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Anti-Money Laundering Trends in the Equipment Leasing and Finance Industry

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Recent changes to anti-money laundering (AML) laws are likely to have a profound effect on the business of equipment leasing and finance. The new enhanced customer due diligence (CDD) rule promulgated by the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) will change both legal requirements and market expectations related to identifying the beneficial owners of certain counterparties. Specialty finance companies in the equipment leasing and finance industry should:

- **Develop risk-based policies and procedures to identify the beneficial owners of counterparties;**
- **Consider utilizing "screening" services to screen counterparties against economic sanctions lists and other databases; and**
- **Develop form contractual language to gain comfort that counterparties are not involved in money laundering or are subject to economic sanctions.**

The Enhanced Customer Due Diligence Rule

In 2016, FinCEN announced its new enhanced CDD rule (the Rule). Pursuant to the Rule, which becomes effective on May 11, 2018, certain "covered financial institutions" will be required to collect information regarding the identity of 25 percent or more beneficial owners and certain "controlling" persons of new account holders. While many specialty finance companies in the equipment leasing and finance industry will not be covered financial institutions directly subject to the Rule, as a practical matter, banks that finance or hold accounts for specialty finance companies will likely require such specialty finance companies to implement enhanced CDD procedures. In order to meet these market expectations, specialty finance companies should:

Develop policies and procedures to identify beneficial owners and controlling persons of counterparties;

Consider utilizing "screening" services; and

Develop strong form contractual language to gain comfort that counterparties are not involved in money laundering.

There is an express exemption from the Rule with respect to accounts established to finance the purchase or lease of equipment and for which payments are remitted directly by the financial institution to the vendor or lessor of the equipment. This exemption would be applicable if the specialty finance company pays the third-party vendor directly, but would not be applicable if payment is made to the lessee in a sale-leaseback transaction. The exemption would also be applicable in the context of a syndication where the bank partner remits funds directly to the lessor to finance the lessor's purchase of the leased equipment. The exemption is not available if there is the possibility of a cash refund which could occur if payment is made to the third-party vendor with the understanding that a portion of the payment is to be paid to the lessee as a refund of a deposit or progress payment. If there is the possibility of such a cash refund, the specialty finance company must

identify and verify the identity of the beneficial owner(s) either at the initial remittance or at the time such refund occurs.

Enhanced Customer Due Diligence Policies and Procedures

The first step in complying with market norms in identifying beneficial owners and controlling persons of counterparties is developing policies and procedures to collect the necessary information. Such policies and procedures would provide for the collection of the following documentation:

- Articles of incorporation and bylaws (or equivalent organizational documents) of the counterparty;
- A list of officers and directors of the counterparty;
- A questionnaire designed to identify major shareholders or members (especially those that own 25 percent or more of the counterparty);
- A search of Google, LexisNexis, or other database for news stories related to the counterparty; and
- An executed "Certification Regarding Beneficial Owners of Legal Entity Customers" form provided by FinCEN or a substantially similar form.

Additionally, such policies and procedures would be tailored to the counterparty on a risk basis with additional documentation required for counterparties located in high-risk jurisdictions (e.g., the Middle East) or in high-risk industries (e.g., natural resources extraction).

Transaction Screening

In addition to the AML requirements discussed above, the Department of the Treasury's Office of Foreign Assets Control (OFAC) prohibits specialty finance companies and other U.S. persons from doing business with certain sanctioned individuals and entities. Many banks and payment processors engage in real-time transaction screening of all parties to a transaction. Such screening generally involves electronically matching a customer name against the list of OFAC-sanctioned persons and entities and other lists of persons and entities that present a high-risk of money laundering.

Equipment leasing and lending do not generally present risks that necessitate real-time screening. However, specialty finance companies should consider screening counterparties at the closing of a transaction and, for certain high-risk counterparties, upon the disbursement of any funds to the counterparty. Per industry best practices, the results of such screenings should be documented and retained for a five-year period.

To be effective, the specialty finance company should subject each of the following persons or entities identified in the enhanced CDD process to screening:

- The counterparty;
- Directors of the counterparty;
- Officers of the counterparty;
- Owners who beneficially own 25 percent or more of the equity interest in the counterparty; and
- Any other person who the specialty finance company has reason to know plays a significant role in the operations or management of the counterparty.

Contractual Protections

While only covered financial institutions have affirmative legal enhanced CDD and AML program requirements, all actors are prohibited from engaging in money laundering. In order to demonstrate that it did not know or have reason to know that a counterparty is engaged in money laundering, a specialty finance company should insist on:

- A representation that the counterparty does not engage in money laundering;

- A representation that the counterparty is in compliance with the Bank Secrecy Act, PATRIOT Act, and other U.S. AML laws;
- A representation that neither the counterparty nor any of its directors, officers, employees, or agents is subject to sanctions by a government agency;
- A representation that the counterparty has provided all necessary documentation or information needed by the specialty finance company to identify beneficial owners and controlling persons; and
- A covenant not to use the proceeds of a financing to engage in money laundering or any activity in violation of economic sanctions.

While such contractual language will not necessarily fulfill all of a specialty finance company's AML obligations, it will provide a degree of comfort that the counterparty does not engage in money laundering.

For any questions regarding the material contained in this update or other regulatory and compliance matters, including providing diligence, screening, and contract review services, please contact Taylor Tipton or a member of Baker Donelson's Government Enforcement and Investigations Group.