



# AMERICAN BAR ASSOCIATION

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## **STATEMENT OF KEVIN L. SHEPHERD**

**Member, Task Force on Gatekeeper Regulation and the  
Profession**

**On behalf of the  
AMERICAN BAR ASSOCIATION**

**Before the  
Senate Committee on Homeland Security  
and Governmental Affairs**

**CONCERNING S. 569, “INCORPORATION  
TRANSPARENCY AND LAW ENFORCEMENT  
ASSISTANCE ACT”**

**November 5, 2009**

Mr. Chairman and Members of the Committee:

My name is Kevin L. Shepherd, and I am a member of the American Bar Association's ("ABA") Task Force on Gatekeeper Regulation and the Profession and a former chair of the ABA Section of Real Property, Trust and Estate Law. I am the co-chair of the Real Estate Practice Group at Venable LLP and President of the American College of Real Estate Lawyers. I appreciate the opportunity to present the ABA's views on S. 569, the "Incorporation Transparency and Law Enforcement Assistance Act." I am appearing on behalf of the ABA, and my testimony here today is limited to that legislation.

The ABA supports all reasonable and necessary domestic and international efforts to combat money laundering, tax evasion, and terrorist financing activity. Indeed, the ABA has collaboratively worked with the Financial Action Task Force ("FATF") and the U.S. Department of Treasury in developing risk-based guidance for legal professionals and is presently working to implement this guidance by developing good practices guidance for U.S. lawyers. These efforts underscore the ABA's unwavering commitment to work with the national and international communities in combating money laundering, tax evasion, and terrorist financing activity. The ABA, however, opposes the proposed regulatory approach set forth in S. 569 and any other legislation that would unnecessarily regulate state incorporation practices and impose government-mandated suspicious activity reporting ("SAR") on the legal profession. The ABA's opposition is grounded in three fundamental aspects of the proposed legislation.

First, S. 569 would essentially federalize state incorporation practices, meaning that states would be required to obtain, keep current, and make available to law

enforcement authorities “beneficial ownership” information on corporations and limited liability companies. In our view, the imposition of a federal regulatory regime focused on beneficial ownership information is not workable, would be extremely costly, would impose onerous burdens on state authorities and legitimate businesses, would run counter to formation practices of major countries (including Canada, Mexico, Japan, and China), and will not achieve the laudable goal of assisting federal law enforcement authorities with pursuing and prosecuting criminal activity. For instance, obligating state agencies to collect beneficial ownership information would involve significant and expensive hardware and software changes, including the creation of a parallel record keeping system consisting of public and non-public information. These impediments, coupled with an unwieldy definition of beneficial ownership and the bill’s focus on only a limited number of entities, would sow confusion into the formation process that would not enhance law enforcement’s goals.

Second, S. 569 would create a new class of “financial institutions,” known as formation agents, that would be subject to enhanced anti-money laundering (“AML”) requirements. Because lawyers assist clients in forming corporations and limited liability companies, the designation of formation agents as financial institutions subject to additional AML requirements threatens to sweep in U.S. lawyers and treat them as the functional equivalents of banks.

Third, S. 569 could potentially impose SAR requirements on the legal profession, meaning that lawyers would have to report to governmental authorities a suspicion that their clients are engaging in money laundering or terrorist financing activity. These requirements are in direct conflict with ethical obligations of confidentiality, the attorney-

client privilege, and fundamental aspects of the attorney-client relationship. They could also undermine the rule of law by dissuading clients from seeking legal counsel from lawyers on proposed conduct.

The ABA believes that a more effective and workable solution would involve collective and collaborative action of state government representatives, working with U.S. Department of Treasury and U.S. Department of Justice, as described below. While the ABA has not taken a position on any such proposal since we favor a state-based approach, we suggest that Congress give this solution an opportunity to be implemented and assessed for its effectiveness before imposing unprecedented federal regulation of state incorporation practices. The ABA believes that the effort to designate formation agents as “financial institutions” is premature and does not take adequate account of the implications for the legal profession. In light of other initiatives that the legal profession is undertaking on a voluntary basis, such as the development of the good practices guidance noted above, the ABA believes the imposition of AML requirements on the legal profession is unnecessary.

### **Beneficial Ownership Information**

The Permanent Subcommittee on Investigations (“PSI”), through a series of hearings and investigations into tax abuse havens, and FATF’s Mutual Evaluation of the United States (“Mutual Evaluation”), separately have expressed strong concerns that the U.S. company formation process is at risk for exploitation by money launderers, tax evaders, and terrorist financiers. Without trying to examine the strength and depth of that concern, the ABA (and others) recognize that improvements are needed in the company

formation process with a view to having more visibility on those involved in forming non-public entities in the 50 states and the District of Columbia.

The ABA, however, believes that federal legislation is premature and is neither necessary nor the most effective means for addressing the concerns prompting S. 569. The National Conference of Commissioners on Uniform State Laws (“NCCUSL”) adopted in July 2009 the “Uniform Law Enforcement Access to Entity Information Act.” This suggested legislation was developed through the collective efforts of NCCUSL, members of the ABA, and others and is intended both to balance the interests of the various stakeholders and to address effectively the risks identified by the PSI and FATF without imposing undue burdens on state authorities and legitimate businesses. Congress should give these and other efforts a fair chance to work, especially at this time when the U.S. financial system and the domestic economy are under severe stress and the economic recovery remains fragile.

The PSI has expressed concerns that the U.S. is not in compliance with FATF Recommendation 33, which has prompted, in part, the introduction of S. 569. FATF Recommendation 33 states in pertinent part that countries should “ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.” According to law enforcement authorities, the U.S.’s non-compliance with Recommendation 33 hampers their ability in many instances to locate the “beneficial owners” of privately held corporations and limited liability companies. As a result, these authorities contend that money laundering, tax evasion, and terrorist financing

investigations can be difficult to resolve and the U.S. financial sector is at heightened risk for abuse.

The ABA believes that effective state laws can obviate the need for federal regulation of business entities while meeting the requirements of FATF Recommendation 33. It also appears to me that the approach taken by the Uniform Commissioners is consistent with the mechanisms for compliance identified in the FATF Report: *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations* (February 2008). See FATF, *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations* (February 2008), available at <http://www.oecd.org/dataoecd/16/54/40339628.pdf>.

It is noteworthy that the United Kingdom studied the merit of a system that would require the up-front disclosure of beneficial ownership. According to the 2007 Mutual Evaluation Report prepared by FATF for the United Kingdom, the UK authorities concluded that there were significant disadvantages and no clear benefits to adopting such a system, particularly when taking into account the costs of introducing such measures. These authorities concluded that the disclosure of beneficial ownership information would add no information of benefit to the register of members and that those engaged in criminal activities would not provide true information about the beneficial owners. Another reason was that disclosure would result in misleading information being included in the register. According to the UK Mutual Evaluation report, “beneficial ownership is, as a matter of law, impossible to define precisely [and]

any information requirement designed to require by law disclosure would have to be complex and detailed. Many ordinary, innocent shareholders would be unable to understand or comply with it.” See FATF, *Third Mutual Evaluation Report Anti-Money Laundering and Combating the Financing of Terrorism, The United Kingdom of Great Britain and Northern Ireland* (June 29, 2007), at ¶1132 (p. 234), available at <http://www.fatf-gafi.org/dataoecd/55/29/39064399.pdf>.

The ABA, during its August 2008 annual meeting, adopted Resolution 300 supporting the efforts of the states to assume responsibility for a more effective incorporation regime that is supportive of U.S. law enforcement needs, and noted that absent effective state law action, the case for federal legislation would be more compelling. NCCUSL, with participation from the ABA Business Law Section’s Committee on Corporate Laws, the National Association of Secretaries of State, the National Conference of State Legislatures, the International Association of Commercial Administrators, the Association of Registered Agents, and the National Public Records Research Association have developed a model state law. The model law would require, among other things, an incorporator to identify an individual within the U.S. who could provide law enforcement with the necessary information identifying the record owners and key officers of non-publicly traded entities formed under state law. The model law would enhance record-keeping requirements for covered businesses by requiring those businesses to maintain current and accurate records on record owners and managers, and on the individuals responsible for maintaining those records, and by assuring that this information is accessible by law enforcement officials. It would include penalties for

failing to abide by the requirements for identifying a responsible records contact, as well as failure to comply with a request for information.

For these reasons, S. 569 is ill-designed to achieve law enforcement's goals and runs the very real risk of imposing unreasonable burdens on state authorities and legitimate businesses. The ABA will continue its efforts to work closely with the various stakeholders in developing an effective, workable, and balanced state-based solution meeting the requirements of FATF Recommendation 33.

### **Lawyers as Financial Institutions**

Section 4 of S. 569 would establish a new class of "financial institutions" under U.S. AML laws that would cover "any person who, for compensation, acts on behalf of another person to assist in the formation of a corporation or limited liability company" (i.e., formation agents). These formation agents would then be required to adopt certain AML compliance mechanisms, much like U.S. banks have done, to detect possible money laundering and terrorist financing activities in the formation of corporations and limited liability companies. These requirements would include the following four elements: the development of internal policies, procedures, and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs.

Although not explicit on its face, the definition of "formation agents" in S. 569 would appear to include lawyers (and many others) involved in the formation of corporations and limited liability companies. This legislation would thus impose federal regulation on the legal profession for AML purposes, and treat lawyers as if they were banks. The ABA believes such treatment is inappropriate, nor does it make sense given



the obvious distinctions between large financial institutions, the resources they have at their disposal, and the function they play in handling money transactions, as compared to sole practitioners and small and medium firms – which make up the vast majority of the U.S. legal profession.

### **Suspicious Activity Reporting**

Designating new formation agents in this manner runs the substantial risk of imposing SAR obligations on lawyers. Pursuant to S. 569, the Treasury Department would have the ability to impose SAR obligations on lawyers. The ABA has strongly objected to making lawyers subject to the SAR obligation. Starting in 2003 with the passage of ABA Resolution 104 and reiterated in 2008 with the passage of ABA Resolution 300, the ABA has consistently expressed its concerns with, and objections to, imposing government-mandated reporting obligations on lawyers vis-à-vis their clients based on “suspicion”; imposing an obligation on lawyers to not inform clients of any such report if provided to the government (the so-called “no tipping off” rule); and imposing criminal penalties on lawyers if a SAR is not filed.

The ABA has registered these objections with representatives of the Department of Justice, the Department of Treasury, and the FATF, and the concerns underlying the ABA position are shared by legal professionals in many jurisdictions around the world, and led to litigation in Canada successfully challenging the imposition of such requirements on Canadian lawyers. Tellingly, FATF’s recently adopted risk based guidance for legal professionals specifically does not impose the SAR (referred to within FATF as “suspicious transaction reporting”) obligation on lawyers.

The attached Resolutions and accompanying reports detail these objections, but they center on the most fundamental core principles of the legal profession. Government-mandated SAR requirements would, among other untoward consequences, erode the attorney-client privilege that is a bedrock of the U.S. judicial system and effective counseling of clients on legal compliance. The SAR requirement would conflict with ethical obligations of lawyers under various state law rules to maintain client confidentiality. It would also create inherent conflicts between lawyers and their clients as lawyers would be acting as informants vis-à-vis their clients, be precluded from informing the client of the filing of a SAR, and elevate the lawyer's own interests over the client to avoid criminal liability for failure to report. A SAR requirement would also alter the attorney-client relationship, as lawyers would no longer be acting independent of the state and in the best interests of their clients.

There are also practical concerns with any SAR requirement, including the fact that no basis exists to believe that imposing this type of requirement will materially add to the quality of information the federal government already receives from tens of thousands of such reports received annually from financial institutions. As regulators in the United Kingdom have discovered, the legal profession routinely files SARs defensively in an abundance of caution so as not to run afoul of the reporting requirements. This type of defensive filing activity does nothing to enhance the fight against money laundering and terrorist financing.

#### **ABA's Engagement with the FATF**

The ABA has been working collaboratively with legal professionals throughout the world, FATF, and the Treasury Department to develop risk-based guidance on client

due diligence (“CDD”) for legal professionals, so as to enhance the ability of legal professionals to identify and avoid illicit money laundering and terrorist financing activities. FATF has been actively collaborating with specially designated non-financial businesses and professions, including lawyers, to produce voluntary, risk-based guidance for the legal profession to ensure that adequate CDD is performed at the outset and during the course of a client representation, so as to further minimize the risk that lawyers would be used by unscrupulous clients to launder illegally-obtained money. The ABA and members of other U.S. specialty bar associations, along with counterparts in the United Kingdom and elsewhere, participated extensively in this effort, attended numerous meetings with FATF officials, and assisted in the preparation of the guidance. The proposal for legal professionals was released by the FATF on October 28, 2008. This was a major achievement for the FATF and resulted directly from the active and extensive participation of the U.S. legal profession in this effort.

Education of U.S. lawyers regarding anti-money laundering and counter-terrorist financing compliance is an important cornerstone of an effective AML compliance program. The ABA, as well as members of specialty bar associations, continues to be active in this educational area. Through the efforts of members of the ABA Gatekeeper Task Force, as well as others in the ABA, the American College of Real Estate Lawyers, the American College of Mortgage Attorneys, and the American College of Trust & Estate Counsel, and other professional organizations in the United States, additional voluntary CDD guidance is being prepared in collaboration with members of the Treasury Department. On a personal note, I have written extensively on this topic in an effort to educate the U.S. legal profession on this topic.

Combating money laundering, tax evasion, and terrorist financing activity while minimizing the impact on our economy and state regulators are critical objectives. The ABA, together with other private and government sector groups, has expended a considerable amount of resources – and has made great headway – in developing an effective solution to the identified problem. We continue to support collaborative state efforts and oppose premature federal legislation. We look forward to working with you on developing a comprehensive solution that addresses the mutual objectives of all concerned.

Thank you for the opportunity to appear before you today to present the views of the ABA on S. 569.

I would be happy to answer any questions you may have.