank you for holding today's hearing.

Criminals and other bad actors wishing to do harm to Americans have used the U.S. financial system for many years to hide their illicit activities. Because of this abuse, it has always been important for financial institutions to remain vigilant, and that is why anti-money laundering and counter-terrorist financing regimes are so crucial.

Implementation of the FinCEN Customer Due Diligence Rule is rapidly approaching, as we have talked about. And so testimony from the various stakeholders and experts before us will be crucial in determining whether or not we are on the right track.

So the first question to you, Ms. Martinez, and I would like to add, you work for a great group of folks.

Ms. MARTINEZ. Thank you.

Mr. WILLIAMS. I understand that the bank that you are with devotes a lot of resources to complying with BSA regulations. And as one of the key components of BSA compliance is the filing of Suspicious Activity Reports, or SARs, as we have talked about. So how does your bank identify potential SARs filings? And further, do you find that the information you provide law enforcement is useful to them? And do they give you any kind of feedback at all, as we have spoken?

Ms. MARTINEZ. So I have been told that this is my hobby horse, so thank you for asking me that question. At the bank, and most financial institutions work this way, we have a surveillance system. And this surveillance system is made up of a series of rules that have various thresholds on different types of transactions. We review hundreds of thousands of alerts on an annual basis. Those hundreds of thousands of alerts give us several thousand transactions that we need to investigate. Of those thousands of transactions that we investigate, we end up with a smaller number of Suspicious Activity Reports that we file.

I have been BSA officer at IBC for 27 years. We do at times get requests from law enforcement for supplemental information. There are law enforcement task forces that look at these SARs, but there is no transparency from FinCEN with regards to this data.

I have no idea, of the thousands of SARs that we filed at IBC, how many of those were helpful to law enforcement, what percentage of those SARs were helpful to law enforcement. And I believe that FinCEN has a responsibility to give us that transparency.

We believe in these regulations and we take our corporate responsibility very seriously, but let's develop rules that make sense for all of the stakeholders.

Mr. WILLIAMS. OK. Again, let's talk about onboarding process for new costumers.

A 2016 Thomson Reuters survey of companies discussing their onboarding process with the bank found that 30 percent of the respondents reported an onboarding time of more than 2 months, and 10 percent claimed an onboarding time in excess of 4 months.

So if companies that have to wait that long to do business with yours or a similar institution, they may decide to take their business elsewhere.

So will the CDD Rule increase onboarding times for new customers, and are you at risk of losing customers because of it?

Ms. MARTINEZ. Yes and yes. And so I spoke about that earlier. Rarely is the beneficial owner the one that walks into the bank to open the account. It is usually the controlling person. We are now required to identify the beneficial owners. The controlling person will not have the identification for those beneficial owners. So I anticipate that it is going to be very rare that we are going to be able to open an account when that individual actually wants the account open.

Even today, sometimes it takes months to collect all the corporate documents that we need to collect from customers. And so I think it is a very big danger for our small business customers.

Mr. WILLIAMS. OK. Mr. Greene, as we all know, the May 11 implementation date of CDD Rule is rapidly approaching, as we have talked. And, however, FinCEN earlier this month released an additional set of FAQs to assist institutions in compliance.

So do the recent FAQs give institutions the needed clarity to meet compliance standards, or does FinCEN need to offer technical corrections or other changes to the regulation?

Mr. GREENE. Thank you, Congressman. I think that the FAQs take care of a number of the questions and concerns that industry had raised during the 2-year period where they had a chance to work on implementation to the rule. I do think there are some questions that are still outstanding, and I think that that is going to require close collaboration with FinCEN to get those questions answered, and that FinCEN needs to address those and provide extra guidance, where needed, so that institutions can meet their obligations.

I also think that once the May 11 implementation date arrives and they go forward into implementation, FinCEN needs to demonstrate some leniency and flexibility with the inevitable issues that are going to arise as people start to implement.

Even if they were to resolve tomorrow all the issues that are raised by the FAQs, there are going to be other issues that arise as people start to actually implement these rules. And they just need to be patient and flexible, as Mr. Kalman had suggested.

Thank you.

Mr. WILLIAMS. I yield my time back. I am grateful for y'all's testimony. Thank you.

Chairman LUETKEMEYER. The gentleman's time has expired.

Without objection, the gentleman from New Mexico, Mr. Pearce; the gentleman from Arkansas, Mr. Hill, are permitted to participate in today's subcommittee hearing. While not members of the subcommittee, they are members of the full Financial Services Committee, and we appreciate their participation today.

They have just called votes, but I think we can be able to, hopefully, we get both gentlemen in before we need to leave.

And with that, I will recognize Mr. Pearce from New Mexico, for 5 minutes.

Mr. PEARCE. Thank you all.

And I appreciate your testimony today, Ms. Martinez. You are at the intersection of what we are struggling with on this legislation. So let's see if we can lean into the deal here and we will get to you there.

So you talk in section 1, at the end of it, you talk about our helping our law-abiding customers achieve financial success. And believe me, I am on your side in the argument, but I find myself on the other side of the policy. And so it is trying to harmonize those two positions.

Because it is exactly that that says that willingness to help our law-abiding customers achieve financial success. It says we have to do something on beneficial ownership because it is my home county where a lot of trucking and the oil field, and people show up with a lot of money, they buy brand-new trucks, and they can have new trucks all along and so they compete better. They don't have to make a profit.

And so what it is doing is actually taking away the possibility of the law-abiding companies to make a profit because they can price anywhere they want to. Again, they are getting free money from drug traffickers somewhere. And so that drives me.

How do you all evaluate that when you are—I understand the core value of helping our law-abiding customers achieve success, but if they can't be successful because the market is rigged by people who have shell companies, how do you just think about that particular intersection of the question?

Ms. MARTINEZ. I think it is very important for us to try to solve the root cause of the problem and not the symptoms.

Mr. PEARCE. What is the root cause?

Ms. MARTINEZ. The root cause is that beneficial owners should be identified at the point of formation.

I agree with Congresswoman Maloney and what she said earlier, why should the burden be at the bank level only. It should be at the time that the company is formed. That is the best time for the identification of beneficial ownership to be done, and transparency to—

Mr. PEARCE. But you understand—I don't mean to interrupt, but we have a vote coming up. Everybody is trying to get their questions in.

So you get the beneficial ownership at the time that the company is formed and then people trade shares. And so they show up at the bank. And even—if I look down in the second point, and you are talking about that the control person at the company may not know who the beneficial owner is. And to me, that seems like a problem that a bank would want to cure.

If a control person doesn't know who the beneficial owner is, I think that should send off alarm bells. But you presented, and again, I am sensitive to your side. Normally I find myself on your side of the equation. But we are really struggling because the testimony is that the U.S. has become the haven for shell corporations because we are so lax in every regard. And do you feel like the control person should maybe, maybe, know who the beneficial owner is before they are allowed to be the control person?

Ms. MARTINEZ. Yes, I do. And I think all of that should be discussed and entered into record at the time the company is formed.

Back to the example that I used in Mexico, that is what happens at the state level when a company is formed. And if there is a change in ownership, that has to be registered at the federal level and then it has to be re-registered at the state level, then we can rely on that information to be accurate.

Right now, I am basing what a customer is telling me on their attestation. I have nothing to verify that against.

Mr. PEARCE. So your position is based on the fact that people who are willing to sell drugs and create illicit profits are going to tell the truth about—

Ms. MARTINEZ. No, I think—

Mr. PEARCE. They are going to tell the truth about who the beneficial owner is when they incorporate or when they—maybe they just come in to start the bank account and they say—and they are going to tell you the truth?

Ms. MARTINEZ. I think that—

Mr. PEARCE. I don't believe that, but—

Ms. MARTINEZ. I think that is FinCEN's position, which is why they are allowing for the beneficial ownership at attestation.

Mr. PEARCE. Know that we in the Counterterrorism and Illicit Finance Act, we have a section—I am going to provide that to you through the Chairman and all of the people above me in this organization—and I would like your comments. Because we are really trying to address the fact that the bankers submit all these reports and nobody ever gives them feedback. I think you should actually have access to that information. It would allow the process to be a little bit more transparent.

I am going to yield back, Mr. Chairman. I will let somebody else get questions.

Chairman LUETKEMEYER. The gentleman yields back.

And then we will go to—

Mr. PEARCE. I appreciate you. Thanks.

Chairman LUETKEMEYER. With that, we go to the gentleman from Arkansas. Mr. Hill is recognized for 5 minutes.

Mr. HILL. I thank the Chairman. Thanks for letting me come to the hearing today.

I appreciate too, Mr. Chairman, you and Mr. Pearce supporting my effort to delay this rule for 1 year. And I will tell you why, very, very succinctly.

One, I don't think it helps us catch bad guys. Number two, we already have a rule in place that, as Ms. Martinez looked at, is very hard to comply with. And this is made more difficult. But the principal reason I object is, due to Mr. Pearce and Mr. Luetkemeyer's hard work, we are trying to rewrite AML/BSA for the first time in a comprehensive way. And it seems to me to introduce a new complex beneficial ownership rule in the midst of trying to get it right statutorily is a distraction to the banks, in addition to a costly distraction.

So I would like to know, Ms. Martinez, do you support delaying this rule?

Ms. MARTINEZ. Yes, I do, along with many other bankers.

Mr. HILL. Yes. And so I want to be clear, though, that I think secretaries of State should have best practices where they have an active email address, an active phone number, an active name for an agent, for every incorporation in the country, absolutely. And that they have some requirement in their State that there is a penalty associated with being inaccurate. I think that is good. That is not in our Federal jurisdiction, but that is an important thing.

And then I would like to argue again in front of this panel as I have for 2 years now, that we do have accurate beneficial ownership information in this country, at least once a year, when we file the tax returns for every one of these pass-through entities.

And I believe the burden is on the Federal Government and the Executive branch to work with the Legislative branch to see how best to use that data because it is accurate. They can change ownership during the course of the year, no doubt. But to have a simultaneous knowledge of every time someone changes ownership in a company in this country, that isn't going to happen. That is not possible. That is unreasonable.

And so this idea that the IRS has pass-through ownership down to 0 percent, 25 basis points of a percent. Not 25 percent, it is actually an actual reading of the ownership in every pass-through entity of someone who has formed a company and files a tax return in the United States. And that would be a great safe harbor source of information for our financial institutions.

Next thing I would say is I am not a big fan for this data—another infinite database controlled by some unknown entity that people just ping into and find out what the beneficial ownership is. We have enough trouble with keeping people's private, personal information safe in this country. The IRS has failed doing it. OPM has failed doing it. Equifax can't do it. Facebook can't do it.

So to create another database that people can ping into from remote access on a PC or a bank data processing system, I think bears a lot of risk.

So, Mr. Chairman, I appreciate the work you are doing and that Mr. Pearce is doing. We need to design a beneficial ownership rule and customer disclosure capability that banks can easily comply with, provide the Federal Government the information they need. But I argue passionately, the Federal Government has the information we are looking for. Let's find a legal, constitutional way for that information to be shared inside the Federal Government.

Thank you, Mr. Chairman. I yield back.

Chairman LUETKEMEYER. I thank the gentleman from Arkansas for yielding back, and I appreciate his patience and his suggestion. I wholeheartedly agree with it.

I want to thank the panel for your participation. It has been very enlightening. And you guys have done a great job of explaining your concerns and your interpretation of the rule and the consequences of it.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, this hearing is adjourned.

[Whereupon, at 10:52 a.m., the subcommittee was adjourned.]

A P P E N D I X

April 27, 2018



Testimony of Greg Baer
President
The Clearing House Association

Before the House Financial Services Subcommittee on
Financial Institutions and Consumer Credit

Implementation of FinCEN's Customer Due Diligence Rule –
Financial Institution Perspective

April 27, 2018

Chairman Luetkemeyer, Ranking Member Clay, and members of the Subcommittee, my name is Greg Baer and I am the President of the Clearing House Association and General Counsel of the Clearing House Payments Company. Established in 1853 and owned by 25 large commercial banks, we are the oldest banking payments company in the United States, and our Association is a nonpartisan advocacy organization dedicated to contributing quality research, analysis and data to the public policy debate.

Thank you for the opportunity to testify today on FinCEN's customer due diligence ("CDD") rule and efforts financial institutions have made over the last two years to comply with it. In sum, the CDD rule will be used to identify the beneficial owners of companies, which will potentially assist law enforcement in identifying businesses that are used for money laundering and other illicit activities. However, TCH does have concerns about recent guidance issued by FinCEN, which detracts from the clarity and predictability of the CDD rule, and the process by which the rule will be implemented—as the guidance was not subject to notice and comment and was in some instances based on prior guidance, also released without notice and comment, by the federal banking agencies and other regulators. We are also concerned that the banking agencies, perhaps with endorsement from FinCEN, may reinterpret the rules going forward.

Background

FinCEN and the federal banking agencies have long imposed customer due diligence expectations on financial institutions, and the banking agencies have expanded those requirements through their *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*.[1]

On May 11, 2016, FinCEN adopted its *Customer Due Diligence Requirements for Financial Institutions* rule after a multi-year rulemaking process. The rule states that a financial institution's CDD program should encompass the following elements: "(i) customer identification and verification; (ii) beneficial ownership identification and verification; (iii) understanding the nature and purpose of customer relationships to develop a customer risk profile; and (iv) ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information."[2] The first element, a customer identification and verification program, is already an AML requirement known as the Customer Identification Program, or CIP, rule;[3] the second is a new regulatory requirement; and the third and fourth are already expected parts of financial institution's suspicious activity reporting program, now formally codified by this regulation.

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1 *See* FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual, 2014, "Customer Due Diligence–Overview," p. 56.

2 *See* 81 Fed. Reg. at 29,398.

3 *See* Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks ("CIP rule"), 12 CFR Part 21 (Office of the Comptroller of the Currency)("OCC"); 12 CFR Parts 208 and 211 (Board of Governors of the Federal Reserve System)("Federal Reserve"); 12 CFR Part 326 (Federal Deposit Insurance Corporation)("FDIC"); 12 CFR Part 748 (National Credit Union Administration)("NCUA"); and 31 CFR Part 1020.220 (FinCEN).

The new beneficial ownership requirement mandates that covered financial institutions identify and verify beneficial ownership information for certain legal entity customers each time a new account is opened or when a triggering event occurs. In particular, institutions are generally required to collect and certify information on two ownership prongs for a given legal entity: (i) an equity prong that requires the identification of individuals who directly or indirectly own 25 percent or more; and (ii) a control prong that requires the identification of an individual with "significant responsibility to control" the legal entity. The 61-page rule also includes other technical provisions, exemptions, and exclusions.

Overview

TCH believes that the CDD rule and its beneficial ownership information collection requirement will potentially provide law enforcement with useful information, primarily as they use ownership information to learn more about suspect companies or entities. We particularly appreciate FinCEN's efforts to give financial institutions some flexibility in how they collect and certify beneficial ownership information, which was the product of a commendable notice and comment process. Furthermore, FinCEN appropriately decided not to apply the beneficial ownership requirement retroactively.

We understand that FinCEN and the FFIEC have been working to update the BSA/AML examination manual to provide additional technical guidance to examiners about the CDD rule's requirements.[4] While we support publication of a revised manual so that examiners and institutions can have a shared interpretation of the rule, we do not believe that the manual should make substantive changes to the underlying rule unless published for public comment as required under the Administrative Procedure Act.[5] Since adoption of the CDD rule in 2016, financial institutions have invested millions of dollars and rebuilt their internal systems to implement the rule's provisions ahead of the May 11, 2018 compliance deadline. In particular, the new beneficial ownership information collection requirement has obliged them to make substantial changes to the onboarding of new accounts and employee training practices as well as significant technological investments to incorporate the requirements of the final rule.

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[4] On April 24, POLITICO reported that banking regulators indicated that the revised manual would be "released soon" and that "[f]or upcoming exams, regulators will be looking at what banks have been doing to prepare and then providing 'beginning guidance as opposed to looking at strict compliance,' said Doreen Eberley, the FDIC's director of risk management supervision." *See* Victoria Guida, "ICBA asks FinCEN to delay beneficial ownership rule by 1 year," (April 24, 2018).

[5] More generally, TCH believes that Treasury should urge the FFIEC to update and revise the BSA/AML Examination Manual. Since its initial publication in 2005, the manual has frequently been expanded but never substantially edited and revised; such revisions are long overdue. For example, many of the suspicious activity "red flags" included in the manual are anachronistic to today's financial system and make it difficult for banks to efficiently and effectively fulfill their reporting obligations. As the document that effectively serves as the methodology for the regulators' BSA/AML risk assessments, and therefore the regulatory requirements for an institution's BSA/AML program, the manual should be critically reviewed and revised much more frequently and subject to notice and comment under the Administrative Procedure Act.

Financial Institution CDD Implementation Concerns

TCH recognizes the importance of robust CDD processes and agrees with FinCEN's stated position that "[e]xpressly stating the [CDD] requirements facilitates the goal that financial institutions, regulators, and law enforcement all operate under the same set of clearly articulated principles."[6] However, we do have two concerns with the CDD rule: first, the rule requires financial institutions to identify beneficial owners on a per-account basis and not a per-customer basis; and second, its preamble does not explicitly affirm FinCEN's sole ultimate authority to determine CDD standards, and rather appears to leave the door open for further *ad hoc* interpretations by examiners.[7] Additional guidance released by FinCEN earlier this month has exacerbated these concerns.

The CDD rule requires covered financial institutions to reconfirm the beneficial owners of an existing customer each time that same customer opens an additional account. This requirement is extremely burdensome to the point of being unworkable for institutions that routinely open multiple accounts on the same day, or within a short period of time, for customers. For example, title or escrow customers can open multiple accounts daily to assist in closing real estate transactions. Furthermore, large corporations can open multiple accounts in a day or within a few days to assist with business related needs including general checking, lines of credit for business operations, lending, and to facilitate investment strategies.

The cost of reconfirming ownership with each new account does not appear to come with any corresponding benefit. There is no reason to believe that the opening of a new account, in and of itself, is an indication that the beneficial ownership of the customer has changed. Customers with the same ownership frequently open new accounts; customers may change beneficial ownership and not open a new account. Thus, a financial institution should be able to determine, consistent with a risk-based approach, whether re-identification and re-certification is necessary based on whether it has a reasonable belief that it has identified the customer's current beneficial owners by ownership criteria at least as stringent as those required by the final rule. We note that this approach is also consistent with the approach taken by FinCEN and the federal banking agencies in the final CIP rule.

The "new account" requirement is complicated further by guidance released by FinCEN on April 3, 2018, in the form of 37 FAQs.[8] TCH appreciates FinCEN's efforts to provide additional guidance to the industry on implementing the CDD rule. FinCEN's April 3 FAQs provided useful clarity on various aspects of the final rule, including (i) clarifying that when

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6 *See* 81 Fed. Reg. at 29, 449.

7 *See* TCH-FSR Comment Letter to Treasury on its "Review of Regulations" (July 31, 2017) for more information on our concerns, *available at* www.theclearinghouse.org/-/media/tch/documents/tch-weekly/2017/20170731_joint_trades_comment_letter_to_treasury_on-review_of_regulations.pdf. *See also* The Clearing House Letter to FinCEN, Re: Notice of Proposed Rulemaking–Customer Due Diligence Requirements for Financial Institutions (RIN 1506-AB-25), (October 3, 2014), *available at* https://www.theclearinghouse.org/-/media/files/association%20related%20documents/20141003%20tch%20comments%20to%20fincen%20on%20cdd.pdf.

8 *See* FIN-2018-G001, "Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions," ("FinCEN April 3 FAQs")(April 3, 2018), *available at* www.fincen.gov/sites/default/files/2018-04/FinCEN_Guidance_CDD_FAQ_FINAL_508_2.pdf.

financial institutions create accounts for administrative or operational purposes, and not at a customer's request, the CDD rule's beneficial ownership information collection requirement does not apply; (ii) indicating that the CDD rule's beneficial ownership collection exclusion for foreign financial institutions, where the foreign regulator collects and maintains beneficial ownership for that institution, is not dependent on whether the beneficial ownership requirements applied by such institution's foreign regulator match the U.S. requirements; and (iii) making clear that a certification can be obtained in various forms and methods, such as by oral confirmation, among other things.

However, the guidance raises other issues. In some cases, the FAQs appear to add requirements that go beyond the parameters of the final rule. For example, the guidance includes statements that institutions are required to "certify" (in additional to collecting and verifying) beneficial ownership information at a triggering event, which is contrary to the plain language of the final rule, including statements in the preamble, that require institutions to certify such information only when a new account is opened. The guidance also provides that in cases where a trust directly or indirectly owns 25% or more of a legal entity customer, for the purposes of the equity prong, the trustee should be identified "regardless of whether the trustee is a natural person or a legal entity," even though the rule clearly states that beneficial owners are "natural persons who own or control legal entities."[9]

Most significantly, FinCEN's FAQ 12 in the guidance states that institutions are required to obtain beneficial ownership information from legal entities when a financial product, like a certificate of deposit or loan, renews or rolls over for the first time following May 11. Therefore, to implement FAQ 12 as written, financial institutions would need to restructure, or "break," their origination systems in order to put products covered by this FAQ into a holding process to allow for customer outreach to reconfirm beneficial owner information, as such products do not require the institution to interact with the customer in order to initiate an automatic renewal. Again, there is no reason to believe that an auto-renewal is evidence that a change in beneficial ownership might have occurred. The FAQ 12 guidance is further complicated by the fact that these products include contractual provisions requiring the financial institution to auto renew them without interruption. Therefore, on May 11, financial institutions will be in the untenable situation of either not being in compliance with the FAQs to the CDD rule or breaching their contracts with customers. For example, a small business may not be able to pay its employees or vendors because its line of credit would be put into default until a financial institution can obtain beneficial ownership information from the business; as that default would be the result of a contractual breach by its bank, it could sue for damages.

We note that FinCEN in its FAQs has recognized and attempted to resolve this issue by providing that, during the initial certification of beneficial ownership information, if the customer also agrees to notify the institution of any change in ownership, then future renewals are covered.[10] However, there likely remain millions of outstanding accounts that require

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[9] *See* 81 Fed. Reg. 29, 398.

[10] FAQ 12 states that "[i]n the case of a loan renewal or CD rollover… if at the time the customer certifies its beneficial ownership information, it also agrees to notify the financial institution of any change in such information, such agreement can be considered the certification or confirmation from the customer and should be documented and maintained as such, so long as the loan or CD is outstanding." *See* FinCEN April 3 FAQs, *supra* n. 8.

grandfathering. We believe that the costs of requiring amendments to all those accounts would dwarf any potential AML benefits.[11]

We note that the FAQs issued by FinCEN were not subject to notice and comment, so any attempt to apply or treat them as binding in nature would violate the Administrative Procedure Act.[12] Therefore, legally, the incompatibility between guidance and contract described above should be resolved by institutions adhering to their contracts, as future contracts would eventually bring them into compliance with the guidance, and we would hope that FinCEN would agree to such a common sense approach. However, we are concerned that financial institutions could be forced by examiners to treat FinCEN's guidance as a binding regulation. Bank compliance officers cannot afford either institutionally or personally to risk examiner sanction, whether in the form of a Matter Requiring Attention in the examination process or a formal enforcement action. Also, given that a firm could be examined by multiple agencies, there is potential for variation in interpretation.

In order to provide covered institutions and FinCEN with additional time to resolve or provide clarity and comfort, we would encourage FinCEN to grant exceptive relief on various aspects of the rule, like the guidance provided in FAQ 12 and complex aspects of the "new account" requirement, until such matters can be further discussed, or as a way to provide institutions with additional time to calibrate their programs to implement aspects of the FAQs that provided further clarity on the regulation, but did not create additional requirements. The BSA grants the Treasury Secretary with the authority to "prescribe an appropriate exemption from a requirement" implemented under it.[13] Along with other authorities, the Secretary of the Treasury has delegated this responsibility to FinCEN.[14] FinCEN has utilized this tool

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11 It is worth noting that FinCEN's FAQ 12 guidance is derived from joint agency guidance released in 2005—also without notice and comment or Congressional review—which included a statement that "[f]or the purposes of the CIP rule, each time a loan is renewed or a certificate of deposit is rolled over, the bank establishes another formal banking relationship and a new account is established." *See* "Interagency Interpretive Guidance on Customer Identification Program Requirements under Section 326 of the USA PATRIOT Act, FAQs: Final CIP Rule," p. 8 (April 28, 2005). That guidance was inconsequential at the time, as it was intended to clarify that the customer whose account is renewed is *not* subject to CIP again, but now has substantial ramifications as the "new account" focus of the CDD rule leads to an illogical conclusion. So, while FinCEN acknowledges in FAQ 12 that the "risk of money laundering is very low," a combination of agency guidance, FinCEN guidance, and a zero-tolerance examination culture is likely to set financial institutions on a path to devoting extraordinary resources towards those products—resources that could better be used elsewhere. We need a regime that deploys financial institution resources to combating financial crime, not checking boxes that were created by guidance issued in 2005.

12 *See* U.S. Government Accountability Office "Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation--Applicability of the Congressional Review Act to Interagency Guidance on Leveraged Lending," (October, 19, 2017), *available at* www.gao.gov/assets/690/687879.pdf. *See also* U.S. Government Accountability Office "Bureau of Consumer Financial Protection: Applicability of the Congressional Review Act to Bulletin on Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act," (December 5, 2017), *available at* www.gao.gov/assets/690/688763.pdf.

13 *See* 31 U.S.C. 5318(a)(7).

14 *See* Treasury Order 108-01 (July 1, 2014).

infrequently, but it could prove particularly useful in providing some regulatory comfort while institutions seek further clarity and direction from FinCEN.[15]

CDD Rule's Triggering Event Requirement

We were pleased that FinCEN declined to impose its beneficial ownership information collection requirement retroactively, or to all covered legal entity customer accounts at a financial institution, and instead took the prudent approach of applying it from the compliance date of the rule. FinCEN's approach strikes the right balance, as banks typically use the initial information obtained under the CIP rule and through KYC processes to do a risk assessment of the customer. Customers that the bank views as higher risk will normally be subjected to additional levels of due diligence, which may already involve obtaining beneficial owner information. Moreover, banks may seek to refresh information about accountholders when certain events trigger a review. Therefore, the final rule's requirement that a financial institution need acquire beneficial ownership information for a current account on the occurrence of a triggering event is more appropriate than a broad, retroactive requirement.

Beneficial Ownership Legislation

Furthermore, as financial institutions test their CDD implementation systems, they are discovering that meeting the final rule's requirements with respect to current customers on the occurrence of a triggering event takes a substantial period of time, as banks must request beneficial ownership information from clients, verify it, then perform additional due diligence as needed, including screening the names provided against both internal and external bank OFAC lists.[16] There is also a client friction, as clients want to know why their bank (and no other company with which they conduct business) must investigate their ownership. As TCH has previously testified, the government should collect this information and allow access to it by law enforcement and financial institutions legally obligated to determine ownership in the exercise of their BSA/AML obligations. We strongly support Congressional efforts in this regard, including those in the draft "Counter Terrorism and Illicit Finance Act."

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15 *See* 31 CFR 1010.970 which states that "[t]he Secretary, in his sole discretion, may by written order or authorization make exceptions to or grant exemptions from the requirements of this chapter. Such exceptions or exemptions may be conditional or unconditional, may apply to particular persons or to classes of persons, and may apply to particular transactions or classes of transactions. They shall, however, be applicable only as expressly stated in the order of authorization, and they shall be revocable in the sole discretion of the Secretary."

16 While not the subject of this hearing, TCH also recommends that Treasury increase the efficiency and effectiveness of sanctions compliance, and further recognize a risk-based approach to such compliance. OFAC sanctions programs are a vital tool to U.S. foreign policy and therefore it is essential that compliance expectations are risk-based and communicated consistently in order to avoid inconsistent application of program requirements. For example, Treasury should clarify that (i) financial institutions are expected to apply sanctions to a subsidiary of a person listed on a relevant OFAC list when there is a reason to know that the entity is a majority-owned subsidiary of a listed person, such as when the subsidiary is a customer of the financial institution or is listed as a subsidiary on an OFAC list; (ii) publish the names of all known sanctioned parties on OFAC-published lists to allow financial institutions to properly screen for and interdict prohibited transactions; and (iii) standardize the information in the various sanctions lists published by OFAC.

Of course, there are other benefits to that legislation, including a bar on forming anonymous companies. Many criminals avoid the banking system and launder money by forming LLCs and using them to hold real estate, art, jewelry or other valuables—all without having to touch the banking system. The CDD rule does nothing to prevent this behavior, but beneficial ownership legislation could be of valuable assistance to law enforcement in determining who owns what.

With respect to implementation, the CDD rule's preamble states that the federal functional regulators have authority to "establish AML program requirements in addition to those established by FinCEN that they determine are necessary and appropriate to address risk or vulnerabilities specific to the financial institutions they regulate."[17] As TCH has previously testified before this Subcommittee, BSA compliance examinations should be conducted under standards clearly set by FinCEN and not subject to interpretive discretion by the federal functional regulators.[18] Congress vested exclusive authority to implement the BSA in Treasury, not other agencies,[19] and as previously discussed, the Secretary has delegated that authority to FinCEN.[20] Congress also did not exempt this area of law from the Administrative Procedure Act or the Congressional Review Act. Therefore, financial institutions have the same right to know the rules to which the government is subjecting them as any other company or individual, under any other statutory regime.

In particular, public reports indicate that the federal banking agencies have considered directing institutions to collect beneficial ownership at a 10% equity threshold in "high risk" cases, a practice that we understand has been informally enforced for years, even prior to the release of FinCEN's CDD rule.[21] However, FinCEN was very clear in its rule that financial institutions should, on a risk basis, determine when to collect information at a lower equity threshold. Therefore, any effort by federal banking agency examiners to impose such a requirement, or to act in a similar manner with regard to a different provision of the CDD rule, is not only unsupported by law but also an unwise use of financial institution resources.[22]

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17 *See* 81 Fed. Reg. 29,403-29,404.

18 *See* Testimony of Greg Baer before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit, "Examining the BSA/AML Regulatory Compliance Regime," (June 28, 2017), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba15-wstate-gbaer-20170628.pdf.

19 31 U.S.C. 5318(a)(2) and (h)(2). We note that other potential AML-related sources of statutory authority do not apply here. For example, section 8(s) of the FDI Act only grants the agencies with authority to "prescrib[e] regulations requiring [banks] to establish and maintain procedures reasonably designed to assure and monitor the compliance of such depository institutions with the [BSA]"; while regulations thereunder may establish procedural expectations for compliance with the BSA, they cannot interpret the BSA itself.

20 *See* Treasury Order 108-01 (July 1, 2014).

21 *See* The Clearing House, "Appropriate Implementation of FinCEN's Customer Due Diligence Rule," (December 14, 2017), *available at* www.theclearinghouse.org/-/media/new/tch/documents/advocacy/20171214_tch_letter_cdd_rule_implementation.pdf.

22 *Id.*

More broadly, this situation illustrates why the Treasury Department should take a more prominent role in coordinating AML/CFT policy across the government to set priorities for the AML/CFT regime. This leadership role should extend to establishing definitive CDD standards to be enforced by FinCEN and, if necessary, examined for compliance by the banking agencies.

Domestically, banks of all sizes report that current CDD requirements have increased the cost of opening new accounts, and may represent a majority of those costs. Of course, disproportionate and heightened account opening requirements make low-dollar accounts for low- to moderate-income people much more difficult to offer and price. While the connection is not immediately apparent, AML/CFT expense is clearly an obstacle to banking the unbanked, and a reason that check cashers and other forms of high-cost, unregulated finance continue to prosper. The problem, of course, is that bank examiners do not internalize those costs. And those in the government who do internalize those costs play no role in examining the performance of financial institutions.

On April 24, Joint Economic Committee Democrats highlighted data showing that "one in four American households are unbanked or underbanked, representing nearly 34 million families."[23] They go on to note that such individuals rely on alternative financial services like payday, or auto title loans, and this results in their being charged additional fees (e.g. for an income of $22,000 an unbanked household can pay more than $1,000 each year in extra fees). In many cases, these people are making a rational decision, in part related to the topic of today's hearing. Low and moderate income people often do not receive regular paychecks, and therefore frequently make cash deposits. Banks are required to flag frequent deposits as high risk for money laundering, and investigate the source of the funds—in effect, investigate the depositor. LMI customers understandably react badly to being challenged by their bank, and often prefer to retain cash and use a check casher to deposit any checks they receive. Furthermore, if customers fail to respond to such an inquiry, the bank is expected to file a SAR, which could lead to the closing of an individual's account. Of course, these closings become known and further the reputation of banks as a bad place for LMI customers to do business.

Thus, it is easy to understand why LMI families might prefer to remain unbanked—to keep that cash at home, to take the odd check to a check casher rather than a bank, and when there is need for emergency funds—having no existing deposit relationship with a bank—to turn to a payday lender. Therefore, we should not assume that choices to remain unbanked are the product of ignorance, but rather investigate their causes and seek to remove impediments to those people entering the banking system.

One could argue that some of these cash transactions are illicit finance—for example, income that may not be reported to the IRS. However, a thoughtful cost-benefit analysis might conclude that the law enforcement benefits of this regime as applied to low dollar accounts—where prosecution is extraordinarily unlikely—are vastly outweighed by the societal costs of

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[23] *See* Joint Economic Committee Democrats, "Financial Access Still Out of Reach for Millions," (April 24, 2018), *available at* https://www.jec.senate.gov/public/index.cfm/democrats/blog?ID=D5B2E636-5782-4608-B1D4-B7C40E49CE50.

pushing large numbers of people out of the banking system. The one thing that is certain is that the current regime does not allow bank examiners to undertake such a cost-benefit analysis.

For that to occur, the Department of the Treasury would have to exercise serious leadership in this area.

Treasury is uniquely positioned to balance and prioritize the sometimes conflicting interests relating to national security, the transparency and efficacy of the global financial system, the provision of highly valuable information to regulatory, tax and law enforcement authorities, financial privacy, financial inclusion, and international development concerns and there is a clear precedent for such a process.[24]

More broadly, and beyond the scope of this hearing, in order to strengthen the effectiveness of the regime in catching criminals, a technological revolution is required. Such a revolution could allow financial institutions to assist law enforcement and national security agencies far more effectively. For that revolution to occur, however, the Treasury Department and FinCEN must begin to analyze raw data and establish incentives to encourage innovation. The existing system, where priorities are not clearly established and examinations are compliance focused, with zero tolerance across all types of activity, including the adoption of innovative technology, cannot produce this revolution.

Furthermore, we believe that FinCEN should reclaim examination authority for large, internationally active banks that file a majority of the reports required under the BSA and present almost all of the most difficult policy questions with respect to de-risking. As TCH has noted in previous testimony, of the roughly one million SARs filed annually by depository institutions (banks and credit unions), *approximately half are filed by only four banks*. Certainly, reform is warranted for smaller firms, where the cost of filing that handful of SARs is wildly disproportionate to its benefit. But if the goal is to catch dangerous criminals, identify terrorist activity, and reduce collateral damage to U.S. interests abroad, FinCEN need focus its examination energy on only a very few firms.

We estimate that an examination team of only 25-30 people at FinCEN could replicate the existing work of the federal banking agencies and the IRS (for the largest MSBs) at the largest, most internationally active institutions. More importantly, a dedicated FinCEN exam team for this small subset of large institutions could receive appropriate security clearances, meet regularly with end users and other affected parties, receive training in big data and work with other experts in government. They in turn would be supervised by Treasury officials with law enforcement, national security, and diplomatic perspectives on what is needed from an AML/CFT program—not bank examiners with no experience in any of those disciplines. And when FinCEN turned to writing rules in this area, like the CDD rule, it would do so informed by its experience in the field. It would see the whole battlefield, and promote innovative and imaginative conduct that advanced law enforcement and national security interests, rather than auditable processes and box checking.

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[24] The production of the National Security Strategy and the National Intelligence Priorities Framework both use interagency processes to establish priorities.

Importantly, the benefits of a FinCEN examination function would extend well beyond the handful of banks it examined. Priorities set and knowledge learned could be transferred to regulators for the remaining financial institutions. And innovation started at the largest firms, with encouragement from FinCEN, would inevitably benefit smaller firms. The result of FinCEN assuming some supervisory authority would be a massive *cultural* change, as the focus shifted to the real-world effectiveness of each institution's AML/CFT program, rather than the number of SARs filed or number of beneficial ownership certifications financial institutions have on file. That change would start with those banks under sole FinCEN supervision, but would eventually spread to all institutions.

In addition, we believe that Treasury should conduct a broad review of current BSA requirements and guidance, de-prioritize the investigation and reporting of activity of limited law enforcement or national security consequence and create opportunities for the law enforcement and national security communities to provide general feedback on financial institution filings.[25] Banks receive inquiries from law enforcement for follow-up information in less than 10% of cases, and for some categories of SARs, close to 0%. The apparent inutility of the reports that are currently filed is a direct result of the outdated nature and misaligned incentive structure of the current framework. Critically evaluating, updating and streamlining the requirements would not only improve the utility of SARs and CTRs in particular, but also make more resources available to other higher value AML/CFT efforts, such as more proactively identifying and developing techniques to combat emerging trends in illicit activity, investing more heavily in innovation generally (including with respect to machine learning), and engaging in more proactive intelligence-led investigations. Allowing firms to redeploy their resources in this way would substantially increase the law enforcement and national security value of information provided by the financial sector.

Furthermore, one of the most pressing needs related to our national AML/CFT regime is to enable financial institutions to innovate their anti-money laundering programs. Financial institutions need to be able to innovate alone or in concert with their peers as new technologies emerge that allow for both efficiency gains and improved threat assessments. Advances in technology have the potential to truly change the way in which institutions approach illicit finance threats, which can only enhance our nation's AML/CFT regime. It is important for the government to encourage this innovation and provide responsible yet sufficient leeway to test and utilize these new systems and processes. Similarly, it is important that any reform should be flexible enough to address emerging technologies, like crypto currencies, that pose illicit finance risks that are currently being investigated.[26]

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[25] See The Clearing House letter to FinCEN on its "Request for Comments Regarding Suspicious Activity Report and Currency Transaction Report Requirements," (April 10, 2018), *available at* www.theclearinghouse.org/advocacy/articles/2018/04/20180410-tch-comments-to-fincen-on-sar-and-ctrs/

[26] We note that in 2013, FinCEN issued guidance stating that "an administrator or exchanger [of a virtual currency] is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person." *See* FIN-2013-G001, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," (March 18, 2013), *available at* www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering.

The draft "Counter Terrorism and Illicit Finance Act" would further many of these goals, and we encourage Congress to enact it. AML/CFT reform is needed in order to make the system more efficient and effective—the CDD rule is simply a symptom of the larger issue with the system. I look forward to your questions.

Testimony of
Carlton M. Greene, Partner,
Crowell & Moring, LLP, before
the Subcommittee on Financial Institutions and Consumer Credit
April 27, 2018

TESTIMONY AS PREPARED

Chairmen Leutkemeyer, Ranking Member Clay, and members of the Subcommittee, I am grateful for the opportunity to appear before you today and to offer testimony concerning the Financial Crimes Enforcement Network's ("FinCEN's") customer due diligence rule (the "CDD Rule"). My name is Carlton M. Greene. I am a partner at the law firm of Crowell & Moring, LLP, in Washington, D.C., and practice in the areas of anti-money laundering ("AML") and economic sanctions laws. I previously served as FinCEN's Chief Counsel in acting and full capacities from 2013 to 2015. Before that, I spent many years at the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), where I was responsible for directing targeting and investigation for U.S. sanctions programs relating to Iran, North Korea, Syria, and transnational criminal organizations. I appear today on my own behalf, and not on behalf of any client.

The CDD Rule will provide important new information useful to law enforcement in the detection and prevention of money laundering, terrorism financing, and other financial crime. FinCEN deserves credit for formalizing and setting boundaries to practices that previously had existed only in interpretive guidance. The promulgation of the rule, which has been ten years in the making, and FinCEN's recent, extensive guidance interpreting the rule (in the form of 37 frequently asked questions or "FAQs"), represent an enormous labor and expenditure intellectual effort by the agency, and a substantial achievement. FinCEN also deserves credit for the public hearings and other steps it took to solicit and incorporate industry views on the rule. In addition to changes FinCEN made to the final rule based on public comment, FinCEN also has considered and addressed many of the questions and concerns that industry has raised about the final rule in the 37 FAQs it recently issued. This is the kind of responsive partnership that will best assure the success of the rule in providing information useful for combating financial crime.

The banks and other financial institutions covered by the rule likewise have expended extraordinary effort to inform FinCEN's approach to the rule and to re-organize processes across their enterprises to implement its requirements. Over my last two years in private practice, I have seen the never-ending hard work and professionalism that these institutions apply to understanding and complying with their obligations under the Bank Secrecy Act ("BSA"). Like an iceberg, the majority of these efforts typically go unseen by regulators. I also know the outsized expenditure of resources that so many of these institutions devote to AML compliance and the day-to-day frustrations and burdens that come from ensuring compliance. Despite the burdens they already face under existing AML rules, they have stepped forward to collaborate in developing a CDD Rule that promises to be useful, and to accept the new burdens that come with it.

FinCEN's new FAQs provide important interpretive guidance that has solved a number of questions that threatened implementation or threatened to impose large and unexpected costs on it. I also know, however, that this guidance has generated new questions that create new risks for covered financial institutions. The risks to covered institutions of misunderstanding or not being in a position to comply with the new guidance are heightened by the fact that the new FAQs have arrived so close to the May 11, 2018 implementation date for the rule. These include, for example, questions about: (1) how pooled investment vehicles that are advised or operated by non-financial institutions will be treated under the rule's requirement to obtain beneficial ownership information; (2) what events trigger the requirement to update customer information, especially information apart from beneficial ownership; (3) the types of actions and contact with the customer that must be undertaken as part of such updates, especially with respect to information apart from beneficial ownership; (4) what information must be gathered to reasonably understand the "nature and purpose" of a customer's business, and (5) when a covered institution will be deemed to have "knowledge of facts that would reasonably call into question the reliability" of customer-provided information. To account for these questions, FinCEN should continue to work closely and collaboratively with covered financial institutions to provide clarity wherever possible. It also should show leniency in the early years after the rule's May 11, 2018, implementation date, as institutions adapt to FinCEN's recent guidance and encounter the inevitable but impossible-to-predict obstacles to compliance that come with any new rule of this scale.

Beyond the CDD Rule, I have a broader concern that the current relationship between FinCEN and the federal functional regulators poses risks to FinCEN's mission to detect and combat financial crime. Two facts are important to understanding this issue. First, that FinCEN has delegated examination authority to the federal functional regulators and, second, that these agencies use their own independent authorities to examine for and enforce compliance with the BSA. This has the potential to lead these regulators to create and enforce their own interpretations of or additions to BSA rules, or otherwise to emphasize enforcement in areas that diverge from FinCEN's priorities, potentially complicating FinCEN's ability to establish a coherent approach to AML regulation. Furthermore, the mission of these agencies differs significantly from FinCEN's, and they do not have access to the same threat information and analysis that FinCEN relies on to determine which aspects of BSA compliance are important, at any given period, to obtain vital threat information or put a stop to emerging financial threats. Instead, there is a risk that these differences may lead to overly formalistic enforcement of BSA requirements that requires the regulated community to bear substantial costs on aspects of compliance that do not advance the anti-money laundering goals of the BSA, and which might better be spent advancing that mission.

At the same time, there are important benefits from the current arrangement. FinCEN is a very small agency compared to the federal functional regulators, only a few hundred people, and must regulate a very wide variety of financial institutions ranging from banks and broker-dealers to money services businesses and casinos. It would be difficult for FinCEN, even with a larger staff, to have the depth of knowledge that prudential regulators have acquired over the institutions that they regulate. Nor in any case does it currently have the staff or expertise needed to examine all of the institutions it regulates for AML compliance. As such, the best approach to this situation may be to improve the current partnership rather than to break it.

There have been a number of proposals put forward as to how this might be done, and I am not here to advocate for one in particular. However, I think any viable solution should be one that includes closer collaboration between FinCEN and the federal functional regulators and greater authority for FinCEN to establish BSA examination and enforcement priorities across these agencies and similarly to control interpretations of BSA rules. FinCEN, by design, is uniquely positioned to understand the threats posed by illicit finance and to understand the regulatory trade-offs needed to address those threats. In addition to the benefits to FinCEN's mission, such an approach also could substantially lessen the burdens for regulated financial institutions, and give them greater freedom to innovate and partner with FinCEN to find better solutions to illicit finance threats.

Lastly, I am aware that the money laundering risks associated with the lack of beneficial ownership information extend far beyond the customers of U.S. financial institutions. This includes, for example, companies that are formed in the United States but operate and keep their accounts at overseas financial institutions. International standard-setting bodies in this area, such as the Financial Action Task Force, have pointed to the lack of regulation in this area as a failing of the U.S. approach to AML. Here again, a number of different measures have been proposed to deal with this issue, including efforts to require state authorities to obtain beneficial ownership information at the time of corporate formation. There is more than one viable solution to this issue, but these proposals should be seriously considered and evaluated.

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Testimony of Gary Kalman
Executive Director
Financial Accountability and Transparency (FACT) Coalition

Prepared for the

Subcommittee on Financial Institutions and Consumer Credit

Hearing on Implementation of FinCEN's Customer Due Diligence Rule – Financial Institution Perspective

April 27, 2018

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Chairman Luetkemeyer, Ranking Member Clay, and Members of the Subcommittee, thank you for the opportunity to appear before you.

On behalf of the Financial Accountability and Corporate Transparency (FACT) Coalition and our member organizations, I appreciate the opportunity to discuss FinCEN's Customer Due Diligence (CDD) rule and the importance of collecting beneficial ownership information. This remains a critical element in the larger effort to address grand corruption and the nexus between secrecy jurisdictions, crime, corruption, human rights, and national security.

The FACT Coalition is a non-partisan alliance of more than 100 state, national, and international organizations working to combat the harmful impacts of corrupt financial practices.

Before addressing the particulars of the CDD Rule, it is important to review why the collection of this information matters. As detailed below, the CDD rule is a positive step forward but falls short of what is needed to protect the integrity of our financial system.

What Is an Anonymous Company?

When people create companies in the United States, they are not required to disclose who really profits from their existence or controls their activities — the actual "beneficial owners" of the business. Instead, individuals who benefit can conceal their identity by using front people, or "nominees," to represent the company. For instance, the real owner's attorney can file paperwork under his or her own name even though the attorney has no control or economic stake in the company. Finding nominees is not terribly difficult — there are entities whose entire business model is to file paperwork and stand in for company owners. Additionally, some jurisdictions do not require ownership information at all while others allow for companies to own companies, permitting a layering of corporate structures that makes it difficult to impossible to identify the true underlying owners.

The Dangers of Anonymous Companies

Anonymous companies are the vehicle of choice for drug cartels, organized crime, corrupt foreign officials and others who need to launder money. These entities are then able to profit from these funds, prop up their regimes and engage in a host of harmful actions — including fueling the opioid epidemic, human trafficking, counterfeiting goods, upsetting global supply chains, and threatening our national security. These entities have even been implicated in the lack of affordable housing in the U. S.[1]

The 2016 release of the Panama Papers exposed the magnitude of the problem. Eleven million documents, 214,000 companies, 140 politicians from 50 countries — all from just one law firm in one country creating companies with hidden owners.[2] The fallout was widespread. The revelations led to the resignation of Iceland's prime minister, while the exploits of Russian President Vladimir Putin's associates were well documented in the media.[3] The Panama Papers exposed the direct connection

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[1] The New York Times. "Towers of Secrecy: Piercing the Shell Companies." July 27, 2016.
[2] Harding, Luke. "What are the Panama Papers? A guide to history's biggest data leak." The Guardian. April 05, 2016.
[3] Erlanger, Steven, Stephen Castle, and Rick Gladstone. "Iceland's Prime Minister Steps Down Amid Panama Papers Scandal." The New York Times. April 05, 2016.

between criminal practices and the corporate secrecy that enables kleptocrats and others to use legal entities to hide money, fund illicit activity, and move suspect proceeds around the globe with impunity.

Fueling the Opioid Crisis

Early in the 115th Congress, the House Financial Services Committee held a hearing on its oversight plan during which Representative Steven Pearce, Chairman of the Subcommittee on Terrorism and Illicit Finance, noted that drug cartels are coming across the border into his home county in New Mexico, creating shell companies in the trucking sector and "weakening the economic framework by which other companies can be successful."[4] This experience is consistent with recent research.

In 2016, FACT Coalition member Fair Share published the report *Anonymity Overdose* which documented the connection between anonymous companies and the opioid crisis. The report details cases in which opioid traffickers used companies with hidden owners to launder money including the example of "Kingsley Iyare Osemwengie and his associates [who] were found to use call girls and couriers to transport oxycodone, and then move profits through an anonymous shell company aptly named High Profit Investments LLC."[5]

Admiral Kurt Tidd, head of US forces operating in Central and South America, said the US goal is for our forces to interdict 40% of the illegal drugs coming into the country.[6] But John Cassara, former Special Treasury Agent with the Office of Terrorism Finance and Financial Intelligence and a consultant on the report, noted: "We know the drug cartels are in it for the money – and to stop them we need to go after their profits .... Anonymous shell companies make that work much more difficult for law enforcement. We need to do more than just bust the street level distributors, we need to go after the real kingpins, and to do that we need better tools to follow the money."[7]

Human Trafficking

Anonymous companies regularly serve as fronts for those engaged in crimes that involve human rights abuses. According to Global Witness, a FACT Coalition member, "A Moldovan gang used anonymous companies from Kansas, Missouri and Ohio to trick victims from overseas in a $6 million human trafficking scheme."[8]

Stories like that and their own research convinced Polaris, one of the leading U.S.-based organizations fighting human trafficking, to join the call to crack down on companies with hidden owners. Recognizing the role of those companies in trafficking and the difficulty of combatting trafficking schemes if law enforcement cannot "follow the money" to specific individuals profiting from the wrongdoing, in an April 2018 report Polaris wrote the following:

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[4] Maloney, Carolyn, and Peter King. "Unite to crack open shell corporations." NY Daily News. August 28, 2017.
[5] Fair Share. "Anonymity Overdose - How our opioid crisis and shell companies are linked." August 1, 2016.
[6] Woody, Christopher. "US forces are ill-equipped to stop illegal drugs and migrants, says a top military official." Business Insider. March 12, 2016. http://www.businessinsider.com/r-us-forces-ill-equipped-to-stop-illegal-drugs-migrants-admiral-2016-3.
[7] Cassara, John. "Countering International Money Laundering." August 23, 2017.
[8] Global Witness. "Great Rip Off." September 25, 2014.

> *"[A]n estimated 9,000-plus of these [illicit massage] businesses are operating in every state in the country, with earnings totaling nearly $2.5 billion a year across the industry. These businesses dot the sides of highways and are tucked into suburban strip malls between fast food restaurants and dollar stores and behind darkened windows in storefronts in some of America's biggest cities... [E]vidence suggests that behind these bland facades, many of the thousands of women engaging in commercial sex in illicit massage parlors are victims of human trafficking. And for the most part, thanks to corporate secrecy, their traffickers cannot be traced."*

In Fairfax County, Virginia alone, Polaris identified 108 illicit massage businesses that were connected to 181 different corporations.[9]

Several leaders in the anti-human trafficking movement have condemned the use of anonymous companies enabling human trafficking. Melysa Sperber, Director of the Alliance to End Slavery & Trafficking/Humanity United, had this to say when commenting on H.R. 3089, a bill pending in the House Financial Services Committee to require FinCEN to collect beneficial ownership information:

> *"This bill represents a critical first step in ensuring that our federal government partners with financial institutions to restrict traffickers' access to the banking system, thus disrupting their operations. This bill will also improve law enforcements' access to information on traffickers already gathered by financial institutions—making it easier to prosecute traffickers, while reducing the burden on trafficking victims to provide testimony and evidence."*[10]

Upsetting Global Commerce

In a March 2017 report, researchers at FACT Coalition member Global Financial Integrity (GFI) estimated the direct financial cost of transnational crime as follows:

> "[G]lobally the business of transnational crime is valued at an average of $1.6 trillion to $2.2 trillion annually. The study evaluates the overall size of criminal markets in 11 categories: the trafficking of drugs, arms, humans, human organs, and cultural property; counterfeiting, illegal wildlife crime, illegal fishing, illegal logging, illegal mining, and crude oil theft."[11]

GFI highlights anonymous companies as a main vehicle to both engage in illegal trade and hide or launder the resulting proceeds. Recent studies have estimated the scale of money laundering to be in the range of 3% to 5% of global GDP.[12]

Traffickers in counterfeit and other illicit goods and services often hide behind corporate entities that make it more difficult for legitimate businesses to honestly compete in global commerce. In addition, illicit corporations can taint the supply chain of larger corporations that have no desire to deal with suspect entities. That's why a number of leading multinational corporations now support corporate transparency bills in Congress. A letter signed by the Chief Executive Officers of Allianz, The Dow Chemical Group, Kering Group, Salesforce, Unilever, and Virgin Group explained:

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[9] Polaris. "Business Transparency to Combat Human Trafficking."
[10] Sperber, Melysa. "ATEST Letter of Support: End Banking for Human Trafficking Act of 2017." April 26, 2017.
[11] May, Channing. "Transnational Crime and the Developing World" Global Financial Integrity." March 27, 2017.
[12] UNODC. "Money-Laundering and Globalization." 2018.

> *"When the true owners of companies put their own name on corporate formation papers, it increases integrity in the system and provides a higher level of confidence when managing risk, developing supply chains and allocating capital. If ownership information is on record, we can have greater reputational and legal certainty in our dealings with third parties, protecting our ability to enforce contracts and safeguard our investments."*[13]

These CEOs are not alone. In fact, according to Ernst & Young's Fiscal Year 2016 Global Fraud Survey, 91 percent of senior executives believe it is important to know the ultimate owner of the entities with which you do business.[14]

Threatening our National Security

The threats posed by anonymous companies go beyond the commercial and criminal spheres; they also threaten our national security. The stories of anonymous companies obtaining contracts with the Department of Defense are numerous and disturbing. A Global Witness report called *Hidden Menace* identifies, in unsettling detail, the role of secrecy in endangering our troops and undermining U.S. security. One example details how a U.S. - Afghan company that won a contract to supply our troops was secretly controlled by the Taliban, which used the profits to fund weapons to attack our soldiers.[15]

A second troubling report, authored by the U.S. Government Accountability Office, details how corporations with hidden owners are leasing office space to sensitive U.S. military and law enforcement agencies, a situation rife with risks that shouldn't be allowed to continue. The report warned of "security risks such as espionage and unauthorized cyber and physical access."[16]

Writing about the GAO report, Global Witness noted:

> "In the end, the GAO found 26 agencies renting space from foreign owners, and of the 14 contacted, nine of them didn't know they were leasing from a foreign owner because the building ownership wasn't clear. In one case, an FBI field office in Seattle responsible for investigating public corruption and money laundering in Asia, among other things, was discovered to be leasing space in a building owned, through a series of domestic and foreign companies, by the Taib family of Malaysia."[17]

The Taib family has been implicated in substantial fraud and money laundering operations. Global Witness' Eryn Schornick commented: "The FBI has a 20-year lease for the space, and at the end, it will have paid $56 million in rent to this family. That makes no sense."[18]

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[13] Allianz, Virgin Group, Salesforce, The Dow Chemical Group, Kering Group, and Unilever. "U.S. government action crucial to fighting corruption." July 14, 2017.
[14] Ernst & Young. "Corporate misconduct — individual consequences." 2016.
[15] Global Witness. "*Hidden Menace*." July 12, 2016.
[16] Tatum, Sophie, and Pamela Brown. "First on CNN: Report finds national security agencies at risk in foreign-owned buildings." January 30, 2017.
[17] May, Kate Torgovnick. "How anonymous companies can undermine national security." April 19, 2017.
[18] Schornick, Eryn. "Government Contracts and National Security." March 7, 2017.

As Congress considers new economic sanctions to counter North Korean threats, the Committee should take note of a U.S. Department of Justice (DOJ) case charging a Chinese national Ma Xiaohong, her company Dandong Hongxiang Industrial Development, and several colleagues with violating U.S. sanctions laws by working with a blacklisted North Korean bank, Kwangson Banking, to set up shell companies in Hong Kong and elsewhere to hide the business they were doing with North Korean companies that help Pyongyang develop nuclear weapons.[19]

I would also note a DOJ case closed in June of 2016 which confirmed that Iran evaded economic sanctions in part by reaping millions of dollars annually from a New York-based anonymous company with investments in Manhattan real estate.[20]

Inflating Affordable Housing

Increasingly there are stories of secret owners bidding up prices on properties and then using them to launder dirty money rather than to purchase as homes. Not only is our real estate market a magnet for kleptocrats and organized crime, but their real estate deals potentially fuel a loss of affordable housing in growing numbers of communities due to skyrocketing real estate prices and vastly inflated markets.

- In Manhattan, the press reports that eight blocks between Lenox Hill and Central Park are nearly 40 percent unoccupied, and more than a quarter of the properties on the Upper East Side are owned but vacant, pricing middle-income families out of those neighborhoods.[21]
- In San Francisco, the media reports a South Beach neighborhood is one-fifth unoccupied, and, in the competitive California housing market, the rent crisis is affecting middle-income families.[22]
- A 2016 story in The Miami Herald about the impact of offshore money on the local housing market found that, "the boom also sent home prices soaring beyond the reach of many working- and middle-class families. Locals trying to buy homes with mortgages can't compete with foreign buyers flush with cash and willing to pay the list price or more."[23]

Current Lack of Beneficial Ownership Transparency

To the extent that these examples illustrate the depth of the problem, it is important to acknowledge that we have often been able to pierce the veil of corporate secrecy through luck or leaks. That must not continue to be a substitute for the critical information needed to stop criminal enterprises. In a report written by former U.S. Treasury Special Agent John Casarra for the FACT Coalition, Cassara noted that in efforts to reclaim laundered money, we are currently "a decimal point away from total failure."[24] His analysis is based on estimates that globally we catch only about 0.1 percent of laundered money. While

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[19] Press Release, US Department of Justice, "Four Chinese Nationals and China-Based Company Charged with Using Front Companies to Evade U.S. Sanctions Targeting North Korea's Nuclear Weapons and Ballistic Missile Programs, Sept. 26, 2016.
[20] Press Release, US Attorney's Office, Southern District of New York, 2017
[21] Joseph Lawler. "Money Laundering is Shaping US Cities," Washington Examiner, March 27, 2017
[22] Ibid.
[23] Nicholas Nehamas. "How secret offshore money helps fuel Miami's luxury real-estate boom." The Miami Herald. April 3, 2016.
[24] Cassara, John. "Countering International Money Laundering." August 23, 2017.

kleptocrats and other criminal enterprises have updated their tools for the 21st century by utilizing anonymous companies, we have not updated our laws to catch them.

In its 2016 mutual evaluation, the Financial Action Task Force (FATF) found that the U.S. anti-money laundering framework has "significant regulatory gaps" and that the "lack of timely access to accurate and current beneficial ownership information remains one of the fundamental gaps in the U.S. context."[25]

A 2014 report, by academics from the University of Texas-Austin, Brigham Young University, and Griffiths University, found that the United States is the easiest place in the world to establish an anonymous company[26]. The researchers sent out thousands of inquiries to corporate formation agents in over 180 countries with details that should have raised red flags for the recipients. As one example, an agent in Florida responded in an email that, "Your stated purpose could well be a front for funding terrorism ... if you wanted a functioning and useful Florida corporation you'd need someone here to put their name on it, set up bank accounts, etc. I wouldn't even consider doing that for less than 5k a month..."[27]

Past rules are not working.

Customer Due Diligence Rule

The FACT Coalition agrees on the need for the CDD rule as a step toward a comprehensive approach to prevent the abuse of anonymous shell companies to launder money through our financial system.

The CDD rule was published in May of 2016. Financial Institutions have had two years to prepare for the implementation of the rule. In addition, prior to publication of the CDD rule, US federal bank examiners have long required banks operating in the United States to explicitly collect beneficial ownership information for corporate entities wishing to open US accounts in order to create a risk profile and assess the attendant risk. For that reason, most US financial institutions already routinely collect beneficial ownership information as part of their "know your customer" obligations. The new rule primarily codified that already existing practice. Because the CDD rule largely codified existing practice, there is no need to delay the implementation of the CDD rule beyond the current implementation date.

The Coalition does have a concern about the CDD rule's definition of "beneficial owner." The rule's definition is critical to ensuring that the information gathered by financial institutions provides the information needed for accurate assessments of risk and to enable law enforcement investigations into any wrongdoing.

The CDD rule requires covered financial institutions to identify the "beneficial owners" of legal entities that open accounts with them, and currently provides a two-prong definition for that term.[28]

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[25] FATF. "United States' measures to combat money laundering and terrorist financing." 2016.
[26] Findley, Michael et al. "Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism." Cambridge University Press (March 24, 2014), Page 74. http://bit.ly/2uTLptQ.
[27] Ibid. pg 98
[28] 31 CFR § 1010.230.

The first prong defines a beneficial owner as "each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer." The second prong defines a beneficial owner as "a single individual with significant responsibility to control, manage, or direct a legal entity customer, including (i) An executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or (ii) Any other individual who regularly performs similar functions."[29]

The international anti-money laundering standards issued by the Financial Action Task Force (FATF) on money laundering recommends that jurisdictions define a beneficial owner as "the natural person who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement."[30] A longstanding Treasury regulation defines the beneficial owner of a financial account as "an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account."[31]

In contrast, the CDD rule eliminates the concept of entitlement to funds and focuses primarily on control by corporate officers. Unlike the FATF guidance, prior Treasury rule, or virtually any other beneficial ownership definition used in other jurisdictions, the U.S. CDD rule enables a corporate officer to be deemed the beneficial owner of a corporation even if that officer has no ownership role or entitlement to the corporation's funds.

To better understand the problems created by that approach, consider the following example.

In 2004, an attorney named Michael Berger formed a California corporation called Beautiful Vision Inc. for his client, Teodoro Nguema Obiang Mangue, the 40 year-old son of the President of Equatorial Guinea.[32] The incorporation papers named Mr. Berger as the company president; they did not mention Mr. Obiang. No evidence was located proving who actually owned the company shares, but evidence did establish that Mr. Obiang had asked Mr. Berger to form the corporation, supplied millions of dollars to accounts opened in the name of the corporation, and through Mr. Berger, exercised ultimate control over the company's actions and assets.

From 2004 to 2005, Mr. Berger opened several accounts and purchased two certificates of deposit at Bank of America in the name of Beautiful Vision. He identified himself as the owner and president of the company in bank records. Mr. Obiang was not mentioned in any of the bank records as an owner or officer of the company, but was the sole signatory on one of the Beautiful Vision accounts. Mr. Berger used the accounts to pay bills and expenses incurred by Mr. Obiang; Mr. Obiang also wrote checks on two of the accounts. To finance the transactions, Mr. Obiang wire transferred millions of dollars from

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[29] 31 CFR § 1010.230(d)(1) and (2).
[30] FATF General Glossary definition.
[31] 31 CFR § 103.175(b).
[32] These facts are taken from a report and hearing entitled, "Keeping Foreign Corruption Out of the United States: Four Case Histories," U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 111-540 (2/4/2020), starting at 141.

accounts in Equatorial Guinea to Mr. Berger's law firm account at another bank; Mr. Berger then used checks to transfer the funds into the Beautiful Vision accounts.

Even though Beautiful Vision was formed at Mr. Obiang's direction, he supplied the company's funds and directed how the company funds should be spent, if the U.S. CDD rule had been in effect at the time, Bank of America would not have had to inquire into or name Mr. Obiang as a beneficial owner of the corporation. Because Mr. Berger had named himself as the company president and owner, the new U.S. CDD rule would have allowed Bank of America to rely on the information he provided, with no obligation to look deeper.[33] The bank could have named Mr. Berger and stopped there, even though Mr. Berger did not have any ownership interest in the company, did not exercise ultimate control over the company's actions, and was instead acting on behalf of Mr. Obiang.

That's why the control test is so important. Yet under the CDD rule's control prong, because Mr. Berger was the company's president, he qualified as a "beneficial owner." In addition, Bank of America would have been legally entitled to name him as Beautiful Vision's "single" beneficial owner, even though Mr. Obiang was also an account signatory, writing large checks on the company accounts, and supplying its funds.

In 2005, Bank of America became suspicious of several large transactions involving the Beautiful Vision accounts, saw that Mr. Obiang was an account signatory and signing some of the checks, and discovered his reputation as a corrupt government official. The bank immediately closed the accounts due to his involvement.

The fact that the CDD rule would have allowed the bank, due to Mr. Berger's position as company president, to name him as the sole beneficial owner of the company demonstrates the severe shortcomings in the rule's definition of beneficial owner.

The Coalition strongly favors the definition of beneficial owner in the congressional proposals before the House Financial Services Committee. The proposals define beneficial owner as "each natural person who, directly or indirectly exercises substantial control over a corporation or limited liability company through ownership interests, voting rights, agreement or otherwise; or has a substantial interest in or receives substantial economic benefits from the assets of a corporation or limited liability company." That definition, with its focus on natural persons who ultimately control or benefit from a legal entity, is important to prevent the shell games in which one company owns another which, in turn, owns another and so on — all to obfuscate the name of the individuals who exercise ultimate control.

The Need for a Comprehensive Approach

It is important to note that the CDD rule is only one part of the overall strategy to address the abuse of anonymous shell companies. Bad actors have established U.S. companies to purchase real estate, aircraft and other large ticket items with cash. Companies have been created in the U.S. only to route money from one jurisdiction to another, bypassing the U.S. banks. While financial institutions represent the largest gatekeeper to the U.S. financial system, they are not the only gatekeepers. As such, Congress, as the Treasury Department already has, should look beyond the CDD rule.

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[33] See 31 USC § 1010.230(b)(2).

In issuing the CDD rule, the U.S. Treasury Department noted the importance of enacting legislation to complement the regulation and also to press for strong international disclosure requirements. It wrote in the preamble to the final rule:

> *"Finally, clarifying and strengthening CDD is an important component of Treasury's broader three-part strategy to enhance financial transparency of legal entities. Other key elements of this strategy include: (i) Increasing the transparency of U.S. legal entities through the collection of beneficial ownership information at the time of the legal entity's formation and (ii) facilitating global implementation of international standards regarding CDD and beneficial ownership of legal entities.*
>
> *This final rule thus complements the Administration's ongoing work with Congress to facilitate adoption of legislation that would require the collection of beneficial ownership information at the time that legal entities are formed in the United States."*

There are at least two proposals currently pending in the House Financial Services Committee to strengthen corporate transparency by improving beneficial ownership disclosures. We thank Chairman Luetkmeyer for his leadership in sponsoring the Counter Terrorism and Illicit Finance Act and Representatives Pete King and Carolyn Maloney for cosponsoring the Corporate Transparency Act. Both proposals would require covered companies to name their beneficial owners at the time of formation. Both include strong, consensus definitions of beneficial ownership – language that is virtually identical to what was already approved overwhelmingly by Congress in last year's National Defense Authorization Act (NDAA). In the NDAA for FY2018, a provision was included to require the Department of Defense to collect beneficial ownership information when leasing high security office space.

I would also note that the Treasury has just recently extended the Geographic Targeting Orders (GTOs), a pilot project to collect beneficial ownership information for high-end, cash-financed real estate transactions in seven metropolitan areas. The extension came after FinCEN issued a report based on the data that found:

> *"about 30 percent of the transactions covered by the GTOs involve[d] a beneficial owner or purchaser representative that is also the subject of a previous suspicious activity report. This corroborates FinCEN's concerns about the use of shell companies to buy luxury real estate in 'all-cash' transactions."*

FinCEN's then-acting director Jamal El-Hindi stated: "These GTOs are producing valuable data that is assisting law enforcement and is serving to inform our future efforts to address money laundering in the real estate sector."

The CDD rule, the NDAA provision, and the GTOs are all important steps, but if we are serious about protecting the integrity of our financial system and cracking down on the harms caused by illicit entities with hidden owners, Congress should pass one of the above referenced bills to create a consistent, national standard that levels the playing field for all states and corporate entities.

The political support for a comprehensive approach is widespread and crosses party and ideological lines. The Clearing House, sitting beside me today, the Financial Services Roundtable, American Bankers Association, Independent Community Bankers Association, National Association of Federally-Insured

Credit Unions, Credit Union National Association, and other financial trade associations have all indicated support for legislation to require the collection of beneficial ownership information. So has the National Association of Realtors. CEOs of multinational corporations and small business trade associations have also weighed in support of corporate transparency legislation. So have faith based coalitions, law enforcement organizations, scholars at conservative and liberal think tanks, legal scholars, veterans and civilian national security experts. All have weighed in support of a national standard for collecting beneficial ownership information.

As bills move forward through the process we must ensure that those charged with protecting our financial system from abuse are provided the proper tools to do so. State and federal law enforcement should be able to request the information with a civil, criminal or administrative subpoena or summons. Since the majority of law enforcement investigations begin with local law enforcement, it is critical that they be given reasonable access to the corporate ownership information. As our first line of defense against suspect transactions, financial institutions should also be able to request ownership data with written permission from the customer.

Conclusion

Drug traffickers, corrupt officials, and other criminals use anonymous shell companies to hide the money they steal and maintain the power they hold. The total amount of dirty money moved through and held by companies with hidden owners is impossible to know precisely but estimates run into the trillions of dollars. The resulting harm is widespread — impacting national security, trafficking victims, and economic and political stability.

Many of the most dangerous criminal elements now operate sophisticated financial networks. They have updated the way they do "business," which Includes the use of companies with hidden owners. As the rest of the world cracks down on corporate secrecy, the criminals and other wrongdoers are looking increasingly to the United States to set up the corporate entities they need to hide their misconduct. If we hope to adequately address the threats, we need to modernize our laws to match the rest of the world and the existing international standards. Steps such as the CDD rule are necessary but not sufficient.

We must lift the veil of secrecy over the US companies used to hide assets, launder money, and move suspect funds for criminals. It is past time to enact legislation to stop the abuse of US corporate entities.

Testimony of
Dalia F. Martinez,
Executive Vice President of Operations
International Bank of Commerce
On behalf of the Mid-Size Bank Coalition of America
before the Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
April 27, 2018

TESTIMONY AS PREPARED

Chairmen Leutkemeyer and Pearce, Ranking Members Clay and Perimutter and members of the subcommittee, I am honored to have this opportunity to present testimony today regarding FinCEN's Customer Due Diligence Rule. I am Dalia F. Martinez, Executive Vice President and Corporate Bank Secrecy Act Officer for International Bank of Commerce. IBC Bank–Laredo is a member of International Bancshares Corporation (NASDAQ: IBOC), a $12.2 billion multi-bank financial holding company headquartered in Laredo, Texas, with 192 branches and more than 294 ATMs serving 90 communities in Texas and Oklahoma.

I am speaking to you today representing the Mid-size Bank Coalition of America, the voice of 88 community banks with headquarters in 34 States. MBCA banks are primarily between $10 billion and $50 billion in assets with more than 10,000 branches in all 50 states, with deposits of $1.2 trillion. MBCA banks represent, service, and support millions of customers.

I have held the position of Bank Secrecy Act Officer at IBC for more than 27 years. Many of our branches are located in High Intensity Drug Trafficking Areas and in High Intensity Financial Crime Areas, BSA compliance is a top priority for us, and I have seen first - hand how BSA regulations have evolved, the burden they have placed on our bank, and how these regulations have sometimes ended up harming, rather than helping, our most important asset, our law-abiding customers. I would like to focus on four points in my testimony today.

First, compliance with the CDD Rule is very expensive and burdensome. IBC has spent 2,912 hours in design and testing, and 7,859 hours in training 2,142 employees and officers preparing to comply with this regulation. These expenditures are on top of the $5 million a year we

currently spend to comply with existing BSA/AML regulations (see Attachment A - IBC Organizational Charts). Every hour a bank employee spends on regulatory requirements that are not reasonably tailored to meet the legitimate public policy objectives of the BSA is an hour that the employee is not able to spend on another core value – helping our law-abiding customers achieve financial success.

Second, the CDD rule has many gray areas that are difficult to implement. Let me provide you an example that illustrates this. Bank front line employees, who are typically not schooled in complicated business structures, are required to capture beneficial ownership information when an account is opened, but the individual opening the account on behalf of the company is usually a control person at the company and not the actual business owner. While in some cases the controlling person may have knowledge of the ownership structure of the company, they often will not have the identification required for the beneficial ownership CDD requirement. This may result in accounts being turned away, delays in opening accounts, and exceptions that need to be tracked by the bank. And every time a bank makes an "exception," it increases the likelihood of having that decision second-guessed later in a regulatory exam. Accordingly, the burden of obtaining the information and the compliance risk presented to the bank when the customer does not have the information readily available increases the likelihood that the bank will just not do business with that customer as part of "de-risking" (see Attachment B - Details on De-Risking).

Third, the rule puts a burden on banks to ensure the information the customer provides is accurate, but banks are not given either the tools or the guidance they need to make that determination. Specifically, under the rule, banks can rely on the information that customers disclose about the ownership structure of the bank customer only so long as the financial institution does not "have knowledge" of facts that would reasonably call into question the reliability of the information. However, FinCEN does not define "having knowledge". Financial institutions have millions of records. Are we to comb through all our records to ensure information provided on a beneficial ownership attestation does not conflict with a document already contained in the bank's records? Unlike some countries, the United States does not maintain a national database of business ownership information, or require such information at the time of incorporation, that a financial

institution can rely on. Tools and guidance from FinCEN designed to help banks verify customer information are needed (see Attachment C - Mexican Business Requirements and Mexican databases).

Fourth, while FinCEN has provided some guidance to banks in the form of FAQs, the FAQs in some cases are not clear, and in other cases the FAQs create an even greater burden on banks and, ultimately, bank customers. One such example is with Certificates of Deposit (CDs) that auto renew. These CDs are for a specific term and rate. Upon maturity, the CD renews and the customer never has to come to the bank as renewal information is mailed to the customer. FinCEN FAQs state that upon the first auto renewal of a CD established prior to May 11, 2018, the financial institution must obtain the beneficial ownership and CDD information. This means banks will need to contact their customers to try to obtain the beneficial ownership information. From my 39 years in banking, I can tell you customers do not update their phone numbers and email addresses with the bank on any regular basis. Therefore we will most likely have to rely on mail. If the customer does not respond to the bank's request, tracking exceptions will be required. And again, every time a bank makes an exception, the exception is tracked for BSA exam purposes and is subject to second-guessing after the fact. Again, this reality will lead to even more de-risking, which will harm bank customers, especially small business customers who are not exempt from any of these requirements (see Attachment D – Account Exception Report).

In closing, on behalf of IBC and MBCA, it is important that the committee understand the regulatory burden and costs imposed by these rules – burden and costs that ultimately affect our bank customers. Of course, whether a burden or cost of a regulation is too high depends upon the benefit of the regulation and, unfortunately, other than anecdotal information, there is just too little information about the actual benefit of the countless forms and reports that banks must file. The government does not provide any reports on the benefits being achieved from this massive reporting required by BSA. If you want specific information on what I have seen regarding law enforcement investigations, I am happy to answer these questions and any other questions you may have. Finally, it is critically important that FinCEN provide clear and effective guidance to our prudential regulators and banking compliance professionals like myself, absent this guidance the prudential regulators will be left to their own

interpretations and ultimately this will result in customers simply being driven out of the traditional banking system.

Attachment A

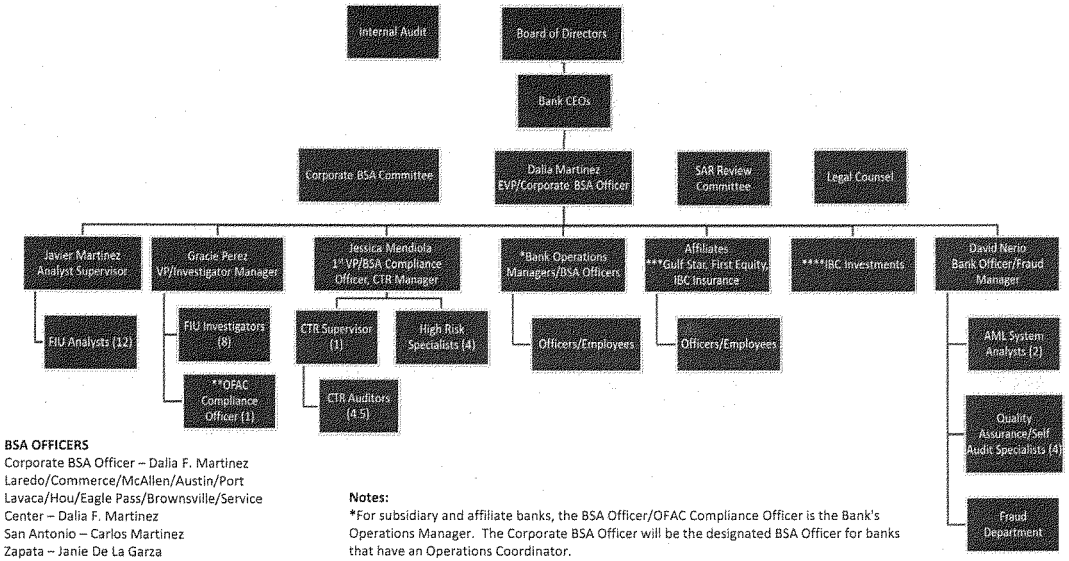
Organization Charts

IBC has 43.50 full time equivalent employees that work directly with BSA regulations. We have four bank officers that oversee this program with a combined experience of 64 years. We have an additional 9 bank officers that have an indirect role in ensuring BSA compliance for the company and they oversee a total of 197 employees that also have indirect responsibility for BSA Compliance. Therefore the direct and indirect number of IBC officers and employees for managing the BSA program is 249.50 FTEs. This does not include the various staff members that work the front line that must be trained on an annual basis on BSA regulations including detecting and reporting suspicious activity.

The salary expense alone for BSA compliance is approximately $5,000,000.

Corporate BSA Committee Member	Division	Number of Officer/Employees
Gilbert Cruz	Corporate Credit Management	12
Eliza Gonzalez/Barbara Saenz	Funds Transfer	13
Lupita Garcia	Foreign Operations	6
Gerald Schwebel	Corporate International	32
Anna Mercado	Trust	5
Ramiro Herrera	Internal Audit	9
Jonathan Paillette	Treasury Management	25
David Nerio	Fraud	10
Gabriela Holloway	Compliance	6
Becky Banda	Litigation	8
Becky Banda	Quality Control	42
Kevin Mullins	Electronic Banking (ACH, Digital, Electronic Services)	39
Total Members with indirect BSA Roles 10		207

International Bank of Commerce/Commerce Bank
Financial Intelligence Unit (FIU) Organizational Chart
2018



BSA OFFICERS
Corporate BSA Officer – Dalia F. Martinez
Laredo/Commerce/McAllen/Austin/Port Lavaca/Hou/Eagle Pass/Brownsville/Service Center – Dalia F. Martinez
San Antonio – Carlos Martinez
Zapata – Janie De La Garza
Oklahoma – Jana Walls
Corpus Christi – Robert Charles
First Equity – Robert Barnes
IBC Insurance – Dale Randol
Gulf Star – Alicia Neal

Notes:
*For subsidiary and affiliate banks, the BSA Officer/OFAC Compliance Officer is the Bank's Operations Manager. The Corporate BSA Officer will be the designated BSA Officer for banks that have an Operations Coordinator.
**OFAC Compliance Officer is point of contact for 314 (a) requests.
***Designated individuals responsible for BSA/AML compliance will report suspicious activity to Corporate BSA Officer.
****IBC Investments - separate entity (owned by LPL Financial), regulated by SEC and FINRA.

Attachment B

Details on De-risking

IBC has a strong record of BSA compliance. Despite this fact year after year a BSA examination brings additional burden to the bank. Regulators evaluate the banks processes for detecting suspicious activity. The bar of monitoring high risk accounts is extremely high. The regulations require a bank to maintain a system for monitoring and detecting suspicious activity. However, banks must establish procedures for monitoring high risk accounts. In every examination an examiner chooses to direct the bank on what the bank must retain in the bank records to 'prove' monitoring has occurred. This expectation varies from exam to exam and varies from examiner to examiner.

In many cases examiners' high expectations increase the cost and burden to the bank. As a result of this increased cost and burden, the bank de-risks accounts. We have de-risked in the area of most of our high risk accounts. By this I mean that we have maintained the accounts we currently have but we no longer allow NEW high risk accounts. An example of this is foreign correspondent banks, as these accounts close we do not open new foreign correspondent relationships.

De-risking has resulted in several thousand accounts being closed by IBC during the last 5 years. The Beneficial Ownership-Customer Due Diligence rule could lead to further de-risking.

Attachment C

Mexican Business Requirements and Mexican databases

Since the US has no government registries that provide Beneficial Ownership information, banks have no way of verifying the information provided. Below is an example of how this is handled in Mexico. I am not advocating the U.S. adopt this method I am merely pointing out that if other countries such as Mexico and the U.K. have been able to establish national registries the U.S. should be able to accomplish this as well. It has been said that establishing a national registry would be disruptive, I submit to you that every new regulation that is introduced into the banking system is disruptive not only to the banking system but more importantly to consumers.

Beneficial Owners

Each Mexican State has their own Public Registry

When an entity is considering changes, a shareholder's meeting (Asamblea) is announced through Secretaria de Economia, https://psm.economia.gob.mx/PSM/

Any Beneficial Ownership Change requires to be conducted through a "Notario Publico" and the Acta de Asamblea is filed with the Public Registry.

All entities, with the exception of non-profits and dba's, are required to indicate the beneficial owners and percent of ownership on the Acta Constitutiva when entity is formed and on an Acta de Asamblea for any BNF changes made after formation.

Attachment C

TYPE OF FOREIGN BUSINESS ENTITIES		
TYPE OF BUSINESS	DESCRIPTION	
SA	Sociedad Anonima	CORPORATION
SA DE CV	Sociedad Anonima de Capital Variable	
SA INSTITUCION DE BANCA MULTIPLE	Sociedad Anonima Institucion de Banca Multiple	
SAB DE CV	Socedad Anonima Bursatil de Capital Variable	
SAPI DE CV	Sociedad Anonima Promotora de Inversion de Capital Variable	
SC	Sociedad Civil	
S DE RL	Sociedad de Resposablidad Limitada	LLC
S DE RL DE CV	Sociedad de Resposablidad Limitada de Capital Variable	
S DE RL MI	Sociedad de Resposablidad Limitada MicroIndustria	
SC DE RL	Sociedad Civil de Resposabilidad Limitada	
SC DE RL DE CV	Sociedad Civil de Resposabilidad Limitada de Capital Variable	
SCL	Sociedad Cooperativa Limitada	
SCL DE CV	Sociedad Cooperativa Limitada de Capital Variable	
SPR DE RL	Sociedad de Produccion Rural de Resposablidad Limitada	
SPR DE RL DE CV	Sociedad de Produccion Rural de Resposablidad Limitada de Capital Variable	
ARIC	Asociacion Rural de Interes Colectivo de Responsabilidad Limitada	
NON PROFIT		
AC	Asociacion Civil	NON-PROFIT ASSOCIATIONS
AR	Asociacion Religiosa	RELIGIOUS ENTITIES/CHURCH

Secretaria de Economia

Web site: https://psm.economia.gob.mx/PSM/

Example: Notice of shareholder's meeting related to BNF Owner change



CONSULTA

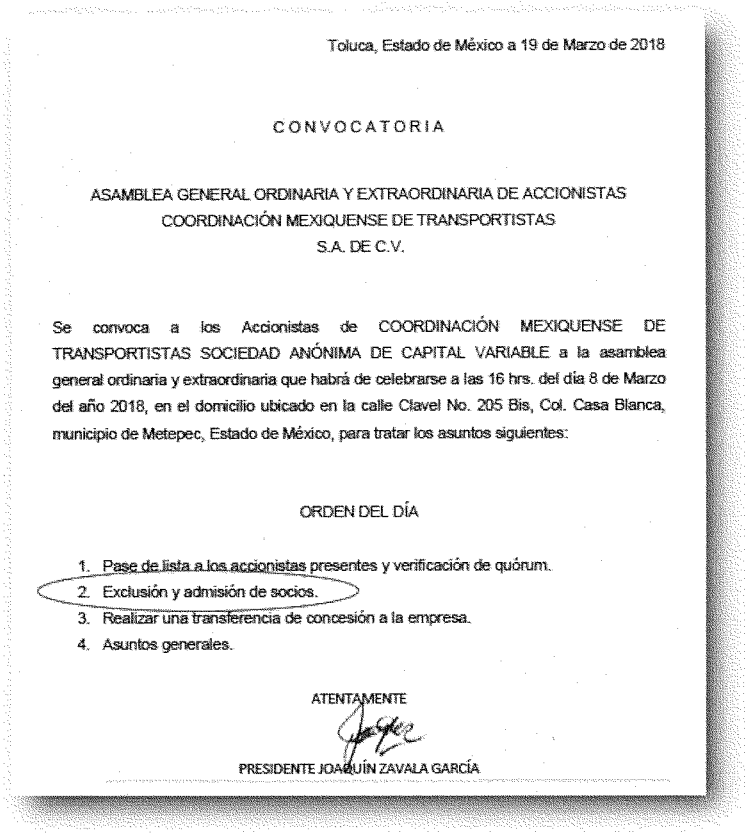
RESULTADO DE LA BÚSQUEDA

Mostrando 621-632 de 632 « ‹‹ 23 24 25 26 27 28 29 30 31 32

Denominación o Razón Social	Tipo de Publicación	Nombre de la Publicación	No. Publicación	Fecha	Texto de la Publicación
COORDINACION MEXIQUENSE DE TRANSPORTISTAS SA DE CV	Convocatoria para Asambleas Generales	Convocatoria de Asamblea General Ordinatia y Extraordinaria de Accionistas	2018-0000001721	19/02/2018	

Attachment C

Actual notice & agenda, in this example, deleting and adding new owners



Toluca, Estado de México a 19 de Marzo de 2018

CONVOCATORIA

ASAMBLEA GENERAL ORDINARIA Y EXTRAORDINARIA DE ACCIONISTAS
COORDINACIÓN MEXIQUENSE DE TRANSPORTISTAS
S.A. DE C.V.

Se convoca a los Accionistas de COORDINACIÓN MEXIQUENSE DE TRANSPORTISTAS SOCIEDAD ANÓNIMA DE CAPITAL VARIABLE a la asamblea general ordinaria y extraordinaria que habrá de celebrarse a las 16 hrs. del día 8 de Marzo del año 2018, en el domicilio ubicado en la calle Clavel No. 205 Bis, Col. Casa Blanca, municipio de Metepec, Estado de México, para tratar los asuntos siguientes:

ORDEN DEL DÍA

1. Pase de lista a los accionistas presentes y verificación de quórum.
2. Exclusión y admisión de socios.
3. Realizar una transferencia de concesión a la empresa.
4. Asuntos generales.

ATENTAMENTE

PRESIDENTE JOAQUÍN ZAVALA GARCÍA

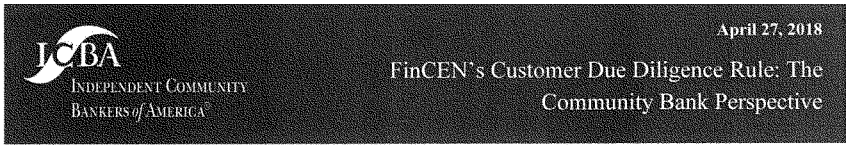
Attachment D

Account Exception Report

Currently it is rare that a business account presents their business documents at account opening. This is not a Customer Information Program (CIP) requirement therefore banks are allowed to open the account and track these exceptions until we obtain the necessary business documents. The beneficial ownership – CDD rule requires beneficial owners to be identified at the time the account is open. This assumes the information cannot be obtained AFTER the account is open. This will result in accounts not being opened at the time the customer is present. Alternatively, customer due diligence requires banks to understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile and conducting ongoing monitoring. If the individual opening the account cannot provide the purpose of the account including the level of activity expected in the account this will most likely be tracked as an exception by banks until they obtain documentation necessary to satisfy this request. Two things will most likely occur:

1) Customers will be slow in providing the required information and eventually banks will decide to close the account because of the risk posed to the bank.
2) Examiners will demand more and more documentation to satisfy this request. This will inevitably lead to increased cost and burden on banks resulting in closing of accounts.

Ultimately both of these examples will result in small business customers that are not exempt from these regulations being displaced from the banking system.



On behalf of the nearly 5,700 community banks represented by ICBA, we thank Chairman Luetkemeyer, Ranking Member Clay, and members of the Financial Services Subcommittee on Financial Institutions and Consumer Credit for convening today's hearing on "Implementation of FinCEN's Customer Due Diligence Rule – Financial Institution Perspective." ICBA is pleased to have the opportunity to submit this statement for the hearing record.

Community bankers are committed to supporting balanced, effective measures that will prevent terrorists from using the financial system to fund their operations and prevent money launderers from hiding the proceeds of criminal activities. The Financial Crimes Enforcement Network (FinCEN) Customer Due Diligence (CDD) Rule under the Bank Secrecy Act requires "covered financial institutions" to identify the beneficial owners who own or control certain legal entity customers at the time a new account is opened. The CDD Rule's mandatory compliance date is May 11, 2018, just over two weeks from today.

In this statement, ICBA recommends certain revisions to the CDD Rule that will make it more effective in meeting its stated goal of combating money laundering and other illicit financing. Whether or not FinCEN agrees to revise the Rule, community bankers recognize their obligation to comply with the complex CDD Rule in its current form and are making every effort to do so before the mandatory compliance date. For reasons described below, **ICBA requests a one-year delay in the mandatory compliance date to May 11, 2019**.

ICBA Recommended Revisions to CDD Rule

ICBA's position is that if the government has an interest in collecting and maintaining records of beneficial ownership, such information should be collected and verified at the time a legal entity is formed, rather than requiring financial institutions to collect this information. Collecting and verifying the identity of all natural person owners of each entity by either the Internal Revenue Service or other appropriate federal agency and/or state in which the entity is formed would provide uniformity and consistency across the United States. Making the formation of an entity contingent on receiving beneficial owner information would create a strong incentive for equity owners and investors to provide such information. Additionally, periodic renewal of an entity's state registration would provide an efficient and effective vehicle for updating beneficial ownership information.

If responsibility for collecting beneficial ownership information remains with financial institutions, ICBA recommends that information collection be based on customers rather than accounts. This change would be consistent with the customer information program (CIP) set forth in the Bank Secrecy Act. A focus on customers rather than accounts would greatly facilitate information collection, alleviating community bank burden and producing more accurate information. The creation of an additional account by an existing customer or the renewal of a customer account should not trigger a new obligation to verify beneficial ownership information as long as the bank has no knowledge of facts that would reasonably call into question the reliability of the information the bank already has on file. A customer basis for the rule, combined with a risk-based approach, would obligate a financial institution to

perform additional due diligence when warranted by a higher level of risk.

Delayed Rule Guidance Warrants a Corresponding Delay in Mandatory Compliance

Despite community banks' commitment to compliance with the new Rule, recent and unexpected developments have made timely compliance unduly challenging. First, FinCEN issued Frequently Asked Questions (FAQs) to assist banks in understanding and complying with the CDD rule on April 3, 2018 – just over a month before the mandatory compliance date. These FAQs address issues on acceptable means of identifying and verifying beneficial ownership information, collecting information for direct and indirect owners, and thresholds for identifying beneficial owners. Additionally, the FAQs provide information on the requirements for obtaining this information when multiple accounts are opened or accounts are renewed (e.g., certificates of deposit or loan renewal), as well as information on monitoring and updating customer information.

The FAQ information is needed for the development of effective policies and procedures for the implementation of a complex new rule. But approximately one month is not sufficient time to adequately review policies and procedures to ensure conformity with the new information provided in the FAQs. Compliance requires systems changes followed by testing and training of employees in new policies and procedures. FinCEN took two years to develop the FAQs because of the complexity of the Rule, the ambiguity it contains, and the novel questions it raises. Community banks should have at least one year to incorporate the FAQ information into their policies and procedures.

Second, the Federal Financial Institutions Examination Council (FFIEC) has not yet released an updated exam manual incorporating the CDD Rule. The FFIEC exam manual is another critical piece of the puzzle bankers need to understand how they will actually be examined for CDD Rule compliance. The FAQs, while important, do not resolve all ambiguities regarding compliance with the Rule. Community bankers should not have to engage in guesswork and court the costly risk of error or misinterpretation when it comes to regulatory compliance. They need certainty to the last detail, and only the exam manual will provide this certainty.

The exam manual's two-year preparation period is due to the complexity of the Rule and its many ambiguities. Community bankers deserve an ample period for the development of policies and procedures based on the FAQs and the exam manual.

Compensation for Anti-Money Laundering and Anti-Terrorist Financing Efforts

For community banks, BSA compliance represents a significant expense in terms of both direct and indirect costs. BSA compliance is fundamentally a governmental, law enforcement function. As such, the costs should be borne by the government. ICBA supports the creation of a tax credit to offset the cost of BSA compliance.

Closing

Thank you again for convening today's hearing. The integrity of our financial system is among the highest concerns of America's community bankers. ICBA looks forward to continuing to work with the committee to ensure the CDD Rule is workable and to modernize the Bank Secrecy Act in a way that will strengthen critical law enforcement while rationalizing community bank compliance with this important law.

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The Honorable Blaine Luetkemeyer
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Wm. Lacy Clay
Ranking Member
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

April 26, 2018

Re: Tomorrow's hearing entitled: "Implementation of FinCEN's Customer Due Diligence Rule – Financial Institution Perspective"

Dear Chairman Luetkemeyer and Ranking Member Clay:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), the only trade association exclusively representing the federal interests of our nation's federally-insured credit unions, I write today in conjunction with tomorrow's hearing on the implementation of the Financial Crimes Enforcement Network's (FinCEN's) Customer Due Diligence (CDD) Rule. With the mandatory compliance date of May 11, 2018 quickly approaching, we appreciate the Subcommittee's timely focus on this matter.

The final CDD Rule issued by FinCEN on May 11, 2016 requires credit unions and other covered financial institutions to identify the beneficial owners (25% or higher ownership) who control legal entities who open accounts. In addition to the beneficial ownership requirements, the rule also amends the anti-money laundering program requirements for credit unions and other covered financial institutions to include risk-based procedures to conduct ongoing member due diligence. While credit unions are already doing this under regulator guidance, some do not realize that this rule formalizes this requirement even for those who do not have legal entity members.

NAFCU and its member credit unions support efforts to combat money laundering and we have been engaging FinCEN on the implementation of this rule and its impact on credit unions. We are appreciative of the recent guidance that they have issued to help in this regard, although there still does seem to be some uncertain areas under the rule. An example is who should be identified under the control prong for incorporated clubs (e.g., Girl Scouts of America, Lions Club, etc.) – the local leader or the President/CEO of the club? These types of groups open thousands of accounts all over the country, and each chapter is in charge of their own finances at the local level. It seems important to obtain guidance from FinCEN on this matter, otherwise there is a risk that different standards could develop across the country, leading to different individuals being identified as beneficial owners and a lack of uniformity in how regulators examine this section of the rule.

In regards to the beneficial ownership requirements, NAFCU supports recent legislative efforts to help facilitate more coordination between state agencies, law enforcement, and credit unions by ensuring that credit unions have access to beneficial ownership information collected by states, relating to corporations or limited liability companies formed under state laws. We would urge the Subcommittee to continue to pursue those efforts as the best way to ensure that needed information is collected, while not placing undue burdens on financial institutions.

On behalf of our nation's credit unions and their more than 110 million members, we thank you for your attention to this important matter. Should you have any questions or require any additional information please contact me or Allyson Browning, NAFCU's Associate Director of Legislative Affairs, at 703-842-2836 or abrowning@nafcu.org.

Sincerely,



Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Subcommittee on Financial Institutions and Consumer Credit

Questions for the Record, Financial Institutions and Consumer Credit Subcommittee hearing entitled, *"Implementation of FinCEN's Customer Due Diligence Rule – Financial Institution Perspective"*
Friday, April 27, 2018 9:30am

Ranking Member Maxine Waters

Questions for Mr. Gary Kalman:

- In your testimony, you state that legislation requiring beneficial ownership information to be collected upon company formation by a state, or by a Federal entity such as FinCEN, would complement rather than replace the CDD rule? You also note that such legislation would "cover companies that bypass the financial system and avoid banks," which would allow for much broader coverage, and this would give law enforcement the information and tools they need to combat financial crime.
    - Could you further expand upon the types of companies that might avoid the formal U.S. banking system, and thereby, coverage by the CDD rule?
    - How might the collection and verification of beneficial ownership information at the time of company formation and at the time of an account opening complement each other?
    - What policy objective(s) does the CDD beneficial ownership requirement seek to achieve separate and distinct from a requirement by a state or Federal entity to collect this information at the time of company formation?

There are any number of companies that bypass the U.S. banking system and these types of companies present some of the greatest risks of illicit activity.

Criminal enterprises based in countries with a history of corruption may choose to launder funds through a U.S. shell company to not only mask ownership but gain credibility. For example, a Ukrainian oligarch could establish an anonymous company in Nevada and use the Nevada company to open a bank account in the Cayman Islands. The funds would then be available to invest anywhere in the world, including in the United States. In practice, a number of companies would be created to make it more difficult to identify the beneficial owner(s). Either way, no money would be deposited in the United States. No customer due diligence would be performed. The Nevada company would simply be a conduit that allows the U.S. corporate formation system to facilitate the laundering of illicit funds.

The growth of cryptocurrencies raises a host of issues that the Committee has rightfully begun to examine. Criminal enterprises that purchase cryptocurrencies and establish operations in the United States would not necessarily open a bank account and would not be subject to customer due diligence. Criminals and corrupt officials can easily create anonymous companies and use those entities to trade online, all behind the veil of secrecy with the added cache of being a U.S. company.

Anonymous companies have fronted for cash purchases of real estate and other high end luxury goods including artwork, aircrafts, boats and even expensive memorabilia (e.g. Michael Jackson's glove). Cash purchases do not involve transfers from one bank to another and do not trigger due diligence around who is the ultimate buyer. This is one reason the U.S. Department of Treasury created and continues the pilot projects known as Geographic Targeting Orders (GTOs). The GTOs collect ownership information for cash financed, high end real estate deals in seven metropolitan areas across the country.

Alternative payment systems create another point of access to the U.S. financial system. Peer-to-peer payment platforms are growing in popularity due to the ease of moving money and making payments on mobile devices. While standards are evolving, currently anonymous U.S. companies can pull funds from foreign bank accounts and even prepaid cards. There are few and varied due diligence requirements for establishing these accounts.[1] The payment platforms provide an access point to the U.S. financial system and anonymous companies provide cover to hide the illicit origin of the funds.

The above examples demonstrate the need for a requirement to disclose ownership upon corporate formation, in addition to the CDD rule.

Financial institutions are still the main gateway to the U.S. financial system and must do their due diligence (including but not limited to beneficial ownership information) to ensure their institutions are not being used for illicit finance. Each are necessary but, individually, not sufficient. A fully fielded soccer team has both defenders and a goalie. Both have the same objective (to keep the opposing team from scoring) and yet both are necessary for effective defense. The proposed legislation and the CDD rule are both necessary for an effective defense.

- With respect to both the CDD rule and pending legislation that would require beneficial ownership information to be collected at the time of company formation, some have suggested that such information should be collected by the IRS, through the process of obtaining Employer Identification Numbers for legal entities.

    - What type of "responsible party" information does the IRS collect, and on what types of companies? To what extend is this information consistent with the beneficial ownership information that financial institutions must collect and verify under the CDD rule?

    - Are there any particular drawbacks, or weaknesses, in pursuing on IRS approach in this area, as some have suggested?

Concerns with the IRS approach to collecting beneficial ownership information to counter money laundering and other illicit finance. fall into three broad categories:

1. IRS forms do not currently collect the right information.
2. Even if the definition was properly amended, not all companies file with the IRS; and
3. Access to taxpayer information is restricted, creating barriers to those who would use the information.

1. IRS Forms Do Not currently collect the right information

It has been argued that the United States already collects beneficial ownership information for American companies through a variety of tax forms. Proponents of this approach argue that new legislation requiring American companies to disclose their beneficial ownership information is therefore unnecessary because the IRS could simply be required to create a beneficial ownership database from the information provided in the identified forms.

Unfortunately, the tax forms identified allow for stand-ins for beneficial ownership to be listed. Requirements for identification of shareholders and partners could be actual real, natural persons, but they

[1] In December 2017 the OCC announced that it would move to accept applications from FinTech companies to become special purpose national banks. See https://www.orrick.com/Insights/2016/12/National-Bank-Charters-for-Fintech-Companies.

could also be other American or foreign companies, trusts, estates, etc., and not what is understood to be ultimate beneficial ownership.

There are six different IRS forms that have been suggested as sufficient to collect "the ownership of every business in America and each business' responsible party" with the exception of non-dividend paying C corporations.[6] While they may collect ownership information, they do not necessarily collect beneficial ownership information, and they do not collect responsible party information for every American company. The six forms identified are:

- SS-4 (application for an Employer Identification Number (EIN))
- 1065 (Schedule K-1: Partner's Share of Income, Deductions, Credits, Etc.)
- 1120S (Schedule K-1: Shareholder's Share of Income, Deductions, Credits, etc.)
- 1041 (Schedule K-1: Beneficiary's share of Income, Deductions, Credits, etc.)
- 1099 DIV (Dividends and Distributions); and
- 8822-B (Change of Address for Responsible Party: Business)

In considering the sufficiency of these forms, there are two key things to remember. First, a beneficial owner cannot be a legal entity — we are looking for the human being(s) at the end of what may be a chain of corporate/legal entity ownership. Second, American companies can and do have foreign legal entity ownership.

The Schedule K-1s and the 1099 DIV are forms that tell the IRS who the shareholders, partners, and beneficiaries are of partnerships' and some corporations' wealth. Essentially, they identify to which owners a corporation or partnership distributed its profits. While, in some cases, that owner will be a human being — representing the end of an ownership chain and therefore a beneficial owner — that owner might just as easily be another corporation, partnership, trust, or estate. That is certainly not a beneficial owner.

One might argue that if those legal entity owners are also distributing profits upward, eventually the payouts will get to a real person. That is not necessarily true. The company may not make a distribution that year. The filer may be a trust or an estate, where those profits are simply absorbed. The distribution may be to a foreign entity that does not need to file in the U.S. In each scenario, we move further and further away from identifying our beneficial owners.

One might argue that none of the above matters because all American companies file an SS-4 form and provide information about a "responsible party" which is a beneficial owner by another name. That is also not necessarily the case.

The SS-4 form collects information on *one* "responsible party". The IRS has amended the definition of "responsible party" a number of times over the past nine years to bring it ever closer to the concept of a beneficial owner. When FACT began working on this issue in 2009, a "responsible party" could be (and often was) another company. In meetings with IRS officials, we were told that the responsible party was intended to simply be a contact in case the IRS had a question.

The IRS most recently amended the definition of "responsible party" on the SS-4 Form in December of 2017. A responsible party is now "the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. The person identified as the responsible party should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. Unless the applicant is a government entity, the responsible party must be an individual (i.e., a natural person), not an entity."

This brings the definition of responsible party closer to the concept of beneficial ownership but still suffers one significant flaw. Someone reading that definition would be quite likely to list the President,

CEO or CFO of the company because they have a level of control over the funds or assets of the entity that enables them to manage it. But being a manager of a company does not make you a beneficial owner — it makes you an employee with a high degree of responsibility.

2. Even if the Definition Was Properly Amended, Not All Companies File with the IRS

Even if the SS-4 Form *did* collect beneficial ownership information (which it does not as a rule), it would still be an inadequate solution. A company only files an SS-4 Form if they need an employee identification number (EIN). A company only needs an EIN if they will be paying taxes in the U.S., which they will only do if they have operations in the U.S. or open a bank account in the U.S. After many congressional hearings on the subject of money laundering and terror finance, Congress is aware that many companies are created in the U.S. and then used to operate abroad or simply used as one layer of ownership in a series of nested companies intended to cement the beneficial owner's anonymity by exploiting this massive loophole in the U.S. system. This is one of the main problems that congress is trying to combat, and the SS-4 Form does nothing to address this problem.

The U.S. has collected the same information via these and similar forms for years, which is known to international assessors of our anti-money laundering and anti-terror finance regime (of which availability of beneficial ownership information is a cornerstone), and yet the U.S. has been found non-compliant with our international commitments to collect beneficial ownership information in recent reviews. [9]

3. Access to Taxpayer Information Is Restricted, Creating Barriers to Those Who Would Use the Information

Even if the IRS collected the requisite information through these forms, the strict confidentiality on which the IRS holds information from these tax forms, and therefore the inability of relevant law enforcement and financial institutions that we charge with assisting efforts to combat money laundering to access it in a timely or cost-efficient manner, would render this approach wholly insufficient.

The personal identification information provided by taxpayers on IRS forms (that some are claiming is effectively beneficial ownership information) is categorized by IRS regulations as "taxpayer return information." Taxpayer return information is treated with a very high level of confidentiality afforded by the IRS.

While available to federal agencies for purposes of tax enforcement[10], these forms can only be accessed by federal law enforcement in relation to investigations of other crimes "upon the grant of an ex parte order by a Federal district court judge or magistrate judge." The application for that ex parte order has to be authorized by the Attorney General, any Deputy, Associate, or Assistant Attorney General, a U.S. Attorney, or certain special prosecutors and attorneys in charge of specifically authorized organized crime strike forces.[11] Such information may NOT be disclosed to State and local law enforcement agencies unless they are working on a team with a Federal agency on an investigation pertaining to a missing or exploited child.[12]

Access to information on these IRS forms for any non-tax related investigation is extremely onerous for federal law enforcement and almost nonexistent for state and local law enforcement.

Jennifer Shasky Calvery, then Senior Counsel to the Deputy Attorney General at the U.S. Department of Justice and later Director of FinCEN, testified before the Senate Committee on Homeland Security and Government Affairs in November 2009 about the effects of lack of access to beneficial ownership information on law enforcement investigations. She stated:

The audience — including investigators from nine federal law enforcement agencies and prosecutors from a variety of districts and offices — was attending a financial investigation seminar designed to teach them how to investigate the financial aspects of international criminal organizations. The instructor, who was lecturing on U.S. shell companies, asked the members of the audience to raise their hand if they had ever reached a dead end in one of their investigations because of a U.S. shell company. Nearly every

person in the room raised his or her hand. Departmental instructors report that such a response is common in money laundering courses delivered both domestically and abroad.[13]

Collecting beneficial ownership information via IRS forms is clearly not a tenable option given that the information is needed in state and federal criminal investigations on a regular basis.

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