"KNOW YOUR CLIENT" PRACTICES IN COMMERCIAL REAL ESTATE LOAN TRANSACTIONS

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INTRODUCTION

Combatting money laundering and illicit finance has long been a matter of national security in the United States, as well as a matter of increasing concern globally.[1] Anti-money laundering (AML) efforts date back to the Bank Secrecy Act[2] (BSA), passed in 1970 and considered the cornerstone of AML legislation. The BSA takes a recordkeeping and reporting approach to AML and requires persons regulated thereunder to report suspicious financial activity, including cash transactions exceeding $10,000.

The terrorist attack of 2001 brought new focus on the potential use of opaque "shell" entities and complex ownership structures for money laundering and terrorism financing. These concerns gave rise to an amendment of the BSA known as the USA PATRIOT Act of 2001[3] (Patriot Act) which includes "know your client" (KYC) provisions to enlist the aid of financial institutions in the fight against terrorism and financial crime. KYC regulations require banks and certain other financial institutions to develop and implement a Customer Identification Program (CIP) with procedures to verify the identity of each customer so that the financial institution can better understand its customer's business and form a reasonable belief that it knows the true identity of each customer.

The real estate industry underwent even greater scrutiny when the Financial Crimes Enforcement Network of the United States Department of the Treasury (FinCEN) began to issue geographic targeting orders (GTOs) to: (i) look through shell entities which were extensively used to purchase luxury apartments in Manhattan and Miami potentially using funds from illegal sources; and (ii) identify the beneficial owners of the entities.[4] Originally issued in 2016, GTOs have since expanded to cover geographic areas beyond the initial targets of Manhattan and Miami. In 2021, FinCEN issued an Advance Notice of Proposed Rulemaking (Anti-Money Laundering Regulations for Real Estate Transactions)[5] which seeks to expand the requirements to collect, report, and retain information to a wider range of transactions, in effect potentially expanding the requirements of the GTOs to all non-financed commercial real estate purchases nationwide.[6]

This article will explore the origin of KYC processes and AML regulatory regimes in real estate finance, the evolution of lender KYC practices in commercial real estate loan transactions, and the future of lender KYC practices in the digital age.

THE PATRIOT ACT AND REAL ESTATE TRANSACTIONS

Real estate transactions have risen to the forefront for US AML regulators who have stated that such transactions are particularly susceptible to money laundering and other financial crimes. FinCEN outlined key risks and vulnerabilities in real estate transactions:

> Real estate transactions and the real estate market have certain characteristics that make them vulnerable to abuse by illicit actors seeking to launder criminal proceeds. For example, many real estate transactions involve high-value assets, opaque entities, and processes that can limit transparency because of their complexity and diversity. In addition, the real estate market can be an attractive vehicle for laundering illicit gains because of the manner in which it appreciates in value, "cleans" large sums of money in a single transaction, and shields ill-gotten gains from market instability and exchange-rate fluctuations.[7]

Sophisticated lenders in the syndicated loan market typically perform extensive due diligence on elements of the credit transaction and the borrower and related parties prior to closing the transaction or disbursing funds. Such loans may thereafter be sold or transferred, in whole or in part, in the secondary loan market. As a result of such extensive due diligence, the syndicated and secondary loan markets generally have a low risk of money laundering or terrorist financing. Nonetheless, under the Patriot Act, financial institutions are required to develop formal CIPs in order to detect potential money laundering or other financial misconduct. Such CIPs must address the vulnerabilities related to the limited transparency that FinCEN noted to be prevalent in real estate transactions. The Loan Syndication and Trading Association (LSTA) has been instrumental in providing and updating lender guidance for KYC and CIPs, issuing its original Guidelines for the Implementation of Customer Identification Programs in 2004.[8] LSTA has updated its guidance to reflect changes in regulations as well as market practices.[9] The guidance aims to: (i) identify the types of transactions or relationships in the primary and secondary loan market which do, and those which do not, require CIP scrutiny; and (ii) highlight potential AML or The Office of Foreign Assets Control (OFAC) compliance risks arising from such transactions or relationships including counterparty relationships.

In a loan transaction, customer identification and verification are performed on the borrower, any guarantor and, pursuant to FinCEN's beneficial ownership rule of 2016 (discussed below), any other person or entity that has a direct or indirect ownership interest of at least 25 percent in the borrower or any guarantor. A financial institution may wish to screen other parties to the transaction as well, depending on the nature of the transaction, including indirect owners of less than 25 percent in the borrower. Customer due diligence information to be gathered as part of the CIP process includes, at a minimum, the customer's name, address of principal place of business, and taxpayer identification number as well as the names of the company's directors and their similar identification information. This information is then required to be verified through the financial institution's CIP by documentary means (which may be the entity's charter documents or an individual's driver's license or passport) or other means such as internet searches of publicly available information or physical visits to the customer's place of business.

US banks must also comply with OFAC regulations which set out prohibited types of transactions and persons with whom US persons may not engage in transactions. Failure to comply with OFAC regulations can have severe consequences including civil or criminal liability as well as possible non-repayment of the loan should a borrower become the target of sanctions.[10] Once customer information is obtained and verified, it is compared against various lists (such as the US Department of State sanctions lists, the Specially Designated Nationals and Blocked Persons Lists, and Financial Action Task Force Lists) to determine whether persons or entities are subject to sanctions administered by OFAC or otherwise considered "blocked" by OFAC.

Using a risk-based approach, a financial institution may engage in enhanced due diligence if information obtained in the CIP process indicates that the customer or transaction poses a higher risk of money laundering or terrorist financing. Primary lenders, including every lender in a syndicate for a syndicated loan, will give the greatest scrutiny. Lenders who acquire a loan in the secondary market or by merger, asset purchase, or the like are not required to perform CIP under a "transfer exception."[11]

In addition to CIP and risk assessment protocols, lenders will typically include Patriot Act, OFAC, and other AML and anti-corruption representations and covenants in the loan agreement, which are designed for compliance with AML and anti-corruption regulations at the time of signing the loan agreement and for the life of the loan. These provisions include, among others, a required Patriot Act notice notifying the borrower that the lender is subject to the Patriot Act, a covenant to provide KYC information, and representations and covenants relating to sanctions compliance. Loan agreements will also provide for continued compliance with KYC regulations such that transferees of interest in the borrower will be subject to CIP and compliance with the KYC requirements of the loan agreement. These representations or covenants may help the lender avoid severe penalties in the event that a borrower misrepresents its status or compliance or if a violation occurs after disbursement, as such provisions evidence the lender's intent to comply with the regulations.

LSTA has published a number of loan agreement provisions to best protect lenders:[12]

- PATRIOT Act. Each Lender subject to the PATRIOT Act hereby notifies the Borrower that pursuant to the requirements of the USA PATRIOT Act (Title III of Pub. L. 107-56 (signed into law October 26, 2001)) (the ' PATRIOT Act'), it may be required to obtain, verify and record information that identifies the Borrower, which information includes the name and address of the Borrower and other information that will allow such Lender to identify the Borrower in accordance with the PATRIOT Act.
- KYC Information. Upon the reasonable request of any Lender made at least [ten] days prior to the Closing Date, the Borrower shall have provided to such Lender the documentation and other information so requested in connection with applicable "know your customer" and anti-money-laundering rules and regulations, including the PATRIOT Act, in each case at least [five] days prior to the Closing Date.
- Sanctions Representations. None of the Borrower, any of its Subsidiaries or[, to the knowledge of the Borrower,] any director, officer, [employee, agent, or affiliate] of the Borrower or any of its Subsidiaries is an individual or entity ("Person") that is, or is owned or controlled by Persons that are: (i) the [subject/target] of any sanctions administered or enforced by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), the U.S. Department of State, [the United Nations Security Council, the European Union, Her Majesty's Treasury [, or other relevant sanctions authority]] (collectively, "Sanctions"), or (ii) located, organized or resident in a country or territory that is the subject of Sanctions, [including] [currently,] Crimea, Cuba, Iran, North Korea, Syria, and the so-called Donetsk People's Republic and Luhansk People's Republic.

  The Borrower[, its Subsidiaries [and their respective directors, officers and employees] and, [to the knowledge of the Borrower, the agents of the Borrower and its Subsidiaries,]] are in compliance with all applicable Sanctions in all material respects. The Borrower and its Subsidiaries have instituted and maintain policies and procedures [reasonably] designed to [promote/achieve/ensure] compliance with applicable Sanctions.
- Sanctions Covenants. The Borrower will not, directly or indirectly, use the proceeds of the Loans or Letters of Credit, or lend, contribute or otherwise make available such proceeds to any subsidiary, joint venture partner or other Person, (i) to fund any activities or business of or with any Person, or in any country or territory, that, at the time of such funding, is the subject of Sanctions, or (ii) in any other manner that would result in a violation of Sanctions by any Person (including any Person participating in the Loans or Letters of Credit, whether as Administrative Agent, Arranger, Issuing Bank, Lender, underwriter, advisor, investor, or otherwise).

> The Borrower will maintain in effect policies and procedures [reasonably] designed to [promote/achieve/ensure] compliance by the Borrower, its Subsidiaries, [and their respective directors, officers, employees, and agents] with applicable Sanctions.

2016 BENEFICIAL OWNERSHIP RULE

In order to clarify and strengthen customer due diligence under the BSA, including the Patriot Act, FinCEN issued regulations enhancing requirements for customer due diligence to include identification and verification of the beneficial owners of legal entity customers (the Beneficial Ownership Rule).[13] The beneficial owners identified must be natural persons. There are two prongs to the beneficial ownership determination: (i) identification of each natural person that directly or indirectly owns 25 percent or more of the equity interests of a legal entity customer; and (ii) identification of one natural person with significant responsibility to control, manage, or direct a legal entity customer (who may be one of the equity interest owners). The Beneficial Ownership Rule requires covered financial institutions to obtain a certification from the individual opening an account on behalf of a "legal entity customer" which identifies all such beneficial owners and lenders will typically include a covenant to deliver such certification and a representation as to its accuracy in the loan agreement. Once identified, the financial institution will perform its CIP with respect to such beneficial owners.

FIRRMA AND CIFIUS

The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee with authority to review certain foreign investment transactions for potential national security concerns. CFIUS analyzes a transaction by assessing the sensitivity of the US business/assets being acquired and the potential threat presented by the foreign acquirer. CFIUS may review any transaction that could lead to the acquisition of "control" of a US business by a foreign person (generally considering "control" to be a greater than 10 percent equity/voting interest in the business along with special control rights, including the right to appoint a member or observer to the board of directors). If a transaction is determined to be a risk to national security, it may be blocked by the President.

The jurisdiction and scope of CFIUS authority was significantly expanded in the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA)[14] to include the acquisition of a non-controlling interest in a US business. Of particular significance to the real estate industry, FIRRMA added certain acquisitions of real estate to CFIUS review authority. Under FIRRMA, the acquisition of real property by a foreign person may be subject to CFIUS review if it presents a national security risk for reasons such as: (i) being in US air or seaport facilities; or (ii) near specified US government or military installations or in a location where a foreign person could obtain intelligence on activities at a military or other government property.

A purchase, lease, or concession of covered real estate by a foreign person may be reviewed by CFIUS if the foreign person will acquire any three of four property rights: (i) the right to access the covered real estate; (ii) the right to exclude others from physically accessing the covered real estate; (iii) the right to improve or develop the covered real estate; and (iv) the right to attach fixed or immovable structures or objects to the covered real estate. It is up to the parties to the transaction to determine whether a national security risk might exist. The parties may then opt to voluntarily submit a filing to CFIUS for review. If a foreign person will have direct or indirect control over a property owner or the property after an acquisition financing, the lender for such financing will want to ascertain as part of its diligence whether the transaction may be subject to review by CIFIUS.

THE FUTURE OF LENDER KYC PRACTICES

The Corporate Transparency Act (CTA), enacted as part of the National Defense Authorization Act for Fiscal Year 2021,[15] is intended to address the problem of law enforcement's inability to pierce opaque entity structures to determine the individuals who control a legal entity, particularly in cases where bad actors conceal their identity and use complex ownership structures in order to commit financial crimes. While government authorities can issue GTOs to obtain beneficial ownership information in the residential real estate arena, the CTA broadens the scope beyond residential transactions. The CTA requires that certain companies disclose to FinCEN the name, address, date of birth, and unique identification number of beneficial owners who exercise substantial control over the company or who own or control at least 25 percent of the company. They must also provide similar identifying information about the individual who formed the company (known as the "company applicant"). The CTA also permits FinCEN to disclose this sensitive information to authorized government authorities and to financial institutions through a FinCEN request with the consent of the disclosing entity.

On September 29, 2022, FinCEN issued final rules under the CTA (CTA Rules),[16] to become effective on January 1, 2024, which provide specific guidance as to the types of companies required to file reports, the reports required to be filed, when such filings are to be made, and what constitutes a "beneficial owner." Additional regulations are needed regarding access to, and safeguarding for, the information collected by such filings and appropriate revisions to FinCEN's CDD requirements for financial institutions following the CTA Rules. Issues concerning the creation and security of the registry have yet to be resolved but once the CTA and its registry are in effect, financial institutions will have another option for obtaining customer information for the due diligence process. A beneficial ownership registry will be one of the more significant advances in KYC for financial institutions by reducing the burden on banks who currently have to collect customer information themselves.

Financial institutions may one day have an additional tool in their AML tool chest. An Advance Notice of Proposed Rulemaking was issued by FinCEN in June 2022[17] to solicit public comment on the implementation of a no-action letter process at FinCEN. Comment is specifically sought on whether a no-action letter process should be implemented, including 48 questions on its scope and limits, how it should be implemented, and how it would coordinate with the independent authority of other government agencies to examine institutions and transactions. This process might be utilized by financial institutions when conducting KYC and complying with BSA requirements.

CONCLUSION

The process involved in setting up and maintaining CIPs and performing KYC due diligence has only become more onerous to lenders and borrowers since its inception. US financial institutions which have a global presence are required to comply not only with US AML regulations but also with those of other countries which may be more stringent, creating a complex web of compliance requirements. Global digital connections among organizations and innovative technological developments may increase financial crimes, and government regulators must continue to keep up.[18] Financial institutions will often need to monitor customers on an ongoing basis or based on triggering events, or "perpetual KYC." An industry has developed around attempts to automate such KYC processes. In addition to industry service providers, banks are now beginning to share information among themselves using new global information-sharing platforms which may be searched to help identify potential AML transactions or terrorist financing.[19] While the ambitious registry to be created under the CTA will eventually assist in customer identification and verification, the data in the registry will be self-reported by the entities. Further risk analysis and enhanced due diligence for each customer and transaction will remain to be performed. Challenges will continue to arise, but undoubtedly the increasing use of data and technology by regulators and financial institutions will be a key factor in the continuing efforts to combat financial crime.

Notes

1 An earlier version of this article was published in The ACREL Papers – Fall 2022.

2 31 USC § 5311 et seq.

3 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, Title III of Pub. L. 107-56 (signed into law October 26, 2001).

4 FinCEN Press Release, Geographic Targeting Orders Require Identification for High-End Cash Buyers, Jan. 13, 2016, available at https://www.fincen.gov/news/news-releases/fincen-takes-aim-real-estate-secrecy-manhattan-and-miami. Geographic targeting orders require certain title insurance companies to report the identity of beneficial owners of shell companies purchasing residential real estate in all-cash transactions.

5 Anti-Money Laundering Regulations for Real Estate Transactions, 86 Fed. Reg. 69589 (Dec. 8, 2021), available at https://www.federalregister.gov/documents/2021/12/08/2021-26549/anti-money-laundering-regulations-for-real-estate-transactions.

6 While GTOs and the Proposed Rule are significant developments in the movement toward more transparency in real estate transactions, they relate to either all-cash residential real estate transactions (GTOs) or non-financed residential and commercial real estate acquisitions (ANPRM) and, as such, are not within the scope of this paper which is limited to commercial lending practices.

7 FinCEN, Advisory to Financial Institutions and Real Estate Firms and Professionals, FIN-2017-A003, Aug. 22, 2017, available at https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf.

8 LSTA Guidelines for the Implementation of Customer Identification Programs for Syndicated Lending and Loan Trading, September 2004.

9 LSTA Know Your Customer Considerations for Syndicated Lending and Loans (LSTA KYC Guidelines), Oct. 22, 2018.

10 LSTA Regulatory Guidance: U.S. Sanctions Issues in Lending Transactions (LSTA Sanctions Guidance), Apr. 25, 2022.

11 LSTA KYC Guidelines, supra note 9. The LSTA KYC Guidelines analyze an array of roles and relationships in syndicated loans and provide guidance as to whether a relationship gives rise to CIP requirement and whether CIP is required to be performed by financial institutions in such roles.

12 See LSTA KYC Guidelines, supra note 9, and LSTA Sanctions Guidance, supra note 10. The provisions are reprinted with the permission of the LSTA which is gratefully acknowledged by the author.

13 The Rule is available at https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

14 Foreign Investment Risk Review Modernization Act of 2018, Subtitle A of Title XVII of Public Law 115-232 (Aug. 13, 2018).

15 Title LXIV of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Public Law 116–283 (January 1, 2021).

16 Beneficial Ownership Information Reporting Requirements, 87 Fed. Reg 59498 (September 30, 2022), https://www.federalregister.gov/documents/2022/09/30/2022-21020/beneficial-ownership-information-reporting-requirements.

17 No-Action Letter Process, Advance notice of proposed rulemaking, 87 Fed. Reg. 34224 (June 6, 2022), https://www.federalregister.gov/documents/2022/06/06/2022-12048/no-action-letter-process.

18 Legislators and regulators continue to search for more effective measures to crack down on corruption and financial crimes. Consider the Kleptocrat Liability for Excessive Property Transactions and Ownership (KLEPTO) Act, S.4075 (IS), a bipartisan bill introduced in the Senate this spring aimed at tracking down real estate, yachts, and other assets owned by Russian oligarchs. This bill would require beneficial ownership disclosure for all direct and indirect transfers of real estate where a buyer or seller is a covered entity, regardless of price.

19 "Banks Start Using Information-Sharing Tools to Detect Financial Crime," The Wall Street Journal, July 25, 2022.