Stepping up Customer Due Diligence

CDD/EDD and the New Beneficial Ownership Rules

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PRESENTED BY
MALEKA ALI - BANKERS TOOLBOX
VICTOR CARDONA - PLAZA BANK
Cornerstone of a Strong BSA/AML Compliance Program

- “Adoption and implementation of comprehensive CDD policies, procedures, and processes for all customers”
- “Particularly those that present a higher risk”
Lack of Transparency

- Lack of transparency in the formation process poses vulnerabilities both domestically and internationally.
Over past 10 years, U.S. has attempted to combat risks associated with criminal abuse of legal entities, such as shell companies, and the associated exploitation of the financial system to facilitate financial crime, including money laundering, financing of terrorism and proliferation, and tax evasion.
Shell Companies

Term “shell company” generally refers to limited liability companies and other business entities with no significant assets or ongoing business activities.

Typically no physical presence other than mailing address, employ no one, and produce little to no independent economic value.
Shell Companies

“Shells are the No. 1 vehicle for laundering illicit money and criminal proceeds,”

- Lanny A. Breuer,
  Assistant Attorney General for the Criminal Division of the Justice Department

“An enormous criminal justice problem. Ridiculously easy for a criminal to set up a shell corporation and use the banking system, and we have to stop it.”
Aired January 31, 2016

- Global Witness used hidden camera footage in law firms across Manhattan
- Portrayed the representative of a foreign minister needing advice on how to move millions into the U.S.
- 12 out of 13 law firms interviewed suggested ways funds could be moved without disclosing minister’s identity
- Recommended shell companies in multiple jurisdictions
Panama Papers

Major win against lack of transparency?
Panama Papers

- 11.5 million leaked documents from world’s fourth largest offshore law firm located in Panama
- Obtained from an anonymous source by a German newspaper
- Shared with the International Consortium of Investigative Journalists (ICIJ)
Why the Concern

- Firm helped establish secret shell companies and offshore accounts for some global big players
- Including 12 current or former world leaders as well as 128 other politicians and public officials
- Rarely knew identities of real owners on accounts (Example: Only knew identities of owners for 204 accounts out of 14k accounts established in Seychelles tax haven)
- Entities on banned list with strong ties to terrorism
- Tax Avoidance
- Hiding assets from divorce
Lack of ability for authorities to obtain and share information regarding the identification of companies and their beneficial owner(s).
2010 Beneficial Ownership/CDD Guidance:

• Determine whether customer is acting as an agent for or on behalf of another, if so, obtain information regarding the capacity in which & on whose behalf the customer is acting

• If Customer is a legal entity that is not publicly traded in the U.S., such as an unincorporated association, a private investment company (PIC), trust or foundation:

  Obtain information about the structure or ownership of the entity so as to allow institution to determine whether account poses heightened risk

If Customer is a trustee:

  Obtain information about the trust structure to allow institution to establish a reasonable understanding of the trust structure & to determine the provider of funds & any persons or entities that have control over the funds or have the power to remove the trustees
Strengthening and Clarifying Customer Due Diligence

James H. Freis, Jr.
Former FinCEN Director

- Strengthen due diligence obligations, including requirement to identify beneficial ownership of their accountholders.

- “Explicit requirement that a financial institution know its customers, and the risks presented by its customers, is basic and fundamental to both serving those customers and implementing a program that protects a financial institution from abuse by illicit actors”
Challenges

- No consistent CDD practices
- Reduce business competitiveness concerns by promoting a more even playing field
Regulatory Response

2012 FATF Revised recommendations:

- Take reasonable measures to verify the identity of the beneficial owners and understanding the ownership and control structure of the customer

In the U.S.:

- FinCEN started the buzz in February 2012 with the “Advanced Notice of Proposed Rulemaking” on CDD
- August 4, 2014, FinCEN released the proposed rule to amend BSA regulations to clarify and add new customer due diligence (CDD) obligations
FATF Evaluation

- Plan to issue final rule in August 2015 was designed to address a shortcoming in U.S. AML rules ahead of our evaluation by Financial Action Task Force in 2016.

- Previously graded our program “noncompliant” or “partially compliant” with its recommendations on customer due diligence and beneficial ownership rules.

- In a recent hearing of the House Financial Services Committee, lawmakers heard from witnesses that the global financial system is prone to abuse because of the ease in which terrorists and criminals can obtain bank accounts in the names of “untraceable” shell companies formed in several U.S. states.

- “U.S. is a preferred destination for illicit actors from around the world to set up companies for the purpose of moving or hiding dirty money,” committee members said in a statement.
FinCEN Publishes Final Rule

May 11, 2016

Customer Due Diligence Requirements for Financial Institutions
Establish & maintain written procedures that are reasonably designed to identify & verify beneficial owners of legal entity customers & to include such procedures in their AML compliance program.
Key Elements

CDD consists at minimum of 4 elements:

1. Identifying & Verifying the Identity of Customers;
2. Identifying & Verifying Identity of Beneficial Owners of Legal Entity Customers;
3. Understanding Nature & Purpose of Customer Relationships;
Highlights

• Effective 60 days after publication in Federal Register (July 11, 2018)
• Compliance by **May 11, 2018**
• Not retroactive
Concept of CDD

Begin with verifying customer’s identity and assessing the risks

Processes should include:

- Enhanced CDD for higher-risk customers
- Ongoing due diligence of customer base
Customer Identification Program

All institutions must have a written CIP

- Appropriate for size
- Incorporated into BSA/AML program
- Approved by board of directors
- Intended to enable bank to form a reasonable belief that it knows the true identity of each customer
- Must include certain minimum requirements
Minimum Requirements

• Name
• Date of birth for individuals
• Address
• Identification number

Based on risk assessment, institution may ask for additional information for certain customers or product lines.
Other Items of Note

- Verify identity of each beneficial owner identified according to risk-based procedures to the extent reasonable and practicable. (CIP)

- Institution has the option to accept a copy of actual identification for Beneficial Owners

- Record Keeping: 5 Years after date account is closed
Beneficial Ownership Certification

- Required to identify and certify beneficial owner(s) of legal entity at time new account is opened.

- Accomplish this either by:
  - Sample certification (available in appendix A of rule) from individual opening account on behalf of legal entity
  - Or same information required in sample form by another means, as long as individual still certifies, to the best of their knowledge, the accuracy of the information

- May be produced in paper or electronic format

- **Rely on information** supplied by customer regarding identity of its beneficial owners, provided you have no knowledge of facts that would reasonably call into question the reliability of the information
Re-certification

• Not Retroactive
• Update on a risk based approach if needed changes are identified during normal reviews and monitoring
• If customer opens another account—recertify beneficial ownership
Covered Legal Entities

So This Includes:
• Corporations
• Limited Liability Companies
• Limited Partnerships
• General Partnerships
• Business Trusts (Created By State Office Filing)
• Any Other Entity Created By A State Office Filing
• Including Similar Entities Formed Under Laws Of Other Countries

Does Not Include:
• Natural persons
• Sole Proprietorships
• Unincorporated Associations
• Trusts -Other Than Statutory Created By State Office Filing
Exclusions Include

- Employee Benefit Plans formed under ERISA
- Federal or State regulated Financial Institutions
- Bank or Savings & Loan Holding Companies
- U.S. or State Departments or Agencies
- Entities with stock listed on NY, American or NASDAQ Stock Exchange
- Issuers of a class of securities under Section 12 of Securities Exchange Act
- Investment Companies or Advisors registered with SEC
- Public Accounting Firms registered under section 102 of Sarbanes-Oxley Act
- Pooled Investment Vehicles
- Non-Profit entities

Only exempt from Ownership Prong
Beneficial Ownership - Two Prong Approach

Ownership Prong
- Each individual (natural person) who owns 25% or more of equity interests in the legal entity customer 25% ownership or more

Control Prong
- One Individual (natural person) who exercises significant managerial control over the legal entity customer
Beneficial Ownership - Ownership Prong

- No obligation to analyze calculations - may rely on info provided by member
- This prong may result in no beneficial owner with 25% or more
- No obligation to determine if entity is structuring to avoid 25% threshold
  - If suspected, depending on circumstances, File SAR
- If an entity is an owner, not required to identify/verify natural persons behind entity
- Establishes a trustee as the BO if trust owns 25% or more of a legal entity
Beneficial Ownership - Control Prong

- Need only identify one!
- This requirement impedes those seeking to obscure their beneficial ownership info by saying there are no natural persons with 25% ownership
- May also identify additional individuals as part of its CDD if institution deems appropriate on basis of risk.
Easier Proof of Wrong doing!

- New rules will provide investigators leverage over those who deliberately cover for financial criminals, according to Chip Poncy, (Former Director U.S. Treasury Department’s Office of Strategic Policy)

- “If the information is required, and if there’s meaningful enforcement against failure to produce or a deliberate intention to mislead, then you no longer have to prove a money laundering case.

- You only have to prove a misrepresentation case, and if you can do that, then the people fronting for the bad actors begin to talk or they don’t want that job any more,”
Customer Due Diligence

The Nitty Gritty!
Officially Incorporated into a New Pillar for AML Requirements

- Understanding the Nature & Purpose of Customer Relationships
- Conducting Ongoing Monitoring to Maintain & Update Customer Information & to Identify & Report Suspicious Transactions

Codifies existing regulatory expectations
Additional Monitoring

- Capture customer information/ expected transactions upfront at account opening or after an account is identified as high risk
- Detect transactional patterns and amounts that deviate from “expected level of account activity”
Objective of CDD

Enable bank to predict with relative certainty the types of transactions in which a customer is likely to engage to assist them in determining when transactions are potentially suspicious.
Customer Due Diligence

CDD policies, procedures, and processes are critical to the institution because:

► They assist in detecting & reporting unusual or suspicious transactions that potentially expose bank to financial loss, increased expenses, or reputational risk

► Help avoid criminal exposure from persons who use bank’s products & services for illicit purposes

► Shows Examiners you are adhering to safe and sound banking practices
Examiner’s Objective

- Assess your Customer Due Diligence policies, procedures and processes
  - How do you collect customer information
  - What do you collect
  - Is it appropriate
  - Is it comprehensiveness
- Assess the value of this information in detecting, monitoring, and reporting suspicious activity
CDD Based on Customer Risk

- Thorough understanding of risks within customer database
- Obtain information at account opening sufficient to develop an understanding of normal and expected activity
- Information collected should allow bank to determine risk profile at account opening
- Take a tier approach
- For Example, Appendix K ("Customer Risk Versus Due Diligence and Suspicious Activity Monitoring").
Appendix K: Customer Risk Versus Due Diligence and Suspicious Activity Monitoring

Certain customer relationships may pose a higher risk than others. This chart provides an example of how a bank may stratify the risk profile of its customers (see legend and risk levels). Because the nature of the customer is only one variable in assessing risk, this simplified chart is for illustration purposes only. The chart also illustrates the progressive methods of due diligence and suspicious activity monitoring systems that banks may deploy as the risk level rises. (See Observed Methods, below.)

**Observed Methods of Due Diligence and Suspicious Activity Monitoring:**

- Customized transaction profile with tailored monitoring against transaction profile
- Source of wealth statement, financial statement
- Unique profile specific to products and services used by customer
- Basic profile, generic threshold monitoring

**Legend: Types of Customers / Accounts**

1. Resident Consumer Account (DDA, Savings, Time, CD)
2. Nonresident Alien Consumer Account (DDA, Savings, Time, CD)
3. Small Commercial and Franchise Businesses
4. Consumer Wealth Creation (at a threshold appropriate to the bank's risk appetite)
5. Nonresident Alien Offshore Investor
6. High Net Worth Individuals (Private Banking)
8. Offshore and Shell Companies

**Risk Levels:**

- High
- Medium
- Low
Customer may be higher risk

Because of:

- Business
- Ownership structure
- Anticipated or actual volume
- Types of transactions
- Transactions to/from higher-risk jurisdictions

If so, consider obtaining:

- Purpose of account & Source of funds/wealth
- Financial statements/Banking references
- Country of Origin/Primary trade area
- Proximity to bank
- Are int’l transactions routine
- Anticipated volume of currency/total sales
- List of major customers and suppliers
- Description of business/Occupation (include other individuals with ownership or control)

- Individuals with ownership or control over the account, such as beneficial owners, signatories, or guarantors
Validate/Watch For Change

Much of the CDD information can be confirmed through:

- Information-reporting agency
- Banking references
- Correspondence and telephone conversations with the customer
- Visits to customer’s place of business

- May include third-party references or researching public information online
- CDD processes should include periodic risk-based monitoring of the customer relationship to determine whether there are changes to the original CDD information (e.g., change in activity, employment or business operations)
Customer Risk

- Banks should monitor their lower-risk customers through regular suspicious activity monitoring and customer due diligence processes

  - If there is indication of a potential change in the customer's risk profile (e.g., expected account activity, change in employment or business operations)

  - Management should reassess the customer risk rating and follow established bank policies and procedures for maintaining or changing customer risk ratings
EDD: For Higher Risk

KYC is Critical

- Customers posing higher money laundering or terrorist financing risks present increased exposure

EDD is then especially critical in:

- Understanding anticipated transactions
- Implementing a suspicious activity monitoring program that reduces reputation, compliance, & transaction risks
- Higher-risk customers and transactions should be reviewed more closely at account opening & more frequently throughout the relationship
Assess the appropriateness and comprehensiveness of the bank’s customer due diligence (CDD) policies, procedures, and processes for obtaining customer information and assess the value of this information in detecting, monitoring, and reporting suspicious activity.
Transaction Testing

- Determine whether bank collects appropriate information and effectively incorporates this information into the suspicious activity monitoring process.

- Form a conclusion about the adequacy of policies, procedures, and processes associated with CDD.
Regulators say:

- Level and sophistication of analysis for a Customer Identification Program (CIP)
- And the collection of customer due diligence (CDD) information may vary by bank.
- Detailed analysis is important because within any type of product or category of customer there will be accountholders that pose varying levels of risk.
Customers and Entities

- Any account is potentially at risk for money laundering or terrorist financing, however by nature of business, occupation, or anticipated activity, certain customers and entities may pose additional risks.

- “Exercise judgment and neither define nor treat all members of a specific category of customer as posing the same level of risk.”

- In assessing risk, consider other variables, such as:
  - Services sought
  - Purpose of activity
  - Geographic locations

Be careful of profiling
Risk Rating Accounts

Risk rating provides a better understanding of risk profile. Specifically, analysis of data should consider, as appropriate, the following factors:

- Purpose of the account
- Actual or anticipated activity in the account
- Nature of the customer’s business/occupation
- Customer’s location
- Types of products and services used by the customer
Higher Risk Examples

- Foreign financial institutions, & foreign money services providers
- Nonbank financial institutions
- Senior foreign political figures & immediate family/close associates
- Nonresident aliens
- Foreign corporations & domestic business entities, particularly:
  - Offshore corporations:
    - Shell companies
    - Private Investment Companies (PIC)
    - International business corporations (IBC)
- Deposit brokers, particularly foreign deposit brokers.
- Cash-intensive businesses
- NGOs & charities (foreign & domestic).
- Professional service providers
Business Entities (Domestic and Foreign)

- Refers to limited liability companies, corporations, trusts, and other entities
- Individuals, partnerships, and existing corporations establish business entities for legitimate reasons, but they may be abused for money laundering and terrorist financing

Examiner’s Objective.

- Assess adequacy of systems to manage risks for transactions for both domestic and foreign business entities
- Assess management’s ability to implement effective due diligence, monitoring, and reporting systems
Domestic Business Entities

- Entities formed or organized in U.S.
- All states have statutes governing organization of businesses, including limited liability companies, corporations, general partnerships, limited partnerships, and trusts
- Some states require minimal information, increasing potential for abuse by criminal and terrorist organizations

Shell companies registered in U.S. are a type of domestic entity
Foreign Business Entities

Frequently used foreign entities include trusts, investment funds, and insurance companies.

- Foreign entities opened in Offshore financial centers (OFC) that pose particular money laundering risk are:
  - International business corporations (IBC)
  - Private Investment Companies (PIC)
- Many have limited organizational disclosure and recordkeeping requirements creating a favorable environment for money laundering.
Gather sufficient information on business and beneficial owners to understand and assess risks of the account relationship.

- Type of business
- Purpose of the account
- Source of funds
- Source of wealth of owner or beneficial owner
- Jurisdiction where the business entity was established
- Type of account (or accounts)
- Expected transaction activities
- Types of products that will be used
Ongoing Business Risk Mitigation

- Ongoing account monitoring is critical to ensure that the accounts are reviewed for unusual and suspicious activity.

- Expected versus actual transaction activities.

- Be aware of higher-risk transactions in these accounts, such as:
  - Activity that has no business or apparent lawful purpose.
  - Funds transfer activity to and from higher-risk jurisdictions.
  - Currency intensive transactions.
  - Frequent changes in the ownership or control of the nonpublic business entity.
Examiner Procedures for Businesses Include:

1. Examiners will pull sample of business accounts
2. Each account in entire relationship will be reviewed
3. Review due diligence information and assess adequacy
4. Review account statements and transaction details
5. Compare expected transactions with actual activity.
   - Determine if actual activity is consistent w/ nature & purpose of account
   - Are there any transactions that appear unusual or suspicious.
   - Review higher risk areas, such as funds transfers, private banking, trust, and monetary instruments.
Ongoing Expectations

- Customer Due diligence is an ongoing process, take measures to:
  - Ensure account profiles are current
  - Monitoring is risk-based

- Consider whether risk profiles should be adjusted or suspicious activity reported when activity is inconsistent with the profile
FinCEN Recognizes:

- Financial institutions will be required to modify existing customer onboarding processes to incorporate the beneficial ownership requirement.

- Effective date of two years from date the final rule was issued.

MAY 11, 2018
Checklists to Compliance Success
What needs to be Reviewed

- Policies
- Processes and Procedures
  - Onboarding process
  - Changes to monitoring
- Forms
- Changes to Host/Core software systems
- Changes to AML software
Forms

- Signature Cards
- New Account worksheets
  - Paper
  - Computer generated
- Disclosures
- Lobby CIP signs
- Beneficial Ownership Certification Form
  - Paper
  - Computer generated
Changes to Onboarding Processes

- What will you collect
  - Business Type (NAICs codes)
  - Cash, wire, ach, atm, monetary instrument volumes
- What should be entered during the onboarding process
Changes to Core Software

- Signer information
- Signer CIP information
- Beneficial Ownership information
- Beneficial Owner CIP information
- Relationship Code
  - Do you already have a relationship code flag for beneficial ownership on your new account and core system platforms

Sample relationship codes:
- owner
- signer
- joint owner
- beneficial owner
- power of attorney
AML Systems

- Determine how Beneficial Ownership information will flow into your AML Systems
- Aggregate by beneficial owner for CTRs and structuring
- Determine what information obtained at account opening should feed into your AML systems
- Run reports of accounts whose activity differs from expected
Training

- Branch Operations
  - New Accounts
  - Tellers
- Relationship Managers
- Sales
- Central Operations
- BSA/Compliance Staff
- Senior Management
- Board of Directors
- Other Departments as needed
THANK YOU
QUESTIONS?

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