The Loan and Finance Company:

Facing Compliance with the USA Patriot Act

by Vicki R. Canales, JD Candidate

Although regulations promulgated pursuant to the USA Patriot Act (the Act)[1] have not yet been applied to loan and finance companies, the prudent loan and finance company should begin to consider conforming its policies to the minimum requirements set forth in the Act under the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Title III).[2] This is not, however, an easy task. The Act is over one hundred pages long, and amends hundreds of existing federal laws. In particular, it has imposed various requirements on the financial community in an attempt to encourage efforts at preventing terrorists from obtaining access to funding. The Act also authorizes, and even requires, the Secretary of the Treasury (Treasury) to promulgate regulations that will implement the purposes of the Act. The Treasury has already put forth regulations aimed at educating financial institutions on the methods in which terrorists manipulate legitimate businesses and the prevention of such manipulation. While the Act may seem like a daunting mass of detail, a financial institution can make compliance easier by keeping abreast of the status of existing regulations; preparing for newly developed regulations; and, most importantly, recognizing that the ultimate goal of the Act and its regulations relating to financial institutions is the prevention of money laundering.

Congress has found that money laundering "provides the financial fuel that permits transnational criminal enterprises to conduct and expand their operations to the detriment of the safety and security of American citizens" and that "money laundering, and the defects in financial transparency on which money launderers rely, are critical to the financing of global terrorism and the provisions of funds for terrorist attacks."[3] As a result, Congress enacted Title III for purposes of, among other things, providing the Treasury with broad discretion "to take measures tailored to the particular money laundering problems presented by specific foreign jurisdictions, financial institutions operating outside of the United States, and classes of international transactions or types of accounts . . . to provide guidance to domestic financial institutions . . . [and] to ensure that all appropriate elements of the financial services industry are subject to appropriate requirements to report potential money laundering transactions to the proper authorities."[4] Although Congress can potentially terminate Title III by enacting a joint resolution,[5] relying on this possibility is not advisable since dishonest borrowers will always exist, and the need to protect the integrity of one's institution should always be considered.

Difficulties in Promulgating Regulations Pursuant to the Patriot Act

Many of Title III's provisions require the government to prescribe regulations giving financial institutions specific guidelines regarding how to implement the requirements of the Act. In prescribing these regulations, Treasury has provided different sets of regulations for different types of financial institutions. Regulations with respect to loan and finance companies are no exception. For example, although Treasury has already issued regulations for banks, securities brokers or dealers, mutual funds, futures commission merchants, and introducing brokers with respect to Section 326 of Title III, regarding minimum standards for the verification of the identification of customers of financial institutions, it is still in the process of preparing regulations that will apply to loan and finance companies.[6] In addition, Section 352 requires financial institutions to establish anti-money laundering programs that meet specific minimum requirements. Pursuant to this section, Treasury has adopted regulations regarding certain types of financial institutions such as banks, savings associations, registered brokers and dealers in securities, futures commission merchants, and casinos,[7] but has not yet done so for loan and finance companies, although it is currently in the process of preparing regulations for them.[8]

> "[L]oan and finance companies should consider the legal and reputational risks posed by non-compliance"

One might wonder why Treasury does not simply create a universal regulatory system for all financial institutions. In theory, this would be simpler to implement. However, in practice, such a universal approach would be impractical. For instance, imagine a boutique lending company, a real estate settlement company, a

casino, a precious jewels dealer, a mutual fund, and a nationally known bank worth billions of dollars, all subject to the exact same set of regulations regarding practices for the identification of foreign customers, for preparing anti-money laundering programs and for the administration of concentration accounts. The different institutions will not have the same product offerings, the same customer base, or the same resources. As such, regulations affecting these institutions would have a different impact on each of them, which may or may not be effective or desirable. Therefore, these regulations must be tailored to the idiosyncrasies of each business in order to have maximum effect, because "[a]n inadequate understanding of the affected industries could result in poorly conceived regulations that impose unreasonable regulatory burdens with little or no corresponding anti-money laundering benefits."[9]

Treasury also faces the problem of formulating a workable definition for a loan a finance company that would encompass all necessary businesses without including those that are already covered by other definitions. As its name indicates, a loan and finance company is an institution that extends loans or otherwise finances its borrowers' business. It is also distinguished from a bank, in that it does not accept customers' money for deposit, which means it requires some other source of funds. Should Treasury therefore differentiate among loan and finance companies based on the different sources of funds available to them? And what about companies that lend money incidentally to their primary business function? Think of a furniture dealer that allows a customer to finance his purchase. Should this company be considered a loan and finance company and, as such, be regulated as one? In addition, Treasury must take into account the fact that many of these businesses are small businesses without the resources or sophistication necessary to understand and implement the sorts of regulations that are more appropriate for a large institutional lender. This distinction was not lost on Congress, who recognized that "FinCEN [the Financial Crimes Enforcement Network] and Treasury are also aware that many of these financial institutions are sole proprietors of small businesses, and that any regulations affecting them must recognize this fact."[10] With such a myriad of questions, and no easy answers to any of them, a mistake at this stage could spell disaster for the overall effectiveness of the effort.

So, what is a business that defines itself as a loan and finance company to do? Although regulations required by Title III have not been specifically issued for them, prudent loan and finance companies should immediately consider conforming their internal policies and procedures to the minimum requirements set forth in Title III. Treasury has already stated that it is actively studying regulations for loan and finance companies, and it expects to issue them shortly.[11] Financial institutions should therefore conform their policies now in order to anticipate the burdens likely to be imposed by these impending regulations and comply with them in a timely manner when necessary. Another reason to consider conforming now is that active loan and finance companies may be able to inform, lobby, or control regulations that are promulgated. In preparing regulations, Treasury has actively sought comment from the industry. By taking advantage of this opportunity to comment, the financial industry can educate Treasury on what types of regulations it deems feasible, advantageous, or overly burdensome. It can also request clarification of any ambiguity, as well as become the "master of its own fate," so to speak, with respect to the regulations. Moreover, loan and finance companies should consider the legal and reputational risks posed by non-compliance, both now and when regulations are promulgated.[12] Not only will non-compliance carry with it legal penalties as outlined in the Act, but any financial institution known by the public to be careless in protecting against manipulation by terrorists could face unknown and undesirable public relations repercussions.[13]

A Closer Look at Title III

THE SECTIONS IN TITLE III that are most likely to require action on the part of loan and finance companies are Section 352, requiring the imposition of anti-money laundering programs by those institutions for whom regulations have been issued,[14] Section 326, regarding verification of the identity of customers,[15] and Section 314, providing for an information exchange between the government and financial institutions, as well as among financial institutions themselves.[16] According to industry experts, in the next few months Treasury plans to issue proposed rules pursuant to Section 352 requiring loan and finance companies to implement anti-money laundering programs, and within those proposed rules it will include a definition of a loan and finance company. Once a definition is decided upon, Treasury will issue rules for the customer identification programs pursuant to Section 326. In addition, under Section 314(b), those financial institutions that are subject to the anti-money laundering requirements of Section 352 are automatically allowed to share information among themselves concerning customers suspected of money laundering. However, pursuant to Section 314(a), the government can ask any financial institution for information regarding their customers at any time. Each of these sections is discussed in further detail below.

The most substantive amendment regarding money laundering is found in Section 352, "Anti-Money Laundering Programs."[17] This amendment requires, at a minimum: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs.[18] Loan and finance companies should begin by examining the relevant money laundering laws and regulations with which they must currently comply.[19] Companies should also consider the specific money laundering risks posed by their business, including money laundering methods most likely to be used by their customers, and tailor their policies, procedures, and con-

trols to respond to these risks. Ongoing employee training programs should address the risks likely to be encountered by the business and employees that are in the best position to manage that risk. Compliance officers should champion the effort, as well as monitor all applicable laws and regulations and ensure continuing compliance with them. The independent audit function should be ongoing, and compliance officers should be prepared to enforce necessary changes in policies and procedures. Business leaders within the company should be able to provide support to the extent necessary. As suggested above, companies should consider the reputational risks posed by non-compliance in addition to the legal risks.

A loan and finance company should also consider the requirements set forth in Section 326 of Title III.[20] This section adds a requirement to the BSA that Treasury issue regulations regarding the types of identification required for foreign nationals who open new accounts.[21] As set forth in Section 326, the minimum requirements for identification procedures are the following: (1) verification of the identity of persons opening accounts "to the extent reasonable and practicable;" (2) maintenance of records of the information used to verify identity; and (3) consultation of lists of known or suspected terrorists or terrorist organizations.[22] At this point, it is not clear what exactly is meant by "to the extent reasonable and practicable." However, what is clear is that companies should use a common sense approach to verify their customers' identities, taking into account the relevant risks posed by the types of loan and financial products offered, types of identification information available, and the company's "size, location and types of business or customer base."[23] In addition, if a customer is a business entity, loan and finance companies may, in some situations, consider looking beyond the corporate identity to verify the identity of the corporation's key managers, officers, members or other principals. Moreover, since terrorists and money launderers frequently use an apparently legitimate business front as a means of obtaining funds that are ultimately used for illegitimate or illegal purposes, loan and finance companies may even consider the identity of key shareholders, if the identity of the borrowing entity itself cannot be properly determined.

FinCEN and Treasury have offered guidance on the FinCEN website in the form of Frequently Asked Questions regarding these issues.[24] Answers to questions posted on this site suggest that when an institution lacks proper documentation to verify the identity of a partnership or sole proprietor, the institution should look to other individuals possessing authority or control over the partnership or sole proprietorship account, and gather names, addresses, dates of birth and taxpayer identification numbers.[25] This is most helpful when a customer is a partnership or sole proprietor; however, when the customer is another type of business entity, such as a corporation or limited liability company, financial institutions will have to use basic common sense when determining whether to look beyond the borrower's corporate identity.[26] When considering this possibility, loan and finance companies should use these guidelines as a tool to formulate their own customer identification procedures.

Finally, Section 314 provides for an information exchange between the government and financial institutions, as well as for an information exchange among financial institutions.[27] Subsection (a) of Section 314 directs Treasury to adopt regulations that encourage cooperation among financial institutions, regulatory authorities, and law enforcement for the purpose of facilitating an information exchange about suspected money launderers and terrorists.[28] Section 314 also states that federal law enforcement agencies can use FinCEN to solicit information from one or more financial institutions.[29] In this situation, an institution is obligated to search their records for any current account, or an account maintained within the preceding twelve months, for a named suspect, as well as any transaction or transmittal of funds conducted by or on behalf of the named suspect during the past six months.[30] The financial institution is then required to report back to FinCEN with the name, account numbers, dates and types of transactions, and other identifying information associated with the suspect.[31] Subsection (b) permits the sharing of information among financial institutions regarding the customers of financial institutions, and

participation in the information sharing among financial institutions is voluntary.[32] However, with regard to requests made by the government, a loan and finance company should not hesitate to evaluate its ability to comply with such a request, and take any steps it deems appropriate to be able to provide the requested information. This will enable the loan and finance company to immediately comply with any potential government information request once regulations are issued.

Conclusion

ALTHOUGH INTERPRETATION OF TITLE III and application of its many regulations can seem like an intimidating task, there are simple ways in which a loan and finance company can narrow the task to a more manageable size. Generally, when evaluating the applicability of Title III, a company should first analyze the different categories of financial institutions covered by Title III and the BSA, and determine which category it falls under. A company should then update itself on the regulations relevant for that category of financial institution. By evaluating Title III and related regulations in terms of the proper type of financial institution, a company can greatly ease its compliance burden by eliminating any inapplicable requirements.

A loan and finance company should also analyze its internal policies and procedures regarding money laundering and determine if any existing procedures are deficient when compared to the minimum requirements already set forth in Title III. A company should also keep in mind that although specific regulations may not have been issued for loan and finance companies yet, it would be prudent to begin evaluating the company's ability to meet the minimum requirements of Title III and take any necessary steps to come into compliance. A company should look at the information it already requires of its customers in its credit procedures, both before extending a loan and during the life of the loan, as this information, particularly information mandated by Form 8300 cash reporting requirements and procedures for monitoring suspicious forms of payment, is likely to be fairly comprehensive, and any new information required by Title III can be easily incorporated into a company's existing procedures. A company should also continually monitor the status of existing and proposed regulations and update their procedures accordingly. Most importantly, in keeping with the ultimate purpose of the Act, which is to deter terrorist acts and money laundering activities within the United States, a company should continually evaluate how a potential customer could manipulate the company to obtain funds for illegitimate purposes and take all available steps to prevent such manipulation. BLB

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1 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act of 2001, Pub. L. No. 107-56.
2 The loan and finance company is a subset of the financial institution defined in the Bank Secrecy Act. The Bank Secrecy Act is codified at 31 U.S.C. § 5312 (2003).
3 USA Patriot Act, § 302 (2001).
4 *Id.*
5 USA Patriot Act, § 303 (2001).
6 Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks, 68 Fed. Reg. 25090-25149 (May 9, 2003).
7 Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Financial Institutions, 67 Fed. Reg. 21110 (April 29, 2002).
8 Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Financial Institutions, 67 Fed. Reg. 67547 (Nov. 6, 2002).
9 *Id.*
10 *Id.*
11 *Id.*
12 As suggested by Amy Rudnick at Gibson, Dunn & Crutcher LLP.
13 USA Patriot Act, § 314 (2001).
14 USA Patriot Act, § 352.
15 USA Patriot Act, § 326.
16 USA Patriot Act, § 314.
17 USA Patriot Act, § 352.
18 *Id.*
19 In particular, Form 8300 cash transaction reporting requirements found at 26 U.S.C. § 6050I include many of the same underlying concerns as those at issue here. It should be noted that in certain circumstances, this includes cash equivalents such as money orders, cashiers checks, bank drafts and travelers checks.
20 USA Patriot Act, § 326.
21 To date, Treasury has issued regulations pursuant to this section regarding some financial institutions, including banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers and has indicated that they will propose separate rules for non-bank financial institutions, a category which includes loan and finance companies. 68 Fed. Reg. 25090-25149. Regulations for banks and broker-dealers will be the model for regulations that will apply to loan and finance companies. See 31 C.F.R. 103.121; Customer Identification Programs for Broker-Dealers, 31 C.F.R. 103.122 (2004).
22 USA Patriot Act, §326.
23 *See* http://www.fincen.gov/finalciprule.pdf.
24 *See* http://www.fincen.gov. The Frequently Asked Questions involve the application of regulations promulgated pursuant to Section 326 of the Act for banks, savings associations, credit unions, and certain non-federally regulated banks. The loan and finance company can look to these Frequently Asked Questions for guidance because, according to industry experts, the regulations for banks will become the model for regulations that will be issued for the loan and finance company.
25 *See* http://www.fincen.gov.
26 The traditional rules of the relevant jurisdiction allowing a piercing of the corporate veil would be useful to keep in mind in this situation.
27 USA Patriot Act, § 314. Although regulations for this section have been issued as of September 26, 2002, they do not yet apply to loan and finance companies. See Information Sharing Between Federal Law Enforcement Agencies and Financial Institutions, 31 C.F.R. § 103.100 (2004); Voluntary Information Sharing Among Financial Institutions, 31 C.F.R. §103.110 (2004); Financial Crimes Enforcement Network; Special Information Sharing Procedures To Deter Money Laundering and Terrorist Activity, 67 Fed. Reg. 60579 (Sept. 26, 2002).
28 USA Patriot Act, §314.
29 *Id; see also* 31 C.F.R. § 103.100.
30 USA Patriot Act, §314.
31 *Id.*
32 *Id.*