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Newsletter

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# Notes From The Chair

*Deborah A. Cohn*[1]
*Paley, Rothman, Goldstein, Rosenberg, Eig and Cooper*

To combat money laundering and terrorist financing, the international community has issued various laws, regulations and guidance on international financial flows. U.S. residents, for example, have had to report on material overseas financial holdings[2] under the Bank Secrecy Act[3] since 1970 and in recent years have had to disclose significant personal information when opening financial accounts[4] and to file additional reports on material overseas financial holdings.[5]

Additional recent changes reflect the efforts of the international Financial Action Task Force (FATF)[6], established in 1989 to "set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system."[7] In 2010 FATF issued its Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing (Recommendations)[8] to combat these threats.

These Regulations may create serious conflicts for lawyers. They require a lawyer to file suspicious activities reports (SARs) with government agencies on potential or ongoing client activities that the lawyer suspects may involve money laundering or terrorist financing and, at the same time, they call for a ban on informing clients about these reports (the "no tipping-off" rule). These recommendations clearly conflict with the ABA's Model Rules of Professional Conduct and state professional ethics rules under which attorney-client confidentiality generally takes precedence over disclosure requirements. The U.K. has already adopted this aspect of the FATF recommendations, and lawyers there are filing significant numbers of SARs and complying with the no tipping-off requirements.

Although the U.S. has not yet enacted laws and regulations calling for SARs and imposing no tipping-off rules, these may not be far off. The U.S. continues to be viewed as a relatively easy country in which to launder funds, and Congress and the Administration have proposed measures to address this issue.

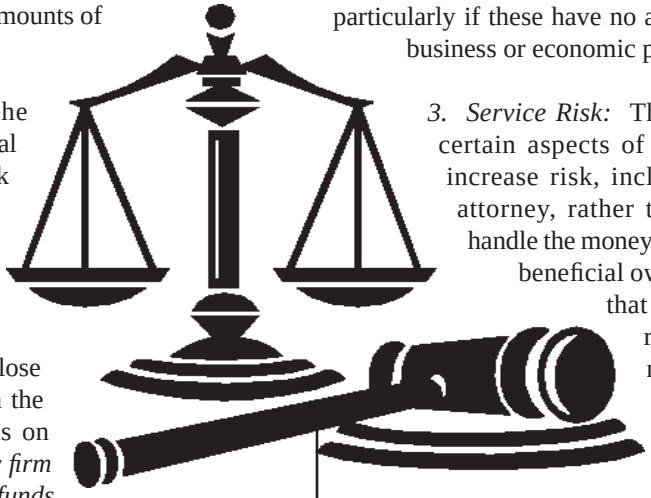
*(continued on page 2)*

## In This Issue

## Notes from the Chair. . .

*(continued from page 1)*

In 2011, Senator Levin (D-MI) introduced two acts,[9] each of which would designate "persons engaged in the business of forming new corporations, limited liability companies, partnerships, trusts or other legal entities" as financial institutions subject to anti-money laundering regulations unless the attorney or firm uses a paid formation agent to form the entity.[10] The exception would not protect trust and estate lawyers since they do not use formation agents in creating trusts. Lawyers preparing trusts or forming other entities for their clients would be required to undertake the scrupulous due diligence that banks and other financial institutions undertake before opening new financial accounts and to collect and report on massive amounts of information about their clients.



Similarly, in March 2012, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued a Notice of Proposed Rulemaking regarding Customer Due Diligence Requirements for Financial Institutions.[11] The proposal would require a law firm to disclose the identity of its clients when the firm creates financial accounts on behalf of clients, *including law firm trust accounts that hold client funds in trust for the firm's clients or that hold a client's advance payments of fees and expenses.* These initiatives clearly conflict with client confidentiality standards.

In October, 2008, before issuing its Recommendations, FATF issued separate guidance for lawyer due diligence when taking on and representing clients (FATF Guidance).[12] This guidance is based on the recognition that some clients and matters pose much greater risks of money laundering and terrorist financing than others and the principle that a lawyer's obligation should be to take prudent, proportional, risk-based steps to investigate the potential for money laundering or terrorist financing.

The FATF Guidance identifies three risk categories and calls for attorneys who identify potentially high risk clients to conduct enhanced due diligence and, if appropriate, to decline matters.

*1. Country Risk*: The FATF Guidance suggests that higher risk countries include those subject to sanctions, embargoes or similar measures; countries identified by credible sources as having significant levels of corruption or criminal activity; and countries known to support terrorist organizations.

*2. Client Risk*: The FATF Guidance identifies several categories of potentially high risk clients. These include, *inter alia*, politically exposed persons (PEPs) in foreign countries (*e.g.*, a former deputy Minister of the Interior in a country with a history of civil strife or missing persons); clients conducting their relationship or requesting services in unconventional circumstances (*e.g.*, offering to pay a premium for secrecy or speed, or requesting that cash wire-transferred from a foreign country be deposited in the firm's escrow account rather than in a bank account); and the use of legal structures making it difficult to identify the true beneficial owner or controlling interests (*e.g.*, use of nominees or layers of entities and trusts), particularly if these have no apparent legitimate legal, tax, business or economic purpose.

*3. Service Risk:* The FATF Guidance identifies certain aspects of potential matters that may increase risk, including: requesting that the attorney, rather than a financial institution, handle the money; concealment of the source or beneficial ownership of funds; requesting that a particular lawyer lacking relevant expertise handle the matter even after the lawyer refers the potential client to an attorney knowledgeable in the field; and rapidly transfering funds into or out of real estate with no apparent legal, tax or business need for the speed.

The ABA considered the FATF Guidance as too vague to assist lawyers in evaluating client and matter risks and, hence, as inadequate to forestall laws and regulations that would create a conflict between cooperating with efforts to block money laundering and terrorism financing and maintaining client confidentiality obligations. Hence, in 2010, it built on the three categories of risk identified by the FATF Guidance and adopted Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing (Good Practice Guidance).[13] The ABA Guidance calls for lawyers and law firms to develop systems to minimize the risks. These systems might include expanding client intake procedures (e.g., conflicts checks) to require an assessment of client and matter risks before a new client can be accepted. Firms may want to appoint a partner to evaluate difficult situations and a compliance officer to engage in web-based research to obtain additional information about potential clients that appear to present high risks. They may also want to establish internal controls that ensure that new

*(continued on page 3)*

## Notes from the Chair. . .

*(continued from page 2)*

client matters are not opened without evidence that the attorney has exercised due diligence in evaluating the risks posed by the client or matter.

How might a high risk situation present itself in your practice? Here are two fact patterns that have clear indicia of potential risk:

A potential client, Artemio Cruz, a Mexican national, contacts you. He wants you to prepare a trust for his children in the U.S with his wife, of Argentinian nationality, as trustee. He will fund it with part of an inheritance he just received from his grandfather's estate and will have the estate wire transfer $5,000,000 directly to your law firm's escrow account. He asks that you prepare a legal memorandum on tax issues and filing requirements involving a large gift by a foreign national to a trust with U.S. beneficiaries. He also requests referrals to accountants and a banker.

Another potential client, Abdul Hakim Khan, a Pakistani national with a green card, living in Chicago, says he made substantial profits in hedge funds and commodities trading, and now wants to retire in the Washington area. He had lived in D.C. as a child while his father was employed at the Embassy of Pakistan. He asks you, as his nominee, to set up an LLC or similar entity in Maryland. He wants you to help him purchase contiguous smaller parcels of undeveloped land in rural Frederick County over time so that the purchases do not inflate land prices. He hopes to create an idyllic escape from the bustle of Chicago. He says he loved hiking the Appalachian Trail as a child and thinks the farmland between Frederick and the Appalachian Trail will remind him of his childhood vacations. He understands that the county, like many rural areas, is conservative and, because he is clearly of foreign extraction, wants to maintain anonymity. He asks that you maintain utmost discretion in your purchases. He will wire transfer into your escrow account additional cash over time as you locate appropriate properties. He will pay you a 15% premium over your usual fees for prompt and discreet service each time he sends additional cash and you establish a new LLC.

What are the risk factors that might lead you to undertake additional due diligence? Does the client or someone involved in the transaction come from a country with a history of corruption, drug trafficking, political upheaval or terrorist financing? Does your client or someone involved in the transaction come from a family with a member who currently or previously held a high government position? Does the transaction involve substantial sums of cash being transferred by wire into your account rather than to a financial institution that has the ability and legal obligation to conduct significant client due diligence? Are you being asked to handle the money? Are you being asked to create trusts or business entities that might obscure the true owner or beneficiary? Does the transaction involve the purchase and sale of land (or tangibles such as cars or jewelry) that could be used to launder the cash? Are you being asked to maintain secrecy, serve as a nominee, or handle the transaction quickly? Are you being offered additional fees to maintain secrecy or work quickly?

Each of us needs to be sensitized to the need for enhanced client intake procedures to reduce the risk that we are inadvertently participating in money laundering or terrorist financing. We also need to be aware of the evolving legal framework, both in FATF and in the U.S., impacting our relations with our potential and existing clients and the potential pressures on client confidentiality.

Endnotes:

[1] The author thanks Duncan E. Osborne, President-Elect of the American College of Trust and Estate Counsel, of the firm Osborne, Helman, Knebel & Deleery, L.L.P., in Austin, Texas, for his generous support and guidance with respect to the issues discussed in this column.
[2] Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR reports).
[3] 31 U.S.C. 5311 *et seq.*
[4] USA Patriot Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001), PL 107-56, 115 STAT 272 (2001)
[5] IRS Form 8938 under the Foreign Account Tax Compliance Act (FATCA), 26 U.S.C. 6038D.
[6] FATF's members are the G-7 nations (U.S., U.K. Germany, France, Italy, Japan and Canada), the European Commission and eight other countries.
[7] www.fatf-gafi.org/pages/aboutus/
[8] www.fatf-gafi.org/topics/fatfrecommendations/
[9] The Stop Tax Haven Abuse Act (S.1346) and the Cut Unjustified Tax Loopholes Act (S.2075).
[10] Under the Bank Secrecy Act, as modified by the USA PATRIOT Act, 31 U.S.C. §§ 5311-5332 (2001).
[11] 77 Fed. Reg. 13047 (March 5, 2012).
[12] For a detailed analysis of the FATF Lawyer Guidance, *see* Kevin L. Shepherd, "Guardians at the Gate: The Gatekeeper Initiative and the Risk-Based Approach for Transactional Layers," *Real Property Trust and Estate Law Journal* (Winter 2009).
[13] Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing, www.americanbar.org.