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# Would You Believe...OFAC and Money Laundering Regulations Bump Into Real Estate Transactions

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Thanks to Kevin Shepherd for his permission to use portions of his USA Patriot Act Power Point presentation from the 2004 ABA/RPPT Spring CLE Meeting.

In response to the September 11, 2001 terrorist attack, the Federal Government enacted new laws and amended existing laws designed to prevent terrorism.

- USA Patriot Act
  - new prohibitions on certain kinds of financial transactions.
  - new detection responsibilities for companies and individuals involved with financial transactions

- Executive branch orders issued by the President and the Departments of Treasury and State, one of which prohibits nearly all business dealings with thousands of individuals and entities named in the Executive Order and on lists updated by the Departments of Treasury and State.

Attempts to fight terrorism by trying to eliminate financial transactions that enable terrorism pre-date September 11.

In 1989, the G-7 Summit in Paris established the **Task Force on Money Laundering (“FATF”)**. This inter-governmental body had as its mission to, on an international basis, fight money laundering activities worldwide. It has no “legal” standing as such, its pronouncements are not binding, but countries are designated as either “cooperative” or “non-cooperative”. The International Monetary Fund uses FATF in its activities and the World Bank also collaborates with FATF.

## FATF Initiatives

FATF developed the “**Forty Regulations**” for governments and private sector entities.

After September 11, FATF issued the “**Special Regulations on Terrorist Financing**” to be implemented by nations around the world.

In October, 2003, FATF released its “**International Best Practices on the Freezing of Terrorist Assets.**”

# Gatekeeper Initiative

An adjunct to the “Forty Recommendations” is the so-called “Gatekeeper Initiative.” Gatekeepers are “those professionals, including lawyers, accountants and auditors, who are involved in assisting clients with domestic and international financial transactions and business dealings.”

The ABA issued comments on the Gatekeeper initiative and noted that “many of the Forty Regulations may be applicable to lawyers.”

For example, one recommendation is that “lawyers... should report suspicious transactions when they engage on behalf of a client... buying or selling real estate securities ... the operation of companies ... or the buying or selling of business entities.”

- U.K. Lawyers are subject to “suspicious activity reporting” (**SAR**) requirements and international compliance requirements. There is an exception for some litigation matters. U.K. makes it a criminal offense for a lawyer to alert a client that the lawyer is filing a SAR with the government.

- EU Directive Approach. Lawyers are subject to the SAR requirement with a litigation exception and an exception for “ascertaining the legal position” of a client.
- Switzerland/Channel Islands. Lawyers are subject to registration with a regulatory body, licensing, AML compliance programs, recordkeeping and SAR requirements.

- In the U.S., the Gatekeeper Initiative is controlled by the Department of Justice (Patriot Act Sections 352 and 326 are under the Treasury). The Departments of Justice and Treasury have differing views of the role of certain businesses and individuals in the fight against terrorism and money laundering. The Justice Department thinks Gatekeepers can and should do more in the fight against terrorism.

Currency Transaction Reports. The obligation of persons engaged in real estate transactions to file a currency transaction report under the Bank Secrecy Act under certain circumstances in which cash or other instruments are used as the means of payment also predates the Patriot Act.

## Executive Order 13224

- Prohibits nearly all business dealings with thousands of individuals and entities named in the Executive Order and on the lists (the “**OFAC List**”) of “Specially Designated Nationals and Blocked Persons” (“**SDN’s**”), which is maintained and updated by the Departments of Treasury and State and published by the Office of Foreign Assets Control.

- Operates to freeze all property and property interests in the US, or that come into the US, of SDN's.
- The prohibition extends to any transaction, dealing or donation of any kind by a “US Person” (“USP”) in blocked property or with a SDN.

- The interim final rules state that “any transfer in violation of the rules is null and void.”
- Limited exceptions for unknowingly entering into prohibited transactions with no intent to violate the rules.
- Applies to ALL US persons and entities regardless of their trade or business.

# Noncompliance Penalties

- U.S. businesses can commit both civil and criminal money laundering violations that can result in penalties of not less than twice the amount involved in the financial transaction, up to \$1 million, per violation.
- To satisfy the financial penalties, courts can issue restraining orders against property; for individuals, the penalties for money laundering under the Act include imprisonment of up to 20 years for violation and fines of at least twice the value of the property involved in the offense, up to \$500,000.

- The Executive Orders also subject violators to substantial criminal and civil penalties, as well as asset freezes and forfeitures; corporations may be subject to \$500,000 in penalties for each violation, and individuals are subject to \$250,000 fines and 10 years in prison.

## **Bank Secrecy Act of 1970s (“BSA”)**

- Enacted to shed light on banking practices
- Requires “financial institutions” to adopt anti-money laundering program
- Originally, BSA covered traditional financial institutions, such as banks
- Has now been expended to cover 27 categories of “financial institutions”

## **“Financial Institutions”**

- BSA amended in 1988 anti-drug abuse law to add several new categories of financial institutions
- New financial institutions included:
  - Automobile, airplane, and boat dealers
  - The United States Postal Service
  - **“Persons involved in real estate closings and settlements”**

## **“Persons Involved in Real Estate Closings and Settlements”**

- Eight word phrase rich in ambiguity
- No legislative history on the purpose of this phrase – anyone’s guess as to what it was intended to cover
- Pure conjecture – response to proliferation of fast boats, fancy homes, and drug money in South Florida in 1980s?

## **Dormant Action between 1988 and 2001**

- No federal regulatory action taken between 1988 and 2001 to develop anti-money laundering regulations for “persons involved in real estate closings and settlements”
- September 11, 2001 dramatically changed that situation

# **Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept Terrorism Act (“USA Patriot Act”)**

- Enacted in response to terrorist attacks on September 11, 2001
- Enacted mere 45 days after 9.11
- Massive legislation (342 pages) designed to combat international terrorism. Press has primarily focused on civil liberties aspects of the Act.

## Background of Law

- Original bill introduced by the Bush Administration did not contain any anti-money laundering provisions
- Anti-money laundering provisions added by Rep. Oxley (Title III of the USA Patriot Act)
- Nowhere does the USA Patriot Act use the term “real estate”

## Section 352 Requirements

- BSA now requires every “financial institution” to establish an anti-money laundering (“AML”) program that includes four elements.
- Original April 24, 2002 deadline extended twice. Led to one year extension (April 24, 2003).

## Section 352 AML Requirements

- Develop internal policies, procedures and controls to prevent money laundering.
- Designate compliance officer to ensure compliance with AML laws.
- Develop an ongoing employee training program that assists employees in detecting and preventing money laundering and terrorism financing.
- Implement an independent audit function to test effectiveness of AML programs.

# FinCEN

- Treasury Department's Financial Crimes Enforcement Network ("FinCEN") is in the process of preparing AML regulations, including those for "persons involved in real estate closings and settlements."
- FinCEN responsible for administering the BSA – agency oversees Treasury's money laundering prevention and detection policies

## **Persons Involved in Real Estate Closings and Settlements**

- On April 10, 2003, and after almost a year of delay, FinCEN finally issued an advance notice of proposed rulemaking for the remaining financial institution: “persons involved in real estate closings and settlements.”

## The “Four Questions”

- What are the money laundering risks in real estate closings and settlements?
- How should persons involved in real estate closings and settlements be defined?
- Should any persons involved in real estate closings or settlements be exempted from coverage under Section 352?
- How should the AML requirement for persons involved in real estate closings and settlements be structured?

## **What are the money-laundering risks in real estate closings and settlements?**

- 1996 report prepared by the National Institute of Justice states that “real estate transactions offer excellent money-laundering opportunities.”
- Treasury cited 3 federal appellate cases.

# Risks

- Cases offer little support for proposition that real estate is a money laundering haven – cases do not involve situations where an innocent real estate actor was duped by money launderers
- 1996 study simply cited extreme examples involving bribery and money laundering
- No empirical data, though, to support regulation of *multi-trillion* dollar industry.

# Defining Persons involved in real estate closings and settlements

- What is a “person”?
- Real estate closing and settlement involves up to a dozen or more participants
- Counsel, title company, lender, appraiser, surveyor, pest inspector, building engineer, environmental consultant, brokers

## Definition of “Person”

- FinCEN’s focus is on those who are “well positioned” to identify suspicious conduct
- A “significant factor” is who is involved in the flow of funds at closing
- FinCEN believes attorneys play a “key role” in the closing process and thus merit consideration along with the other professionals
- Recent FTC/ABA case casts doubt on whether lawyers are “persons” under applicable statutes

## **Definitional Issues: “Involved”**

- What does “involved” mean? What level of involvement will trigger regulation?
- Level of involvement may vary from deal to deal (e.g., local counsel to primary counsel)

## “Closings and Settlements”

- Does a difference exist between a “closing” and “settlement”?
- Limited to fee conveyances and financing transactions?
- FinCEN refers to “lease agreements” – why?
- Are other real estate activities covered?  
Construction contracts? Sale of member interests?  
Leases?

### **Question 3: Who should be exempt?**

- Buyer and seller of own home not covered – why not?
- FinCEN wants to focus on commercial, not residential, transactions
- What about sale of vacation home? Is that commercial real estate activity?
- Exempt those already covered by AML regulations, e.g., banks

## **Question 4: Structuring an AML Program**

- Focus on the extent to which AML programs are commensurate with the size, location, and activities of persons in the affected industry
- FinCEN sought feedback on impact of AML requirements on small businesses and sole proprietors

## Structuring an AML Program

- No volume threshold – regulate those who handle one closing per year the same as those that handle thousands per year?
- No dollar threshold – treat low dollar deals the same as multi-million dollar real estate deals?

## **Comments Received by FinCEN on June 9, 2003**

- 52 comment letters received.
- Varying and wide ranging approaches.
- Number of industry participants commented.

## Significant Comment Letters

- ABA Real Property Section
- American College of Real Estate Lawyers (“ACREL”)
- American College of Mortgage Attorneys (“ACMA”)
- Florida Bar Real Property Section
- ABA Gatekeeper Task Force

## **ABA Real Property Section**

- Advocated “financial intermediaries” test
  - “Touch the money” concept
  - Recognition that lawyers not performing legal service when handling funds – do not need law degree to handle/disburse funds
- Emphasized adverse impact on attorney-client privilege and client confidentiality

## **ABA – Attorney-Client Privilege Concerns**

- AML program also requires development of internal policies, procedures, and controls to prevent money laundering
- May require lawyers to conduct due diligence on own client (ethnicity, political beliefs) – forces client into adversarial relationship with lawyer
- Undermines attorney-client privilege

## ABA - Attorney-Client Privilege Concerns

- Independent audit function requirement may require lawyers to open client files to others for inspection
- Concern about ultimate reporting obligation. **Major issue** not discussed in advance notice of proposed rulemaking. But logical for “SAR” requirement to follow. Program not effective if lawyer could simply be allowed not to report suspicious activity

## **ABA – Attorney-Client Privilege Concerns**

- Lawyers are not governmental informants
- Clients need ability to confide in counsel without risk that counsel will disclose communications with government – assists lawyers to advise clients to understand and comply with the rule of law
- Lawyers help clients comply with laws by advising of their legal obligations

## **ABA – Attorney-Client Privilege Concerns**

- Existing rules are adequate to prevent lawyers from assisting clients in money laundering and terrorist financing
- Lawyers cannot counsel clients to engage in criminal activity
- Federal law already prohibits lawyers from aiding in the commission of money laundering offenses

## ACREL Position

- “**Designated party**” test for allocating AML due diligence. Place responsibility on party best able to perform due diligence and allow others to rely on that work.
- Need to avoid redundancy and duplication and minimize costs – importance of market efficiencies.

## ACREL

- Proposed **\$10MM threshold** standard for institutional loans. Lower amount loans should be excluded.
- Additional proposed exemptions include sale of mineral and royalty interests and sales of businesses where part of assets include real property.

## What Next?

- ABA and ACREL, and the USA Patriot Act Task Force members have met with Treasury to discuss next steps
- Productive discussions with Treasury at September 2003 meeting in Washington. Perhaps Treasury will ultimately formulate “best practices” rather than regulations

## Best Practices Approach

- No evidence that money laundering is even a minor issue in the real estate industry
- Best practices approach would allow FinCEN and real estate industry to work together to develop effective AML program
- Avoid risk of imposing federal regulatory regime on critical component of domestic economy – understand and appreciate cost-benefit of AML program requirements

## **Best Practices Approach**

- Education is critical component of best practices approach
- Sensitize and heighten awareness of issue to avoid real estate closers from being duped into participating in criminal activity

## Alternatives

- If FinCEN does not adopt best practices approach, FinCEN should adopt financial intermediaries “**touching the money**” test and a protocol to avoid redundant due diligence