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Practical Compliance

M&M Consulting, LLC Compliance Group

Jay Friedland
(207) 650-4665
jaybanker@mandm.consulting

Edward Bambauer
(774) 275-7017
ebambauer@mandm.consulting

Daniel Capozzi
(781) 507-4579
dcapozzi@mandm.consulting

Jessica Coulombe
(774) 218-1004
jcoulombe@mandm.consulting

Steve D'Arrigo
(207) 400-5121
sdarrigo@mandm.consulting

Jeff Hubbard
(603) 440-3702
jhubbard@mandm.consulting

Kevin Hughes
(603) 339-7088
khughes@mandm.consulting

Deanne Kiilsgaard
(207) 929-0757
dkiilsgaard@mandm.consulting

Eddie Milhorn
(207)653-3015
emilhorn@mandm.consulting

Bruce Ray
(207) 712-2587
bray@mandm.consulting

Marcy Rodrigue
(207) 240-6527
mrodrigue@mandm.consulting

Dean Stockford
(207) 458-8559
dstockford@mandm.consulting

Jeffrey Sullivan
(413) 478-4299
jsullivan@mandm.consulting

Roy Thattacherry
(978)-646-7149
rthattacherry@mandm.consulting

Deborah Yates
(207) 677-6354
dyates@mandm.consulting

In This Issue

Customer Due Diligence

On May 11, 2016, the Financial Crimes Enforcement Network (FinCEN) issued a Final Rule under the Bank Secrecy Act which clarifies and strengthens customer due diligence (CDD) requirements for covered financial institutions (covered institutions). The Final Rule defines these covered institutions as banks *(with respect to which, credit unions are included in this definition)*, broker-dealers, mutual funds, and futures commission merchants and introducing brokers in commodities. The Final Rule now requires covered institutions to maintain BSA/AML programs that formally satisfy all four AML pillars, and adds a new "fifth pillar"; to develop customer risk profiles, and monitor suspicious activity on an ongoing basis, including maintaining and updating customer information and beneficial ownership. The CDD Final Rule becomes effective 60 days after publication (July 11, 2016) and compliance with the Final Rule is required by May 11, 2018.

The Four Core Elements of CDD

FinCEN identifies the following as the four core elements of an effective CDD program:

1. Identifying and verifying the identity of customers;
2. Identifying and verifying the identity of beneficial owners of legal entity customers (i.e., the natural persons who own or control legal entities);
3. Understanding the nature and purpose of customer relationships; and
4. Conducting ongoing monitoring.

These four elements constitute the minimum standard of CDD, and are likely already part of most financial institutions' BSA/AML programs. Up to now, only the 1st element (customer identification and verification) has been explicitly required for AML programs. The Final Rule provides explicit requirements for the three remaining elements of customer due diligence. As the 3rd and 4th elements (understanding the nature of customer relationships and ongoing monitoring) have been implicitly required for covered institutions to comply with suspicious activity reporting requirements, the major impact of the Final Rule is the new requirement that covered institutions identify and verify the beneficial owners of legal entity customers. The AML program rules are also being amended by the Final Rule in order to include the 3rd and 4th elements as explicit requirements. The Final Rule has basically transformed the four core elements of CDD into the four pillars of an effective AML program.

New Fifth "Pillar" of AML

The Final Rule supplements the four pillars of AML programs by adding a

new "fifth pillar". Covered institutions will now be required to develop customer risk profiles, and to monitor suspicious activity on an ongoing basis. This includes maintaining and updating customer information beneficial ownership information.

- ***Customer Risk Profile*** refers to the information gathered about a customer at account opening used to develop a baseline against which customer activity is assessed for suspicious activity reporting which may include self-evident information such as the type of customer or type of account, service, or product. This profile may, but need not, include a system of risk ratings or categories of customers.
- ***Ongoing Monitoring*** requires covered institutions to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information. This includes updating beneficial ownership information when the financial intuition becomes aware of changes information during its process of assessing or re-evaluating the risk posed by the customer.

Identification and Verification of Beneficial Owners of Legal Entity Customers

Up to this point, covered institutions have not been required to know the identity of individuals who own or control their legal entity customers (also known as beneficial owners). This loophole has been exploited by criminals, kleptocrats (rulers who use political power to steal their country's resources), and others looking to hide / launder ill-gotten proceeds to anonymously access and utilize the financial system. The Final Rule contains new beneficial ownership identification and verification requirements designed to tighten this loophole, and to provide information that will assist law enforcement in financial investigations, help prevent evasion of targeted financial sanctions, improve the ability of financial institutions to assess risk, facilitate tax compliance, and advance U.S. compliance with those imposed internationally.

The following further explains the key terms relating to these new requirements:

- ***Legal Entity Customers***

  Under the Final Rule, a legal entity customer means a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account.

  There are several exemptions from the definition of a legal entity customer. Specifically:

  - Certain federally registered financial institutions, such as banks, broker-dealers, and investment advisers;
  - Trusts, except for trusts created through a filing with a state (*e.g.*, statutory business trusts);
  - Investment companies registered with the U.S. Securities and Exchange Commission (SEC);
  - Certain issuers of securities registered with the SEC under the Securities Exchange Act of 1934;
  - Exchanges, clearing agencies, or any other entity registered with the SEC under the Exchange Act;
  - Public accounting firms registered under the Sarbanes-Oxley Act;
  - U.S. government departments or agencies, or any entity that exercises governmental authority on behalf of the U.S. federal or state government;
  - Entities whose common stock or equity interests are listed on a stock exchange;
  - Registered entities, commodity pool operators, commodity trading advisors, retail foreign exchange dealers, swap dealers, and major swap participants registered with the Commodity Futures Trading Commissions;
  - Bank holding companies, and saving and loan holding companies;
  - Certain pooled investment vehicles;
  - State-regulated insurance companies;
  - Financial market utilities designated by the Financial Stability Oversight Council;
  - Foreign financial institutions where the foreign regulator maintains beneficial ownership information;
  - Departments, agencies, and political subdivisions of foreign governments; and
  - Private banking accounts subject to FinCEN's private banking account rules.

  Many of the above entities were exempted from the definition of a legal entity customer because information about their beneficial owners is already accessible.

- ***Account***
  The Final Rule definition of an *account* is the same as that in the CIP rules. This definition notably excludes accounts opened for the purpose of participating in an employee retirement plan established under the Employee Retirement Income Security Act of 1974, which are viewed as having an extremely low money laundering risk. Further, the new beneficial owner identification / verification requirements apply only to new accounts opened on behalf of a legal entity after the Final Rules take effect.

- ***Beneficial Owners***
  The definition of beneficial owner for BSA/AML purposes is the natural person(s) who own or control a legal entity or those who exercise effective control over a legal entity. Thus, the regulations reflect a two-prong definition of beneficial owners:
  - ***Ownership:*** Each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25% or more of the equity interests of a legal entity customer; and
  - ***Control:*** An individual with significant responsibility to control, manage or direct a legal entity customer, including: (i) an executive officer or senior manager (e.g., a chief executive officer, chief financial officer, chief operating officer, managing member, a general partner, president, vice president, or treasurer); or (ii) any other individual who regularly performs similar functions.

  Each prong is must be considered independently. A covered institution must identify and verify up to four individuals, as applicable, under the ownership prong ***and*** one individual under the control prong. Thus, if a legal entity is owned equally by four persons (*e.g.*, four 25% owners), and then managed by a separate natural person, a covered institution must identify and verify all five persons.

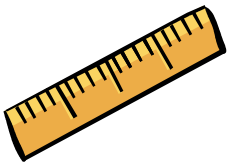
  However, a single individual may satisfy both the ownership and the control prongs. A legal entity may not have any 25% owners. Thus, if a legal entity is owned by one person (e.g., one 100% owner), and is managed by that same person, then a covered institution must identify and verify only that one person to satisfy the two prong requirements. Conversely, if a legal entity does not have any owners with 25% or more ownership interest, then a covered institution must identify and verify only a single person who satisfies the control prong of the Final Rules.

- ***Beneficial Owner Identification and Verification Procedures***
  Covered institutions will be required to identify the beneficial owners of its legal entity customers, subject to the previously outlined exceptions, at the time a new account is opened once the Final Rules take effect. A covered institution may satisfy this identification requirement either by completing a standardized form attached to the Final Rule as Appendix A, or obtaining the information required by the standardized form (e.g., name, date of birth, address, social security number, etc.) through another means. A covered institution may rely on the beneficial ownership information supplied by the customer, provided that it has no knowledge of facts that would reasonably call into question the reliability of the information provided by the customer.

  After identifying the beneficial owners of new legal entity accounts, a covered institution must verify the identity of the beneficial owners. However, a covered institution will not be responsible for verifying the status of beneficial owners. It may verify the identity of beneficial owners using the same elements contained in the risk-based procedures currently used to verify customers under existing CIP practices. Thus, a covered institution may verify the identity of the beneficial owner by requesting a copy of the beneficial owner's driver's license, but would not be required to undergo an exhaustive investigation through corporate records to verify the status of the beneficial owner.

  In addition to the beneficial owner identification and verification requirements at account opening, a covered institution must update and modify beneficial owner information for its legal entity customers if it becomes aware of changes during the ongoing monitoring required under the new "fifth pillar" of CDD.

Short Clips



CFPB Publishes Annotated Loan Estimate, Closing Disclosure

The CFPB has published annotated versions of the Loan Estimate and Closing Disclosure documents. The documents provide citations to the disclosure provisions of the Truth in Lending Act that were referenced in the final TRID rule.

CFPB and Financial Regulators Issue Guidance on Handling Consumer Deposit Account Discrepancies

On May 18, 2016, the CFPB, Federal Reserve, FDIC, NCUA, and the OCC issued Interagency Guidance Regarding Deposit Reconciliation Practices. The Guidance outlines supervisory expectations on how financial institutions should handle consumer deposit discrepancies. The Guidance states that financial institutions should avoid or reconcile, or resolve discrepancies between the amount they credit to a consumer's account and the amount actually deposited. The Guidance calls on financial institutions to adopt policies that (1) treat consumers fairly when they make deposits, and (2) do not violate applicable laws and regulations. The Guidance further states that financial institutions failing to comply with the applicable laws and regulations, including prohibitions against unfair, deceptive, and abusive practices, could open themselves up to liability and possible action by an agency.

OCC Issues Handbook on Private Student Lending

On May 8, 2016, The OCC added a new booklet on private student lending to its Comptroller's Handbook. The booklet provides examples of acceptable practices and policies for banks engaging in private educational lending, including in-school deferment; providing a six-month grace and extended grace periods immediately after graduation or withdrawal from school; and loan modifications for long-term hardships. The booklet also highlights the differences between federal and private student loans and includes guidance for examiners on assessing the risks associated with private student lending.

Interagency Notice of Proposed Rulemaking: Incentive-Based Compensation

On May 16, 2016, the Federal Reserve, FDIC, OCC, NCUA, FHFA, and SEC issued a joint *Notice of Proposed Rulemaking* (NPR) to implement Section 956 of the Dodd-Frank Act. The NPR seeks to strengthen the incentive-based compensation practices at covered institutions by better aligning the financial rewards for covered persons with an institution's long-term safety and soundness.

The proposed rules apply to covered financial institutions with total assets of $1 billion or more, with requirements tailored based on asset size:

- Level 1: institutions with assets of $250 billion and above;
- Level 2: institutions with assets of $50 billion to $250 billion; and
- Level 3: institutions with assets of $1 billion to $50 billion.

Much of the proposed rules address requirements for senior executive officers and employees who are significant risk-takers at Level 1 and Level 2 institutions. All institutions covered by the proposed rules would be required to annually document the structure of incentive-based compensation arrangements and retain those records for seven years. Boards of Directors of covered institutions would be required to conduct oversight of these arrangements. All covered institutions would be subject to general prohibitions on incentive-based compensation arrangements that could encourage inappropriate risk-taking by providing excessive compensation or that could lead to a material financial loss.

The NPR has a public comment period that will close on July 22, 2016.

FFIEC IT Examination Handbook Update – Mobile Financial Services

The FFIEC has issued a new appendix, Mobile Financial Services, to the Retail Payment Systems booklet of the FFIEC Information Technology Handbook. The appendix provides guidance to assist examiners in evaluating the risks associated with mobile financial services.

Good to Know

Send your questions to the
answerperson@mandm.consulting

Sending requests to the above address gets you a written response to your questions. Emails sent to the answer person are received five days a week.

Q: We had a member come in wanting to open a business account. When asked about the nature of the business, the member responded "private money lending". I asked for more details, and was informed that he lent money mainly to construction and other small businesses who need quick short term cash.

I think this business would be considered an MSB, but would like your opinion. Also, are there are any other compliance issues associated with opening the account?

A: Based on the information presented, it's hard to say for certain whether your member would be considered a Money Services Business. The term is defined as including any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities:

(1) Currency dealer or exchanger.
(2) Check casher.
(3) Issuer of traveler's checks, money orders or stored value.
(4) Seller or redeemer of traveler's checks, money orders or stored value.
(5) Money transmitter.
(6) U.S. Postal Service.

The fact that your member is lending money does not make him an MSB, but depending on how the funds he lends are distributed, he could be a money transmitter, which would make him an MSB. Even if he falls outside of the MSB definition, this definitely should be considered a high risk business from a BSA / AML perspective, and should be closely scrutinized and monitored.

Q: We are considering adding a rate tier to one of our savings account products. Our TISA disclosure consists of the typical disclosure and a rate sheet.

II believe adding a rate tier to an account would be considered a change which requires 30-days advance notice. Is this correct?

A: The need to disclose the change in advance is dependent on whether it may reduce the annual percentage yield or otherwise adversely affect the consumer. If you continue to pay the existing interest rate on deposits up to the proposed tier, and a higher interest rate above that amount, the change would not require an advance 30-day notice. However, if you were to pay a lower interest rate on balances up to the proposed tier, and the current interest rate on balances above the proposed tier, that would require a 30-day advance notice.

§1030.5(a) (Subsequent disclosures) of Regulation DD states:

> *Change in terms — (1) Advance notice required. A depository institution shall give advance notice to affected consumers of any change in a term required to be disclosed under §1030.4(b) of this part if the change may reduce the annual percentage yield or adversely affect the consumer. The notice shall include the effective date of the change. The notice shall be mailed or delivered at least 30 calendar days before the effective date of the change.*

Neither the Regulation nor the Commentary discuss the disclosure of changes in terms that do not reduce the APY or adversely affect the consumer, but it is not uncommon to communicate such changes within 30 days after the change has gone into effect.

Q: While a Bank is only required to file its HMDA information once per year, are there time requirements for making entries to the HMDA LAR, specifically with respect to non-originated HMDA reportable applications?

A: HMDA requires a covered institution to record a transaction on the LAR within thirty calendar days after the end of the calendar quarter in which final action on the transaction is taken (such as origination or purchase of a loan, or denial of an application).

Q: We have a question regarding a Facebook contest we plan to hold on Mother's Day. We will be giving away a $35 gift certificate to a local spa, and wanted to see if we are allowed to ask people to "tag" their mom in the comments to

enter. We have never done a contest this way, but have noticed that one of our competitors does a similar thing when holding giveaways for concert tickets. Is this type of practice something we are allowed to do?

A: Any sort of advertising on Facebook or any other social media is something that must be closely monitored and scrutinized. Sweepstakes and promotions can be tough enough to evaluate from a general advertising perspective, and can be even tougher when dealing with social media.

With respect to your specific question, *Facebook's Guidelines for Promotions* appears to prohibit tagging. The fact that a competitor is requiring this in its contests should not sway you to follow suit. Let this practice become your competitor's problem in dealing with Facebook and/or its regulators if this is picked up on.

Q: I have a question related to the disclosure of a prepaid appraisal fee on the Closing Disclosure. A borrower paid $550 up front for the appraisal, however, the actual appraisal fee was $450.00. Is it acceptable if the CD reflects -$100 as borrower paid at closing and $550 as borrower paid before closing, or should the CD show $450 paid before closing and a $100 appraisal credit on page 3?

A: There appear to be a few viable disclosure solutions for such incidents; all of which indicate that the full amount of the appraisal fee collected ($550) should be reflected in the borrower paid before closing column on Page 2 of the CD. Some solutions propose showing the "credit" for the overpayment on Page 3 of the CD as either an "adjustment" or "other credit". However, use of these options is not available to items paid by the lender / creditor.

Based on this information, I'd suggest you apply the straightforward solution, and disclose a $100 "Lender Credit" in Section J on Page 2 of the CD.

Q: We have begun compiling a database of non-customers making deposits on behalf of a customer and non-customers cashing on-us checks. The use of this database is beneficial to us with respect to running OFAC queries and for monitoring cash transactions for CTR purposes. We are collecting the name, address, date of birth, Social Security Number/Tax ID, phone number, gender, occupation, ID information and copy of ID.

Do we need to provide these non-customers with a copy of our Privacy Policy even though they are not customers? Also, does this practice raise any other compliance related concerns?

A: If the information you are collecting on non-customers stays in-house, the GLBA Privacy rules do not apply, so there is no need to provide a Privacy Notice. Also, I am not aware of, nor could I find any other regulatory prohibition regarding the collection of such data that would apply in this case. Consequently, I don't see any issues with your collection and utilization of this non-customer data as described.

Q: I am working on a policy for the Military Lending Act. The Bank does not appear to have any consumer loan products that will apply to the 36% APR. We do have an open end overdraft protection account. The minimum line is $250 with a maximum line of $1000.00. The interest rate is 18% with an annual fee of $30.00.

Is the $30.00 considered a participation fee? According to the recent Practical Compliance Newsletter, the Bank is allowed a participation fee which cannot exceed $100 per year. Any guidance is appreciated.

A: You are correct. The $30 annual fee for the overdraft line of credit is considered a participation fee under Regulation Z, and falls below the MLA allowable annual participation fee threshold of $100.

Q: Do we need to notify customers if we want to change the payment order of checks? We now pay items low to high, but want to change to check number order. Our agreement simply states that we have the right to pay in any order we choose and to change that without notice.

A: I recommend that you provide a 30-day advance notice to customers regarding any such change, as it could potentially have an adverse impact on a customer at some point from an overdraft perspective. Providing advance notification of the change will help avoid any potential UDAP issues, and is consistent with Overdraft Protection Program best practices.

Important Dates– Don't Forget!

Generally, we retain the prior month, and go forward for at least a year as known. Dates are either effective dates of Final Rules, or end of the comment period for proposed rules.)

06/07/2016 OFAC, Burma Sanctions. Expiration of 6-month OFAC General License period.
07/01/2016 Education Dept., Campus Bank Accts. Final rule. Impacts institution and student bank accts.
07/11/2016 FinCEN, CDD Final Rule. Effective date of the Final Rule
07/22/2016 Joint NPR - Incentive-Based Compensation. End of public comment period.
07/29/2016 FinCEN, FBME Bank, Ltd. Special Measures. Effective date of special measures final rule.
08/10/2016 Appraisal Mgmt. Cos. Interagency final rule for AMC registration and supervision mandatory.
09/23/2016 Federal Reserve, Same-Day ACH Service and Schedule. Effective date ACH enhancements.
10/01/2016 Military Lending Act Regulation. Expanded "consumer credit" account coverage mandatory.
10/01/2017 Military Lending Act Regulation. Sections on credit card accounts become mandatory.
01/01/2017 NCUA, Final Member-Business Lending Rule. Provides CUs greater business lending flexibility.
01/01/2017 HMDA, Regulation C. Low volume institutions further excluded from coverage.
01/01/2018 HMDA, Regulation C. Revised transaction coverage and expanded fields effective.
07/11/2018 FinCEN, CDD Final Rule. Mandatory compliance date for the CDD Final Rule.
01/01/2020 HMDA, Regulation C. Quarterly reporting for high volume reporters starts.

More Important Dates... 2016 M&M Compliance School

The 2016 *M&M Compliance School* will be held September 13, 14 & 15, 2016 (Tuesday - Thursday) at the *Doubletree by Hilton* in Milford, Massachusetts (Exit 19 off I-495). The cost for this year's program for clients is $375 for all 3 days! Please contact Jay Friedland (jaybanker@mandm.consulting or (207)-650-4665) for more information!

