

Financial Institutions Advisory & Financial Regulatory Group | July 23, 2009

## FinCEN Seeks Input to Help Shape Future Anti-Money Laundering Program Requirements for Non-Bank Residential Mortgage Lenders and Originators

On July 15, 2009, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") issued an advance notice of proposed rulemaking (the "Notice")<sup>1</sup> to solicit public comment on a number of questions relating to the possible application of anti-money laundering ("AML") program and suspicious activity report ("SAR") regulations to non-bank residential mortgage lenders and originators. The Notice indicates that these institutions will likely be the subject of a future rulemaking that would subject them to AML requirements analogous to those that already apply to federally regulated depository institutions and certain other types of financial institutions. FinCEN issued the Notice in connection with a renewed commitment by the U.S. federal government to combat mortgage fraud related crimes.

### Overview

With the issuance of the Notice, FinCEN has put the mortgage finance industry on notice that non-bank residential mortgage lenders and originators will likely be added to the list of financial institutions required to adopt an AML program. Underlying this action is a concern that non-bank residential mortgage lenders have been particularly vulnerable to financial crime and money laundering in recent years.

**New regulations requiring non-bank residential mortgage lenders and originators to adopt an AML program would be expected to complement both an ongoing governmental effort – involving several agencies of the U.S. federal government as well as state officials –**

**targeting foreclosure rescue scams and loan modification fraud as well as requirements of the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 ("S.A.F.E. Act").<sup>2</sup>**

The Notice specifically seeks input with respect to the following six overarching questions in order to help shape future regulations in this area:

<sup>2</sup> Information regarding the multi-agency initiative targeting foreclosure rescue scams and loan modification fraud is available at <http://www.ustreas.gov/press/releases/tq83.htm>

The S.A.F.E. Act (Title V of the Housing and Economic Recovery Act of 2008) requires the development of a nationwide licensing system and registry for certain mortgage professionals. According to FinCEN, as mortgage companies implement systems and procedures to comply with the S.A.F.E. Act, there will be opportunities for them to review and enhance their educational and training programs to ensure that employees are able to identify and appropriately deal with fraud, money laundering and other financial crimes. The S.A.F.E. Act is codified at 12 USC Section 5101, et. seq.

<sup>1</sup> A copy of the Notice, which was published in the Federal Register on July 21, 2009, is available at: [http://www.fincen.gov/statutes\\_regs/frn/pdf/ANPRM.pdf](http://www.fincen.gov/statutes_regs/frn/pdf/ANPRM.pdf)

- What are the money laundering risks in the non-bank residential mortgage finance sector;
- Should FinCEN pursue an incremental approach to regulation of loan and finance companies that focuses first on persons engaged in non-bank residential mortgage lending or origination;
- How should persons engaged in non-bank residential mortgage lending or origination be defined;
- How should the AML requirements for persons engaged in non-bank residential mortgage lending or origination be structured;
- Should FinCEN require persons engaged in non-bank residential mortgage lending or origination to file SARs or comply with any other Bank Secrecy Act (“BSA”) requirements; and
- Should any persons or transactions be exempted from coverage of AML or SAR regulations?

According to the Director of FinCEN, broad public input through the comment process will aid policymakers seeking to develop an appropriate regulatory framework for the industry sector.

## Background – The Bank Secrecy Act

The Bank Secrecy Act (“BSA”)<sup>3</sup> authorizes FinCEN to require financial institutions to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, or regulatory investigations, including counterterrorism activities. The USA PATRIOT Act of 2001 amended the BSA to require certain financial institutions to establish an AML program that includes: (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.<sup>4</sup>

<sup>3</sup> The Bank Secrecy Act (otherwise known as the Financial Recordkeeping and Currency and Foreign Transactions Reporting Act of 1970) is codified at 31 USC Sections 5311-5332 and 12 USC Sections 1951-1959.

<sup>4</sup> 31 USC Section 5318(h).

Though many categories of financial institutions such as banks and broker dealers are already required to establish an AML program, FinCEN deferred application of AML program requirements to “loan or finance companies” and “persons involved in real estate closings and settlements” – each a “financial institution” for purposes of the BSA. The purpose of the temporary exemption was to provide FinCEN with additional time to consider the extent to which AML requirements should be applied to these institutions.

## Requested Input on Money Laundering Risks in the Non-Bank Residential Mortgage Finance Sector

FinCEN uses the term “money laundering” to refer to the process by which funds with an illicit origin are converted into funds with a plausibly legitimate origin. Despite the relative illiquidity of most real estate assets, research in the area suggests that money launderers have used residential mortgage transactions to disguise the proceeds of a crime.<sup>5</sup>

FinCEN is seeking comment on the following issues in order to achieve a better understanding of the money laundering risks of the non-bank residential mortgage sector:

- Experience of the residential real estate lending sector with money laundering and fraud schemes;
- The existence of any safeguards in the industry to guard against these crimes;
- The impact that compliance with AML program and SAR reporting requirements may have on business operations; and
- Any additional steps that may be necessary to protect the industry from abuse by money

<sup>5</sup> Analysis of SARs filed in recent years also indicate that non-bank mortgage lenders and originators initiated many of the mortgages associated with SARs. See The FinCEN Report – Mortgage Loan Fraud Connections with Other Financial Crimes (March 2009) available at: [http://www.fincen.gov/news\\_room/rp/files/mortgage\\_fraud.pdf](http://www.fincen.gov/news_room/rp/files/mortgage_fraud.pdf)

launderers, including those who finance terrorist activity.

## Requested Input on the Appropriate Categories of Entities to Become Subject to AML Requirements

FinCEN is legally authorized to require any business entity that makes loans or finances purchases (including, e.g., commercial real estate finance businesses and other types of non-bank consumer and commercial finance businesses) to comply with the AML program requirements of the BSA. According to the Notice, however, FinCEN is considering adopting an “incremental approach” that would focus first only on those business entities that are primarily engaged in residential mortgage lending or origination.

In order to effectively determine the appropriate reach of a future regulation, FinCEN is seeking comment on the following:

- Which participants involved in non-bank residential mortgage finance are in a position where they can effectively identify and guard against financial crime and money laundering in the transactions they conduct;
- The extent to which various participants have access to information regarding the nature and purpose of the transactions at issue and the importance of the participants' involvement to successful completion of the transactions; and
- Whether FinCEN should adopt a definition of “non-bank mortgage lender or originator” that would be similar to the definition of “loan originator” in the S.A.F.E. Act.<sup>6</sup>

<sup>6</sup> For purposes of the S.A.F.E. Act, the term “loan originator” refers to individuals who take applications for residential mortgage loan transactions, including employees of mortgage bankers and brokers, as well as loan officers of banks and their subsidiaries.

## Requested Input on the Structure of AML Requirements

In applying the AML program requirements to non-bank mortgage lenders, FinCEN intends to consider the extent to which (1) the standards for AML programs are commensurate with the size, location, and activities of such lenders, and (2) AML programs will complement the anti-fraud and general compliance programs that non-bank residential mortgage lenders and originators have already established to comply with other applicable law. At present, FinCEN is considering proposing SAR reporting,<sup>7</sup> as well as certain currency transaction reporting and recordkeeping requirements for non-bank residential mortgage lenders and originators. In order to help determine the structure of future AML requirements, FinCEN is seeking comment on the following:

- The types of programs and practices that persons engaged in non-bank residential mortgage lending or origination have in place to prevent mortgage fraud and other illegal activities;
- Any particular concerns smaller businesses may have regarding the implementation of an AML program;
- Any factors FinCEN should consider in structuring new requirements, exceptions, and differences from established regulations; and

<sup>7</sup> As a general matter, a financial institution is required to file a SAR when it knows, suspects or has reason to suspect that a transaction of \$5,000 or more: (i) involves proceeds of illegal activity, or is intended to hide funds or assets derived from illegal activity, (ii) is designed to evade BSA regulations, or (iii) has no business or apparent lawful purpose or is not the sort in which the customer would normally be expected to engage, and the institution knows of no reasonable explanation for the transaction after examining available facts. Certain aspects of the filing requirements may differ depending on the type of financial institution involved.

- Estimates of volumes of transactions that might be subject to particular reporting or recordkeeping requirements.

## Requested Input on Possible Regulatory Exemptions and Other Issues

FinCEN is soliciting comment on whether there should be regulatory exemptions for any category of persons engaged in non-bank residential mortgage lending or origination, or any category of transactions conducted by such persons. Exemptions may be justified where the risk of money laundering is sufficiently small for the category of persons (or transactions) that a proposed rule could be crafted to exempt the categories, while also providing adequate protection for the industry from the risks of money laundering.

FinCEN has also requested public input on the following:

- Estimates and financial projections on the likely costs of complying with AML program and SAR reporting regulations by specific types of non-bank residential mortgage lenders and originators;
- The impact of any such regulatory requirements on industry profitability, growth and business practices;
- The impact of these requirements on consumers seeking to obtain residential mortgages;

- The effectiveness of examining for and enforcing compliance with these requirements; and
- The advisability of establishing some minimum transaction threshold value or annual volume threshold below which some or all of these requirements would not apply.

## Going Forward

FinCEN is hopeful that public comments provided in response to the Notice will aid FinCEN as it undertakes to define the contours of future regulations applying AML program and SAR filing requirements to non-bank residential mortgage lenders and originators. The impact of the proposed extension of AML program requirements to these institutions should become increasingly clear as the rulemaking process proceeds and FinCEN further clarifies the scope and nature of the new requirements – including, in terms of customer due diligence responsibilities and AML-compliance program and infrastructure expectations.

Comments on the Notice are due by August 20, 2009.<sup>8</sup> After the comments have been analyzed, a proposed final rule will likely be issued followed by an additional round of comments and then a final rule. We will continue to monitor and report on developments in this area.

<sup>8</sup> Comments may be submitted online through the Federal E-rulemaking Portal located at: <http://www.regulations.gov>.

The Regulatory Identification Number for this matter is 1406-AB02 and the Docket Number is TREAS-FinCen-2009-0003.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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