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THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

Please Address Reply to:

October 2, 2014

Mail: Policy Division
Financial Crimes Enforcement Network
P.O. Box 39
Vienna, VA 22183

Re: The American College of Trust and Estate Counsel (ACTEC®) Comment to Notice of Proposed Rule Making—Customer Due Diligence Requirements for Financial Institutions (Regulatory Identification Number: 1506-AB25)

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel ("ACTEC") believes that the proposed rules reflected in the above-captioned Notice of Proposed Rule Making (the "NPRM") can be improved in a number of important ways. While ACTEC supports the decision not to include private trusts as "Legal Entity Customers," we believe that this decision can be expressed more clearly in the proposed rules. In addition, it appears that the sensible decision not to include private trusts as legal entity customers has not carried over to the determination of the equity owners of legal entity customers when a private trust holds stock, a partnership interest or a membership interest in an LLC. Here, the proposed rules appear to require financial institutions to determine the natural persons who are beneficiaries of a private trust that holds such an interest in a legal entity customer. It is ACTEC's belief that the reasoning behind the decision not to define private trusts as legal entity customers should support a similar limitation when a private trust is an owner of such a customer. Finally, while the proposed rules appear not to require the determination of a lawyer or law firm's clients in connection with the opening or management of a lawyer/law firm trust account (an obvious example of an Intermediated Account Relationship), ACTEC seeks a specific provision excluding law firm trust accounts from application of the proposed rules.

ACTEC is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

If you or your staff would like to discuss the Comment, please contact John A. Terrill, II, Chair of the ACTEC Financial Action Task Force (FATF) Committee, at (610) 940-4172 or jterrill@htts.com.

Respectfully submitted,

Kathleen R. Sherby
ACTEC President 2014-2015

The American College of Trust and Estate Counsel (ACTEC®) Comment to Notice of Proposed Rule Making—Customer Due Diligence Requirements for Financial Institutions (Regulatory Identification Number: 1506-AB25)

The purpose of this submission is to provide comments regarding the Notice of Proposed Rule Making—Customer Due Diligence Requirements for Financial Institutions, 79 Federal Register 45151, (Department of Treasury, Financial Crimes Enforcement Network, August 4, 2014; hereinafter referred to as the "NPRM"). This Comment has four discrete purposes, each of which is responsive to one or more of the list of comment areas contained in Paragraph V of the NPRM:

1. To comment in general terms on the decision by the Financial Crimes Enforcement Network ("FinCEN") not to include a requirement that financial institutions apply the proposed rules to accounts opened by private trusts and to describe some aspects of private trusts that support this decision.

2. To comment on the technical detail by which the proposed rules reflect the decision not to apply the proposed rules to accounts opened by private trusts and to suggest a modification of the proposed rules to clarify this decision.

3. To comment on the requirement that covered financial institutions collect beneficial ownership information concerning the **"individuals"** who directly or indirectly own equity interests in legal entity customers, notwithstanding the overall decision not to require financial institutions to collect information regarding the beneficial ownership of private trusts, and to suggest a modification of the proposed rules to address this issue.

4. To comment on the decision not to include lawyer and law firm trust accounts in the definition of legal entity customers and to suggest that the rules specifically refer to such exclusion.

FinCEN's Decision and the Role of Private Trusts

1. The Treatment of Private Trusts in the NPRM.

The primary purpose of the NPRM stated in the 21-page preamble (the "Preamble") is to create "more explicit rules for covered financial institutions [fn] with respect to customer due diligence (CDD) within the BSA regime." NPRM at 45151, 45152. Moreover, the key elements of CDD must include, *inter alia*, "identifying and verifying the identity of beneficial owners of legal entity customers (i.e., the natural persons who own or control legal entities) . . . ." Id.

The core determination that must precede the application of the proposed rules is whether or not any party opening or managing an existing account is a "legal entity customer." Part of the Preamble is dedicated to a summary of circumstances under which legal entities can be abused by criminals engaged in money laundering and/or terrorists to disguise and support their activities. In describing FinCEN's overall strategy to address what it refers to as "financial transparency," NPRM, at 45155, FinCEN describes one key element of its strategy to be

"facilitating global implementation of international standards regarding CDD and beneficial ownership of legal entities **and trusts.**" Id. (emphasis added.) Here FinCEN draws a distinction between legal entities, the overall subject of the NPRM, and trusts, not the subject of the NPRM.

While the NPRM proposes to modify a number of regulations, the most important new element of the proposed rules is the requirement that financial institutions identify and verify the identity of beneficial owners, down to natural persons, of legal entity customers. To define beneficial owners, FinCEN refers to a definition created by the Financial Action Task Force on Money Laundering ("FATF") as "the natural person(s) who ultimately owns or controls a customer. . . It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." NPRM, at 45156. One question for FinCEN, and one that appears to have been addressed in some of the public meetings held by FinCEN regarding the NPRM, has been the extent to which determining and verifying the identity of such natural persons applies to beneficiaries of private trusts. That this concern was raised during the earlier comment period and through the public hearings is evident; the Preamble notes that "compliance challenges" would be associated with applying beneficial ownership requirements on trusts. NPRM, at 45157.

Responding to the concerns raised during the earlier comment period to the Advance Notice of Proposed Rulemaking ("ANPRM"), FinCEN chose to limit the application of the proposed rules to accounts opened or owned by "legal entity customers." Specifically, the proposed rules do "not include trusts other than those that might be created through a filing with a state (e.g. statutory business trusts)." NPRM, at 45159. As will be noted below, the actual definition of "legal entity customers" in Proposed Rule 1010.230(d)(1) does not **exclude** private trusts, except by inference, nor are private trusts included in the list of entities for which beneficial ownership information is not required in Proposed Rule 1010.230(d)(2). One purpose of this Comment is to reinforce the decision by FinCEN not to include private trusts in the application of the proposed rules, notwithstanding the reference to international standards seeking the application of beneficial ownership rules to private trusts.

In addressing the matter of private trusts, the Preamble concludes with a recitation of FinCEN's reasoning behind not including private trusts under the NPRM (NPRM, at 45160):

> --there are a variety of types of trusts, some of which fall within the definition of legal entity customer but most of which will not.
>
> --unlike corporations, partnerships, LLCs and other business entities, a trust is generally a "contractual arrangement" between the person creating the trust and one or more trustees for the benefit of one or more beneficiaries.
>
> --trusts do not require state action to become effective.
>
> --corporate trustees must receive a government charter to act.
>
> --identifying the "beneficial owner," under the definition thereof in the NPRM, focusing on an "equity" interest, would not be practical.

--existing Customer Identity Protocols ("CIP") already require financial institutions to gather information regarding the trustee or trustees of private trusts and the trustees would have information regarding the settlor and beneficiaries sufficient for law enforcement.

As this summary reflects, ACTEC believes that FinCEN has made a well-considered decision to not treat private trusts as legal entity customers for the purposes of the proposed rules. As will be noted below, ACTEC suggests that this decision, while clear in the Preamble, is not so clearly incorporated into the proposed rules and should be.

Moreover, notwithstanding this decision, neither the Preamble nor the proposed rules addresses the matter of trusts as beneficial owners of legal entity customers. In particular, financial institutions will be required to determine the "natural persons who are beneficial owners of legal entity customers . . . ." NPRM, at 45156. The Preamble goes on to divide this determination into two prongs, an "ownership" prong (addressing the equity ownership of the legal entity customer) and a "control" prong (addressing the ability to manage the legal entity customer). NPRM, at 45157. While it seems clear that the identification of, and collection of information about, the trustee or trustees of a private trust will satisfy the control prong, by requiring the financial institution to pierce the layers of equity ownership when there are entities "in the middle," and to find "natural persons," the proposed rules effectively create an obligation to look into the beneficial ownership of trusts **that themselves are owners of legal entities** where FinCEN would not require such an inquiry when the trust opens an account. It is suggested that this inconsistency be corrected in the proposed rules.

2. **Private Trusts in the American Legal System.**

As the preeminent organization of trusts and estates lawyers in the United States, ACTEC is perhaps uniquely qualified to assist FinCEN in understanding the role that private trusts (and for purposes of this Comment, we will refer to trusts created by individuals for their own estate and other planning purposes as trusts or private trusts interchangeably; this contrasts with business or statutory trusts that are not the subject of this Comment) play in the United States and to reinforce and support FinCEN's determination not to include private trusts within the definition of "legal entity customers."

In this regard, it is important to note that trusts play a role in the estate planning for millions of persons in the United States regardless of the level of wealth. The number of private trusts that exist in connection with estate plans is impossible to determine since many of them require no public filing. However, based on informal inquiries within the ACTEC community alone, it is very likely to be in the millions.

Trusts serve many, many purposes, including the following:

--In states where probate is complicated, trusts are used to avoid or minimize the probate process. This is particularly true in states like California, New York and Massachusetts.

--In many other states where the probate process is relatively streamlined, trusts are still often the main dispositive vehicle for an estate plan. They provide efficiency and privacy for the clients.

--In the several community property states, it is common for married couples to own their assets in so-called "community property trusts," the main purpose of which is to facilitate management of the couple's assets.

--Trusts are also used to facilitate the management of assets and the protection of elderly persons as their capabilities diminish. Trusts can be used to manage assets and to make provisions for persons of all ages who have diminished mental or physical capacity. This is frequently seen with the elderly but it is also seen with persons who have special needs or other compromising factors. For example, many trusts are created for minors or other persons who lack financial acumen. In addition, trusts may be created by a court for the benefit of a person injured in an accident.

--Trusts are frequently created by older members of a family for the benefit of younger members, particularly for purposes such as education and medical needs.

--Trusts are created by family members to protect the assets from division upon a divorce of a beneficiary or from attachment by a beneficiary's creditors.

--Trusts are also used for tax planning by the more wealthy members of society and while this is not a relevant topic to many persons, there are certainly very significant numbers of trusts that are created for purposes of tax planning. It is common, for example to transfer interests in closely-held businesses (whether stock, partnership interests or membership interests in LLCs) to trusts for the benefit of spouses, descendants and other beneficiaries. Trusts serve the important purpose of maintaining control over these interests, control that is more desirable than outright ownership.

Beyond the purposes of trusts, it is useful to address the mechanics of private trusts, mechanics that support and explain the decision by FinCEN not to require financial institutions to "look through" private trusts to determine their beneficial owners and should support a decision to permit financial institutions to limit their inquiry regarding trusts as equity owners of legal entity customers to identifying the trustee or trustees as they do now.

First, trusts can be created during the lifetime of the person creating the trust (the "settlor" or "trustor" or "grantor"); these are customarily referred to as *inter vivos* or living trusts. *Inter vivos* trusts can be revocable during the settlor's lifetime and become irrevocable upon the occurrence of an event, often the death of the settlor. They can also be irrevocable from inception.

Other trusts are created or become operational upon the death of an individual and are created under the will of the person creating the trust; these are commonly referred to as "testamentary" trusts. In some cases, *inter vivos* trusts are inactive during the settlor's lifetime and become active upon death; while they are created during the settlor's lifetime, they act in many ways like testamentary trusts.

All trusts have four "elements"—a settlor or testator who creates and arranges for the funding of the trust; one or more trustees who are responsible for administering the trust; a "corpus" or "res", the assets owned by the trust; and beneficiaries, the person or persons or institutions to whom distributions of trust assets must or can be made.

Trusts are created by written documents (deeds of trusts, agreements, wills, and the like) and their operations are governed by a combination of those writings, applicable state and federal legislation and the supervision of the courts, typically the courts of the state or, in the case of foreign trusts, of the country, where the trust has its legal situs. While the Preamble suggests that trusts are a matter of contract, NPRM, at 45160, in fact, they are governed by trust law, which is its own body of legal relationships and obligations. One important element of trust law is in the nature of the obligation of the trustee to the beneficiaries, an obligation normally referred to as a "fiduciary relationship," in contrast to agency or arm's length relationships.

The proposed rules, and current CIP obligations of financial institutions, are not concerned with the settlor or the corpus of trusts in most cases. Their focus is on two elements—the trustee or trustees, and the beneficiaries. The Preamble makes clear, and ACTEC agrees, that the current process of collecting information about the trustee or trustees of a private trust is sufficient to provide the financial institution, and eventually in some cases, law enforcement, sufficient data regarding trusts so as to permit their exclusion from the definition of legal entity owners.

The complex issue, and the issue that supports and reinforces FinCEN's decision not to require information regarding beneficial ownership of private trusts, is the determination of the beneficial interests in private trusts. A few examples should serve to illuminate this:

(i) A revocable *inter vivos* trust is created by John Jones in which he names himself as the original trustee and the sole person entitled to receive distributions of principal or income. After his death, the remaining assets will continue in trust for his widow, Amy, and following her death for the Jones' descendants who are then living. John as trustee opens bank and investment accounts to hold trust assets. The identification of the trustee is easy. But who are the beneficial owners of the trust? John, clearly, but what about his wife who is only a beneficiary if she survives him? How about their descendants? Is it all children and grandchildren now alive? Are they really "owners" in the way that owners of stock of a corporation are?

(ii) George Smith dies leaving a will creating a series of separate trusts to hold part of his estate for the lives of his four children. Each child is the trustee of his or her own trust except for his disabled child, Sam; for Sam's trust, his sister, Lydia, is the trustee. Each trust is slightly different but in all cases, distributions can only

be made to the child and his or her descendants based on need. Sam's is a special needs trust. Again, trusteeship is easy but who are the beneficial owners of these trusts? The children and their descendants are beneficiaries under trust law but their rights are nothing like the rights of owners of corporations or members of LLCs.

In short, the nature of most private trusts is to leave the rights of beneficiaries uncertain. In some cases, this has to do with timing; one or more than one individual may receive distributions currently and they may be mandatory or permissive. Others may receive distributions only in the future and then only if they are alive and other conditions are met. In other cases, the uncertainty has to do with the existence of discretion in the trustee to make distributions. These timing and discretionary elements leave it difficult or impossible to say who has an equitable interest in a private trust and support FinCEN's decision not to require financial institutions to make this determination.

3. The Definition of Legal Entity Customers and the Need to Include Private Trusts in the List of Excluded Entities.

As noted above, FinCEN has determined that it will not include private trusts in the definition of legal entity customers. However, while this decision is stated very clearly in the Preamble, the implementation of this decision in the actual rules is less clear. ACTEC's concern is that compliance personnel at financial institutions responsible for implementing these CDD rules will look only at the rules and not at the Preamble. ACTEC believes that it will be a significant improvement to the proposed rules to make it completely clear that the beneficial ownership information required of legal entity customers is not required of private trusts.

Proposed Rule 1010.230(a) requires covered financial institutions to "establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers." Subparagraphs (b) and (c) go on to set forth the information that must be gathered to comply with this obligation. Subparagraph (d)(1) provides the following definition of legal entity customer: "*Legal entity customer* means: a corporation, limited liability company, partnership or other similar business entity. . . ." Subparagraph (d)(2) goes on to list ten categories of entities that are not within the definition of legal entity customer. Private trusts are not included in that list of excluded entities. Interestingly, the excluded entity list includes charities or nonprofit entities, **many of which are trusts.**

That the proposed rules do not apply to private trusts must depend on the conclusion that private trusts are not in the category of "other similar business entity." Might an unsophisticated employee at a bank inadvertently conclude that a particular private trust is such an entity? What if the trust holds an ownership interest in a private company or LLC? Adding to the potential uncertainty is the inclusion of charities in the subparagraph (d)(2) list of excluded entities, many or perhaps most of which are created under trusts executed and funded by private individuals. Even more uncertainty comes from the Preamble where, on page 45159, FinCEN states that it will interpret the definition of legal entity customers to include some kinds of trusts (those that might be created through a filing with a state). So the definition of legal entity customer in

subparagraph (d) does include some types of trusts but not others; this can be discerned only if the reader is familiar with the Preamble.

It would be very simple and clarifying for the proposed rules to be modified to incorporate into the rules what is made clear in the Preamble. This can be done in one of two ways, either to modify subparagraph (d)(1) or to add private trusts in subparagraph (d)(2).

For example: "(1) *Legal entity customer* means: a corporation, limited liability company, partnership or other similar business entity (whether formed under the laws of a state or of the United States or a foreign jurisdiction), **but shall not include trusts other than those that might be created through a filing with a state (e.g. statutory business trusts)** that opens a new account."

Alternatively: (2) *Legal entity customer* does not include:

(xi) Trusts other than those that might be created through a filing with a state (e.g. statutory business trusts).

4. The Determination of the Equity Owners of Legal Entity Customers Where Private Trusts are in the Chain of Ownership.

As noted above, FinCEN proposes to require financial institutions, once they determine that a new or existing account is owned by a legal entity customer, to determine the beneficial ownership of the legal entity customer using two prongs, the ownership prong and the control prong. The ownership prong requires the identification of "[e]ach individual, if any, who directly or indirectly through any contract, arrangement, understanding or otherwise, owns 25 percent or more of the equity interests of a legal entity customer." NPRM, at 45157. The use of the word "individual" is included in Proposed Rule 1010.230(c)(1). The requirement that there be an "individual" is carried over to the Appendix A of the proposed rules where the form requires a name, date of birth, address and other information not applicable to private trusts.

While the proposed rules themselves do not directly address the application of the ownership prong where at the first or subsequent level of inquiry an owner of a legal entity customer is itself an entity, the Preamble makes clear on page 45158 that the financial institution must request information regarding intervening entities until it gets to one or more individuals: "the phrase 'directly or indirectly' in the ownership prong of the definition is intended to make clear that where a legal entity customer is owned by (or controlled through) one or more other legal entities, the proposed rule requires customers to look through those other legal entities to determine which natural persons own 25 percent or more of the equity interests of the legal entity customer." NPRM, at 45158.

Now imagine that an irrevocable *inter vivos* trust owns 25% of the stock of X Company and X Company is attempting to open a bank account. The X Company officers attempt to complete Appendix A and find that there is no place to reflect the trust as an owner of 25% of the stock. If it is FinCEN's intent to require a determination here of the individuals who own that equity, this is the same determination that FinCEN chose not to require when it is the trust itself

opening the account. It is suggested that the decision in the latter case, to permit financial institutions to rely on the identification of the trustee or trustees, should be more than sufficient to provide the information required to satisfy the need to determine beneficial ownership.

This issue may be resolved either by modifying Proposed Rule 1010.230(c)(1) or by adding an additional note at the end of (c). In addition, the Appendix A form needs to be modified.

For example, (c)(1) could say "(1) Each individual and each trust, if any, . . ." Alternatively, the note to this rule could include the following: "In the case of a trust, other than a statutory or business trust, that owns 25 percent or more of the legal entity customer, it is sufficient for the institution to identify the trustee or trustees of the trust, applying customer identification procedures already in place." There could be other ways to cross reference the identification of the trustee or trustees but the bottom line is to clarify that this information is sufficient.

The modification of Appendix A will be more complex. There should probably be an information paragraph added to the existing "What information do I have to provide?." Something like the following would achieve this goal: "(iii) In the case of a trust, other than a statutory or business trust, the name and address of all currently serving trustees. There is no requirement to identify the beneficiaries of the trust." Finally, there could be added under Item II an additional table for trustee information.

Clarification Regarding the Inapplicability of the Proposed Rules to Law Firm Trust Accounts: **Intermediated Accounts.**

In the Preamble, FinCEN notes as follows with respect to Intermediated Account Relationships and Pooled Investment Vehicles:

> The ANPRM sought comment on whether and how a beneficial ownership requirement should be applied to accounts held by intermediaries on behalf of third parties. An intermediary generally refers to a customer that maintains an account for the primary benefit of others, such as the intermediary's own underlying clients. NPRM, at 45160.

ACTEC observes that this concept clearly applies to lawyer and law firm trust accounts, sometimes called client accounts. Many if not most lawyers and law firms have segregated accounts in which lawyers deposit and account for client monies. For any number of purposes lawyers and law firms have reasons to hold clients' money.

Typical examples include:

(i) retainers;

(ii) funds escrowed in connection with a closing of a real estate or business transaction;

(iii) funds received in settlement of a lawsuit to be disbursed to one or more litigants.

These accounts are typically subject to stringent state bar rules, and lawyers must keep account records for every client that has money deposited in such accounts.

ACTEC recommends that the rule make it clear that the financial institutions' obligations regarding the beneficial ownership requirement should apply only with respect to its immediate customer, i.e., the lawyer or law firm and not the lawyer or law firm's clients.

This clarification could be made in the proposed rules under (d)(2) where legal entity customer could specifically exclude accounts in which lawyers or law firms deposit client monies.

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