taxnotes® international

Volume 106, Number 8 ■ May 23, 2022

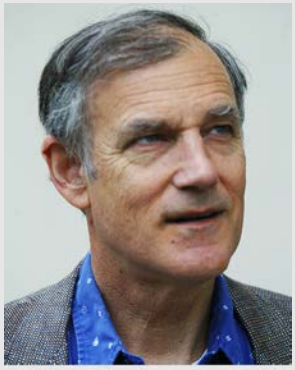
The Status of U.S. Entity Transparency And Gatekeeper Regulations

by Bruce Zagaris

Reprinted from *Tax Notes International*, May 23, 2022, p. 1045

The Status of U.S. Entity Transparency And Gatekeeper Regulations

by Bruce Zagaris



Bruce Zagaris

Bruce Zagaris is a partner with Berliner Corcoran & Rowe LLP in Washington and a former lecturer with the University of the West Indies Faculty of Law.

In this article, Zagaris looks at recent U.S. regulatory developments in corporate transparency and professional conduct and their potential collateral impact on foreign investment in the United States.

With the enactment of the Anti-Money Laundering Act of 2020 and the December 2021 issuance of proposed regulations on the Corporate Transparency Act (CTA), lawyers, trust and corporate service providers, and accounting professionals (known as gatekeepers in the parlance of the Financial Action Task Force (FATF)) in the United States have focused on the new requirements for entity formation and lamented the onerous obligations and potential liabilities the Financial Crimes Enforcement Network has created for them.

Other developments last December include FinCEN's issuance of a real-estate-related advance notice of proposed rulemaking and the American Bar Association Standing Committee on Professional Regulation's release of a discussion draft of possible amendments to model rules of professional conduct for attorneys' due diligence obligations. Despite the committee's anti-CTA and pro-voluntary-reporting stance, recent international developments inducing a wave of strengthened entity transparency regulations, especially the sanctions placed on Russian oligarchs, and the infeasibility of alternative reporting regimes contended by the committee risk designating the United States as a haven for malign investors.

FinCEN will promulgate two more sets of rulemaking to implement the requirements of the CTA, which is meant to prevent money laundering and other illicit activities through shell companies, by requiring some entities to report beneficial ownership information to FinCEN, which keeps that information in a nonpublic, secure database. FinCEN will also implement the act's protocols for access to and disclosure of beneficial ownership information and revise the customer due diligence (CDD) rule to align it with the proposed rule.

While we await final (and maybe additional) CTA regulations, proposed real estate rules, and possible amendments to the model rules for professional conduct, we can still see how those developments will affect the roles of U.S. gatekeeper professionals (known as designated nonfinancial businesses and professions)[1] and the private sector and U.S. desirability as a potential destination for foreign investment.

Those above-mentioned legal and regulatory developments must be viewed in the context of the Biden administration's prioritization of anti-

[1]The FATF definition of designated nonfinancial businesses and professions includes: casinos; real estate agents; dealers in precious metals or stones; lawyers, notaries, other independent legal professionals, and accountants (who are not in-house or government employees); and trust and company service providers not covered elsewhere under the FATF recommendations, and that as a business, provide specific services to third parties.

corruption and transparency measures,[2] as well as the issuance of sanctions against Russian oligarchs and multilateral efforts to enforce those sanctions.[3]

In discussing the status of U.S. gatekeeper regulation, this article will also consider the ABA's policy positions on anti-money-laundering and counterterrorism financial (AML/CFT) due diligence standards.

I. The CTA

Congress has long been trying to enact the CTA largely because of two FATF mutual evaluation reviews. In 2006 and 2016 the FATF gave the United States a noncompliant rating in both entity transparency and gatekeeper regulations. In its 2016 review, the FATF said the lack of timely access to "beneficial ownership information remains one of the most fundamental gaps in the U.S. context."[4] That chasm exacerbates U.S. vulnerability to money laundering by preventing law enforcement from efficiently collecting critical information during investigations and effectively responding to foreign mutual legal assistance requests for beneficial ownership information, it added.

As FinCEN explained when issuing them, the proposed rules are intended to protect the U.S. financial system from illicit use and prevent malign actors from abusing legal entities like shell companies to hide proceeds of corrupt and criminal acts. Those abuses subvert U.S. national security, economic fairness, and financial system integrity.

An important challenge from the beginning of Congress's efforts to enact legislation and issue regulations on entity transparency has been fierce opposition by key elements of the private sector, including the ABA, small businesses, and, until recently, the U.S. Chamber of Commerce. The opposition forced the proponents of the legislation to compromise; as a result, the CTA provides for a restricted-use database of unverified and unverifiable information.

The law conditions and restricts who can use the database and contains harsh penalties for wrongful disclosure or misuse of beneficial ownership information,[5] which is a felony. It restricts use of the database by banks and financial institutions to CDD purposes only. Because of the important potential reputational and legal risk of violating the law, banks will likely have to establish a separate internal database to silo any beneficial ownership information obtained from the FinCEN registry and restrict access to staff working on due diligence. Banks and financial institutions must also warn their staff not to respond to inquiries from other departments for names of beneficial owners and provide vigorous training on database use and misuse.[6]

A limitation of the CTA is that it is unlikely that the beneficial ownership regulations will take effect until at least 2023. FinCEN must still issue final regs and allow adequate advance time for persons to make necessary adjustments to comply.

Perhaps more important, U.S. and foreign governments and financial institutions will be unable to access the beneficial ownership information until FinCEN issues regulations. On April 14 the Financial Accountability and Corporate Transparency (FACT) Coalition sent a letter to FinCEN asking it to implement rules on the collection, storage, and interoperability of beneficial ownership data. The coalition reminded FinCEN that the statute required final rules for implementation to be in place no later than January 1, 2022 — a deadline that has already passed.

As discussed in more detail below, best practices in entity transparency policy call for registries that include a broad range of entities and trusts whose information is verified and accessible to the public. The EU AML directive

[2] White House, "Memorandum on Establishing the Fight Against Corruption as a Core United States National Security Interest" (June 3, 2021).

[3] On March 16, Attorney General Merrick B. Garland and Secretary of the Treasury Janet L. Yellen met virtually with representatives from Australia, Canada, Germany, France, Italy, Japan, the United Kingdom, and the European Commission to launch the Russian Elites, Proxies, and Oligarchs (REPO) multilateral task force. *See* U.S. Justice Department Release 22-241 (Mar. 16, 2022).

[4] FATF, "Anti-Money-Laundering and Counter-Terrorist Financing Measures: United States — Mutual Evaluation Report," at 4 (Dec. 2016).

[5] Jim Richards and Ross Delston, "BankThink: The Corporate Transparency Act Is a Gift to Would-Be Money Launderers," American Banker, Feb. 11, 2022.

[6] *Id.*

((EU) 2018/843) provides for facilitating access to that information via interconnected registries.[7]

From the start, the ABA has opposed the CTA and its predecessors. In 2008 it stressed that "the regulation of those involved in the formation of business entities within the states and territories of the United States should remain a matter of state and territorial law and state sovereign prerogative, with a minimum of federal governmental regulation."

The problem with the ABA's position is that until 2019, the entity transparency legislative initiatives imagined that the U.S. states would be the sole or principal repositories of the information. Many states indicated that their reporting systems were not designed to collect the beneficial ownership information contemplated and that they lacked enforcement resources to go after delinquent and deficient reports. Hence, beginning in 2019, transparency proposals removed the primary responsibility for collecting beneficial ownership information from the states. The initiatives thereafter introduced the federal database for beneficial ownership now being implemented.[8]

Despite the states saying they are unable to administer the entity transparency proposals, the ABA has refused to update its stance. It repeats the fallacy that only states can regulate attorneys in the model rules of professional responsibility.

II. FinCEN's Advance Real Estate Notice

As mentioned, last December FinCEN issued an advance notice of proposed rulemaking to address its disquiet about the systemic money laundering vulnerabilities in the U.S. real estate sector — particularly the ease with which illicit actors can launder criminal proceeds by buying real estate. The easy purchase of real estate threatens U.S. national security and the integrity of the country's financial system. FinCEN issued the notice to seek initial public comment on questions that will help it consider and prepare proposed rules to address its concerns. It said it will likely initially focus on residential real estate, followed by commercial real estate and any other regulatory gaps that may exist.

FinCEN has solicited input to assist in preparing a proposed rule to impose nationwide recordkeeping and reporting requirements on some persons participating in transactions involving non-financed purchases of real estate. Until now, it has imposed specific transaction reporting requirements only on title insurance companies in the form of time-limited geographic targeting orders under 31 U.S.C. 5326(a). Those orders cover nine metropolitan areas, and all title companies operating in those areas must report all-cash transactions, which include monetary instruments, such as personal and business checks, and wire transfers. The reporting threshold is $300,000.

FinCEN and law enforcement agencies have evaluated reporting stemming from the real estate orders issued since 2016, finding that a substantial amount of the reported transactions involved a beneficial owner who was also the subject of a suspicious activity report.[9]

The advance notice solicits public comment on whether FinCEN should impose a similar, continuous, and expanded — that is, nationwide — reporting requirement through regulations (specifically under 31 U.S.C. section 5318(g)(1) and related program requirements under 31 CFR 5318(h)). FinCEN especially seeks input on the volume and type of money-laundering vulnerabilities associated with commercial and residential real estate and any unique factors or complexities regarding non-financed transactions in each.

FinCEN solicits comment on the potential scope of any regulations, especially:

- the persons who should be subject to the reporting;
- which types of real estate transactions should be subject to reporting;

[7] That directive amends (EU) 2015/849 on the prevention of the use of the financial system for money laundering or terrorist financing, as well as directives 2009/138/EC and 2013/36/EU (requiring that EU states ensure that information and data on express trusts and similar arrangements be stored in interconnected registries so that other members can access the information quickly).

[8] Robert W. Downes et al., "The Corporate Transparency Act — Preparing for the Federal Database of Beneficial Ownership Information," *Business Law Today*, Apr. 16, 2021.

[9] FinCEN, "Advisory to Financial Institutions and Real Estate Firms and Professionals," FIN-2017-A003 (Aug. 22, 2017).

- what information should be reported and kept;
- the geographic scope of any requirement; and
- the appropriate dollar-value threshold for reporting.

The notice asked for comments by February 6, or within 60 days of publication. On February 3 FinCEN said it would extend the comment period until February 21.

On March 4 the FATF announced that because of the importance to real estate professionals of preventing criminals from misusing the sector for money laundering or terrorist financing, as well as their poor understanding of the risks, it developed draft guidance on the risk-based implication of AML/CFT in real estate.[10] It published a report for public consultation and solicited input from all interested stakeholders before finalizing the guidance.

On February 7 ABA President Reginald Turner submitted comments to FinCEN, saying the association opposes:

> any proposed rules that would require lawyers who provide legal representation to clients in these transactions to disclose the identity and beneficial ownership of their clients or to report information about their clients' transactions . . ., preserving lawyer-client confidentiality is important for the rule of law, for protecting the rights of the client, and as a primary line of defense against money laundering and other illicit activities. We also continue to oppose any proposals that would regulate lawyers as financial institutions or nonfinancial trades or businesses under the BSA [Bank Secrecy Act] and subject them to the suspicious activity reporting, due diligence, independent audit, and other AML requirements of the BSA. Such requirements would seriously undermine lawyer-client confidentiality, discourage clients from consulting candidly with their lawyers, and thus undercut the legal profession's unique ability to prevent money laundering in the real estate sector and the special role lawyers play in defending against this and other illicit activities. In addition, those requirements would undermine the lawyer's ethical duty to keep confidential information relating to a client's representation; the attorney-client privilege, confidential lawyer-client relationship, and right to legal counsel; and the state supreme courts' primary and inherent authority to regulate the legal profession.

On February 10 the ABA Real Property, Trusts, and Estates Section submitted comments, telling FinCEN it takes the position that despite the CTA, an attorney providing legal advice to a client in a real estate transaction "is engaging in the practice of law, which should be regulated only by the state supreme courts that license them in connection with the delivery of those legal services."

Those comments repeat Turner's above-mentioned positions. They also assert that when dealing with funds in real estate transactions, attorneys conduct CDD under the ABA's 2010 good practices guidance for lawyers to detect and combat money laundering and terrorist financing. The comments also state that rules 1.1 and 1.2 of the Model Rules of Professional Conduct, together with ABA formal opinions 463 and 491, do not allow an attorney to ignore red flags about the funding source in a real estate transaction.

The ABA's position on the entity transparency rules and the role of the gatekeeper has changed. From 2008 to 2018, the association believed only secretaries of state should regulate entity transparency. But in 2018, when the states said they were unable to undertake that work and the leading bills gave the authority to FinCEN, the ABA said only state supreme courts could regulate that conduct.

Despite the ABA's comments, a client's identity and fee information generally are not privileged. When the law requires providing that information, such as in the Foreign Agents Registration Act, the Lobbying Disclosure Act, IRS Form 8300, "Report of Cash Payments Over $10,000 Received in a Trade or Business," and FinCEN 114 (Report of Foreign Bank Acts and

[10] FATF, Public Consultation Guidance for the Real Estate Sector (Mar. 2022). *See also* FATF, "Money Laundering and Terrorist Financing Through the Real Estate Sector" (June 29, 2007).

Financial Accounts), the government has established that those rules apply to attorneys.

III. Changes to Model Professional Rules

Attorneys are among the gatekeepers charged under the FATF standards with helping prevent money laundering. Because the U.S. Treasury Department does not categorize attorneys as financial institutions, they are not required to adhere to any of the AML/CFT requirements, such as "know your client," CDD, and suspicious activity reporting. Instead, relying to a large extent on the ABA model rules, state bars make the rules and supervise their implementation, compliance, and enforcement. Until now, the ABA has relied on Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing in the Model Rules.

Further, the ABA Ethics Committee issued a formal opinion (Opinion 463) concerning efforts to require U.S. attorneys to meet gatekeeper obligations. Addressing client due diligence activities in the context of the Model Rules of Professional Conduct, Opinion 463 offered additional guidance, calling it "prudent" for attorneys to undertake CDD "in appropriate circumstances to avoid facilitating illegal activity or being drawn unwittingly into a criminal activity."[11]

In December 2016, in its last full mutual evaluation review of the United States, the FATF gave the country a rating of noncompliant — the lowest rating possible — for gatekeepers. It said attorneys often have a role in creating, operating, or managing legal persons and buying or selling business entities. Attorneys serving as agents in the formation and administration of companies are not subject to AML requirements other than the Form 8300 filing and targeted financial sanctions obligations.

The 2016 U.S. mutual evaluation review recommended that designated nonfinancial businesses and professions, including the legal profession, be subject to the requirements of the U.S. Bank Secrecy and PATRIOT acts. That would require attorneys to be subject to the above-mentioned know your client, CDD, and suspicious activity report requirements. Hence, on December 15, 2021, the ABA Ethics Committee, while paying lip service to the FATF standards requiring CDD and the 2016 evaluation questioning the lack of enforceable obligations for the ABA ethics rules and the ABA Good Practices Guidance, still determined the black letter of the model rules of professional conduct do not need amending. Instead, the committee focused on potentially issuing additional comments to the existing rules.[12]

In 2020, in response to continued concerns about attorneys' CDD obligations, the ABA Ethics Committee released Opinion 491, interpreting ABA Model Rule 1.2(d). The opinion reiterates that in conducting activities that meet CDD requirements, attorneys' obligations arising from their "knowledge" under Model Rule 1.2(d) may be inferred from the circumstances. It observes that the rule requires that an attorney not engage, or assist a client, in conduct that she knows is criminal or fraudulent. The opinion also explains that Model Rule 1.1. might require an attorney to ask herself whether she has knowledge of red flags.[13]

Since 2017 the ABA Ethics Committee has rejected recommendations to adopt a black-letter rule imposing basic CDD obligations on attorneys. That rule would require attorneys to perform reasonable, proportional, risk-based due diligence on prospective clients and on some new legal matters brought by existing clients.[14]

Despite the ABA voluntary good guidance and opinions 463 and 491, FATF, Treasury, and other commentators urged the legal profession — meaning the ABA — to establish an enforceable CDD in the model rules. Advocates of the need for a black-letter rule cite the Paradise Papers, the Panama Papers, the Pandora Papers, a *60 Minutes*/Global Witness expose on significant AML violations by attorneys, and Treasury's National

[11] *See also* ABA Center for Professional Responsibility, "Discussion Draft of Possible Amendments to Model Rules of Professional Conduct Concerning Lawyers' Client Due Diligence Obligations" (Dec. 15, 2021).

[12] *Id*. at 5.

[13] For a critical review of Opinion 491, see Bruce Zagaris, "Opinion Underscores Need for Formal Rules on U.S. Lawyers' Duty to Avoid Aiding in Crime or Fraud," *Tax Notes Int'l*, July 20, 2020, p. 349.

[14] For background on the proposal, see Kevin L. Shepherd, "ABA Needs a New Model Legal Ethics Rule," Law360, Apr. 6, 2017.

Strategy for Combating Terrorist and Other Illicit Financing.[15] Those observers also have warned that the ABA's failure to act will result in increased federal legislation and regulation, analogous to CTA enactment and the FinCEN advance real estate notice — for example, the Establishing New Authorities for Businesses Laundering and Enabling Risks to Security Act (H.R. 5525) to impose AML/CFT regulations on attorneys and similar professional service providers.

Despite the recommendations on the need for enforceable — as opposed to voluntary — guidance, the ABA has proposed providing additional guidance only in the comments to model rule 1.0-1.2.[16]

The limit of the guidance is that it remains voluntary. State bars do not audit law firms. As a result, law firms have no incentive to follow the guidance, especially because it requires resources to prepare and implement. Plus, it arguably makes law firms adhering to it uncompetitive, especially because their prospective and existing clients might not like the inquiries accompanying the know your client and CDD obligations. Compliance and enforcement occur primarily if an event, such as a prosecution, complaint, or media report, calls attention to a potential violation of the model rules. As a result, the FATF mutual evaluation reviews in 2006 and 2016 found the combination of the ABA Good Practices Guidance and Formal Ethics Opinions ineffective.

IV. Analysis

The sanctions on Russian oligarchs have increased the pressure on financial institutions and designated nonfinancial businesses and professions, especially attorneys, to step up their AML/CFT due diligence work. On April 19 commissioners from the Independent Commission for the Reform of International Corporate Taxation (ICRICT) published an open letter to G-20 leaders, repeating their demands for a global asset registry to identify and track wealth linked to Russian millionaires and billionaires funding the war against Ukraine. The letter was sent ahead of the April 20 meeting of the G-20 finance ministers and central bank governors and presages the demands for public registries.[17]

Although the U.S. Treasury Department continues not to regulate attorneys, despite FATF requirements on gatekeepers and continuous FATF noncompliant ratings, that is not the case worldwide. On February 22 the EU issued a trainers' manual on AML/CFT rules for those who train at the EU level.

In assessing the potential continued use of the United States as a jurisdiction for foreign investment — especially investment driven by financial confidentiality — one must consider the countries' current and near-term position regarding financial confidentiality. In tax transparency, the United States continues to resist fully reciprocating in exchanging information with its intergovernmental agreement partners under the Foreign Account Tax Compliance Act. It also continues to refuse to join the OECD's common reporting standard. Those positions have not changed, even though Congress and the White House are now controlled by Democrats.

In July 2018 the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes downgraded the United States from its 2011 rankings in four areas.[18] On the availability of ownership and identity information, the United States went from largely to partially compliant, with the OECD saying that when beneficial ownership information must be maintained, U.S. procedures do not ensure ownership is adequate, accurate, or up to date. The United States also moved from compliant to largely compliant on the availability of banking information. Because of its failure to ratify any exchange of information agreements since 2010, including the 2010 protocol to the OECD Convention on Mutual Administrative Assistance in Tax Matters, the U.S. rating on exchange of information request mechanisms also went from compliant to largely compliant. The OECD also downgraded the quality and timeliness of U.S.

[15] *See* Zagaris, "Reports Point to Key Areas of Concern for Anti-Money-Laundering Efforts in the United States," *Tax Notes Int'l*, Aug. 3, 2020, p. 639.

[16] ABA discussion draft, *supra* note 11.

[17] *See* Sarah Paez, "ICRICT Calls on G-20 to Establish Global Asset Registry," *Tax Notes Today Int'l*, Apr. 20, 2022.

[18] *See* Stephanie Soong Johnston, "U.S. Must Step Up Action on Beneficial Ownership, OECD Says," *Tax Notes Int'l*, July 23, 2018, p. 424.

responses to tax information exchange requests from compliant to largely compliant.[19]

The CTA's enactment and implementation will likely be insufficient to remedy the downgrade by the OECD global forum.

In the next few years, more jurisdictions will implement public beneficial ownership registries.

In 2018 the EU introduced its fifth AML directive (2018/843/EU), which required EU states to establish publicly available beneficial ownership registries by January 2020. Under that directive, EU members were required to establish by March 2020 registries of beneficial ownership for trusts and similar legal arrangements that competent authorities and those with legitimate interests could access. However, the transposition of the directives into national law has been slow. On September 16, 2020, the European Commission reported (COM(2020) 560 final) a problem in transposing the directive, resulting from the different approaches to and concepts of trusts and similar arrangements between the common and civil law countries.

By December 2020, EU states were required to transpose the sixth AML directive (COM/2021/420 final) into domestic law.[20]

As of early 2021, 82 jurisdictions had implemented registration of beneficial ownership information, and Transparency International and other nongovernmental organizations are clamoring to make public registries the global standard.

Because it has yet to issue final regulations on entity transparency or regulations on protocols for access to and disclosure of beneficial ownership and to revise the existing CDD rule to align it with the proposed rule, the U.S. government will be unable to provide access to its restricted-use database of unverified and unverifiable beneficial ownership information until at least sometime in 2024.

Further, the pace at which FinCEN can complete the regulatory projects on beneficial ownership will depend on funding. The Anti-Money Laundering Act requires all kinds of other FinCEN studies and reports. FinCEN's ability to finish the beneficial ownership regulatory project and other tasks will depend on whether it receives a major budget increase. Even during a Democratic administration, Congress is struggling to provide sufficient funding.

Meanwhile, the private sector's — especially the ABA's — interests in the United States are likely to continue to oppose regulations that impose reporting obligations under the CTA, real estate regulations, or black-letter law CDD.

Looking to the short term, the United States is unlikely to quickly catch up with the tax transparency and AML/CFT standards.

Reading the tea leaves for beneficial ownership, AML/CFT, and tax transparency also requires predicting which party will control the U.S. Congress. Prognosticators believe it will be exceedingly challenging for Democrats to maintain control of both chambers of Congress and the executive branch.

As a result of domestic and global developments, the United States is likely to remain behind international AML/CFT standards in entity transparency and gatekeeper regulation. Thus, foreign investors — both legitimate and illegitimate — are likely to see the United States as a favorable place to invest. The losers include U.S. national security and efforts to bring the U.S. AML/CFT regime up to international standards, especially when a key pillar of U.S. national security against Russia, North Korea, Iran, and other so-called malign actors is strong compliance and enforcement. That is also crucial, given that the Biden administration has prioritized corruption-based AML/CFT as a core element of national security. ■

[19] For more details on the OECD report, see Zagaris, "International Tax Enforcement Cooperation in the Trump Administration," *Tax Notes Int'l*, Sept. 3, 2018, p. 1013.

[20] Sam Eastwood and Chris Roberts, "Beneficial Ownership Transparency: A Spotlight on International Beneficial Ownership Registration," Mayer Brown, Dec. 3, 2020.