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TAB 2

THE SIX-MINUTE Real Estate Lawyer 2017

Proceeds of Crime (Money Laundering) and *Terrorist Financing Act* and Related Record-Keeping

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On February 27, 2016, Manulife Financial Corporation released a brief statement disclosing that an administrative penalty was handed down by The Financial Transactions and Reports Analysis Centre of Canada ("**FINTRAC**") to Manulife Bank. CBC news revealed that the breaches related to the "failure to report 1,174 international electronic money transfers, 45 cash transactions involving at least $10,000 each, as well as one suspicious transaction."[2] The penalty, in the amount of $1,154,670, was the first to be enforced against a bank in Canada, and FINTRAC initially withheld the name of the bank being fined until public protest prevailed. Financial institutions across the country took notice.

PROCEEDS OF CRIME (MONEY LAUNDERING) AND TERRORIST FINANCING ACT

The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*[3] (the "**Act**") was brought into force in 2000. Under the Act, entities such as casinos, financial institutions, and securities dealers must implement record keeping and reporting regimes, and as of 2008, the list of reporting entities was amended and now includes real estate developers.

The Act provided for the establishment of FINTRAC, which started operations on October 28, 2001.[4] FINTRAC's role is to detect, prevent, and deter money

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[2] John Nicol, Dave Seglins, Steve Niles "CBC Investigates: Manulife revealed as bank fined $1.15M for violating anti-money laundering reporting rules", CBC News (Feb 27, 2017) online: <http://www.cbc.ca/news/business/fintrac-fine-name-secret-1.3999156>.

[3] SC 2000, c 17.

[4] Canada Gazette (2002), Canada Gazette Part II, Vol 136 (Ottawa: The Queen's Printer for Canada, 2002) at 52.

laundering and the financing of terrorist activities.[5] FINTRAC is authorized to disclose financial intelligence that it collects to law enforcement and other agencies, and reports to the Minister of Finance of Canada.[6]

The Financial Action Task Force (the "**FATF**") is the international, independent entity that sets the standards for global anti-money laundering and counter terrorist financing.[7] Interestingly, Canada was subject to a regular follow-up process from 2008 until 2014 following deficiencies in its anti-money laundering legislation and was obligated to report back to the FATF on a regular basis. Certain regulations under the Act, which came into force on February 1, 2014, were implemented in response to recommendations by the FATF arising out of a 2008 report which critiqued, among other things, deficiencies in relation to beneficial ownership.[8]

PROCEEDS OF CRIME (MONEY LAUNDERING) AND TERRORIST FINANCING REGULATIONS

Commercial real estate practitioners will have noticed the increased diligence required by lenders, which diligence has resulted in lengthy and complex Anti-Money Laundering ("**AML**") forms required in the context of financings. While these forms are sometimes completed at the lender and customer level, many times the burden of completing these forms falls on the Borrower's counsel. When complex ownership vehicles are involved, often the completion of the AML forms can take just as long, if not longer, to complete as the balance of the loan documents.

The balance of the following analysis will focus on the underlying reason for the necessity of AML forms by financial institutions in the context of lending transactions, and how far a lawyer must "drill down" into the ownership structure of its customers to identify individuals.

Section 54 of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations*[9] (the "**Regulation**") imposes a duty on financial institutions to ascertain the identity of persons, corporations, and trusts with which it conducts business. A financial institution is responsible for identifying customers in respect of the following financial transactions:

1. Account openings and signature card creation;
2. Credit card account opening;

[5] FINTRAC, "Who we are", online (2017) <http://www.fintrac-canafe.gc.ca/fintrac-canafe/1-eng.asp>.

[6] *Ibid.*

[7] Financial Action Task Force, "Mutual Evaluation of Canada: 6th Follow-up Report" February 2014.

[8] *Ibid.*

[9] SOR/2002-184 [*Regulation*].

3. Trusts;
4. Large cash transactions;
5. Suspicious transactions;
6. Electronic funds transfers of $1,000 or more;
7. Foreign currency exchange of $3,000 or more; and
8. Issuing or redeeming $3,000 or more in money orders, traveller's cheques or other similar negotiable instruments.[10]

Penalties

As set out in Section 5 of Regulation SOR/2007-292 entitled "Proceeds of Crime (Money Laundering) and Terrorist Financing Administrative Monetary Penalties Regulations" (the "**Penalties Regulation**"), the penalties for a violation of the Act or Regulation is as follows:

- $1 to $1,000 in the case of a minor violation;
- $1 to $100,000 in the case of a serious violation; and
- $1 to $500,000 in the case of a very serious violation.

The Penalties Regulation includes tables setting out descriptions of possible violations and the classification of such violation into the foregoing categories. Under the Act, in the most serious of circumstances, for failure to report a prescribed transaction the maximum penalty is $1,000,000 and a maximum fine of $2,000,000 and a maximum jail term of five years for failure to report a suspicious transaction.

The Regulation defines "business relationship" as including financial transactions or services relating to financial transactions, whether or not the transaction involves a client with a bank account at the financial entity, and Section 54.3(1) requires a financial entity to keep records of measures taken to monitor its business relationship with its customer.

RECORD KEEPING OBLIGATIONS OF FINANCIAL INSTITUTIONS

Obtaining and Confirming Identity and Information

A financial institution must obtain and confirm the accuracy of information about "beneficial owners" and retain records this respect, such that in an examination by FINTRAC, the financial institution can produce official documentation confirming beneficial ownership information.

Similar to obligations imposed on lawyers for identifying and verifying clients, "obtain" and "confirm" are separate steps under the Regulation. Obtaining information can include verbal or written confirmation from the customer, a review of meeting minutes, or a review of commercially available information. Confirming information involves obtaining official documentation.

For corporations, such official documentation includes:

- articles of incorporation;
- share certificates;

[10] FINTRAC, "When to identify individuals and confirm the existence of entities- Financial entities" online (2017): <http://www.fintrac-canafe.gc.ca/guidance-directives/client-clientele/client/fin-eng.asp>.

- annual returns;
- certificate of corporate status; or
- shareholder agreements.[11]

For non-corporate entities, FINTRAC looks to the organizing document, including articles of constitution or articles of association or a partnership agreement.

For trusts, FINTRAC looks to the trust deed as constituting official documentation.

If no such official document exists (FINTRAC provides the example of a sole proprietorship), the financial institution can rely on a certificate, attestation, or statement authorized to act on behalf of the customer.[12] These "unofficial" documents should be paired with a record of the measures taken to confirm the accuracy of the information contained therein. Documents and references obtained to confirm the information have to be kept in the financial institutions' records for at least five (5) years from the date of the last business with the customer.[13] Documents can be retained in electronic format as long as they can be printed.[14]

Organizational Record Keeping

In addition to retaining the official documentation confirming the entity's identity, a financial institution must retain and keep updated records in respect of the following:

Corporation:

- the names of all directors of the corporation;
- the names and addresses of all actual persons who directly or indirectly own or control 25% or more of the corporations' shares; and,
- information on the ownership, control, and structure of the corporation.[15]

Trust:

- the names and addresses of all trustees, known beneficiaries and settlors of the trust;[16] and,
- information on the ownership, control, and structure of the trust.

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[11] FINTRAC, "Beneficial Ownership Requirements", Online (2017): <http://www.fintrac-canafe.gc.ca/guidance-directives/client-clientele/bor-eng.asp>. [*Beneficial Ownership Requirements*].

[12] *Ibid.*

[13] FINTRAC, Policy Interpretations, "Reasonable measures", Online (2017):< http://www.fintrac-canafe.gc.ca/guidance-directives/overview-apercu/FINS/2-eng.asp?s=7> [*Policy Interpretations*]. *Regulation*, *supra* note 9 at Section 69.

[14] *Regulation, supra note 9* at Section 68.

[15] *Ibid* at Section 11.1(1).

[16] *Ibid* at Section 11.1(1).

Other Entity:

- the names and addresses of all individuals who directly or indirectly own or control 25% or more of the entity; and,
- information on the ownership, control, and structure of the entity.[17]

In addition, there are further specific record keeping and reporting requirements set out in Sections 12 through 14.1 of the Regulation relating to financial transactions and vary with the type of transaction.

"Beneficial Owners"

FINTRAC defines beneficial owner in a different way than most real estate practitioners may interpret this term. "Beneficial Owner" is not defined in the Regulation, however, the FINTRAC guidance section in respect of beneficial ownership defines beneficial owners as follows:

"DRILLING DOWN"

> ***"Beneficial owners are the actual persons who directly or indirectly own or control 25% or more of an entity, which includes corporations. Beneficial owners cannot be another corporation or entity, they must be the actual persons who are the equitable owners of an entity. In order to determine the beneficial owners, you must search through as many levels of information as necessary in order to determine the actual persons.***
>
> ***It is important to distinguish between the names found on legal documentation versus the actual owners of an entity. For example, the legal owners of a company or trust, may not be the actual persons who own or control a company or trust."***[18]

Because of this interpretation by FINTRAC, you often hear lenders refer to the FINTRAC requirements as "drilling down to individuals". The reason behind the "drilling down" is to identify the actual persons behind entities and transactions, which reflects the processes established by other global money laundering and terrorist financing compliance regimes.

Own or Control

Ascertaining who owns or controls 25% or more of an entity may sound straightforward; however, practitioners who have dealt with complex ownership structures can attest to the fact that this task is not a simple one.

Corporation:

In respect of corporations, directors, officers, and voting shareholders control a corporation, while shareholders (both voting and non-voting) own the corporation. More specifically, ownership of non-voting shares constitutes

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[17] *Ibid* at Section 11.1(1).

[18] *Beneficial Ownership Requirements*, *supra* note 11.

ownership. Ownership of voting shares constitutes both ownership and control. Issues of interpretation arise when separate classes and numbers of voting and non-voting shares are issued by a corporation. A careful review of the articles of incorporation or by-laws of the corporation is warranted in these cases.

Trust:

In respect of trusts, Section 11.1(1)(b) requires the names and addresses of all trustees and all known beneficiaries and settlors of the trust to be obtained. FINTRAC published a special interpretation bulletin on trusts defines a settlor "as meaning a person or entity that lends or transfers, either directly or indirectly, property in the trust."[19] Note that the requirement to drill down to individuals owning or controlling more than 25% does not apply to trusts (as set out in Section 11 and 11.1). As such, the financial institution must obtain the names and addresses of all trustees and all known beneficiaries and settlors of the trust, which could be then be entity names and addresses and not necessarily individuals.

FINTRAC has indicated that if an individual is a beneficiary of a family trust, for example, a child or grandchild, and that beneficiary owns more than 25% of the trust, they must be identified and their addresses retained.[20] No guidance is published by FINTRAC as to what a financial institution is to record if the beneficiary is a possible unborn child or if the settlor is deceased and not replaced.

Other Entity:

A person making decisions in respect of other entities, such as partnerships, controls the entity. A board of directors of any other form of entity has control of that entity (for example, a board of directors appointed by a partnership).[21] The partners own the partnership.

In respect of a not-for profit organization, in addition to the information required from different types of client entities, the financial institution is also required to determine and retain information as to whether the entity is registered as a charity with the Canada Revenue Agency under the *Income Tax Act* or an organization that solicits charitable donations from the public.[22]

Keep in mind that through "combinations" an individual may own or control more than 25% of an entity because he or she owns, for example, 15% of one corporation which is the shareholder of a borrower, as well as 10% of another corporation which is the shareholder of a beneficial owner behind the borrower corporation.

The Regulation does not require a financial institution to identify individuals who

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[19] *Policy Interpretations, supra* note 13.

[20] *Policy Interpretations, supra* note 13.

[21] *Ibid.*

[22] *Regulation*, *supra* note 9 at Section 11.1(5).

may own or control less than 25% of an entity, but it must keep records of how it came to the conclusion that there were none or no other individuals that own or control more than 25% of an entity.[23] However, a financial institution may consider, as a best practice, retaining a list of individuals who own or control less than 25% of an entity if these individuals have a managing role or control of a significant percentage of shares.[24]

Public Bodies and Very Large Corporations

Pursuant to Section 62(2)(m) of the Regulation, the record-keeping obligations when opening an account do not apply to "instances where the entity in respect of which a record is otherwise required to be kept is a public body, or a corporation that has minimum net assets of $75 million on its last audited balance sheet and whose shares are traded on a Canadian stock exchange or a stock exchange designated under subsection 262(1) of the *Income Tax Act*, and operates in a country that is a member of the Financial Action Task Force".[25] More specifically, Under Guideline 6G, entitled FINTRAC Record Keeping and Client Identification, Section 4.2 – General Exceptions, FINTRAC clarifies that financial institutions are not required to collect prescribed information on beneficial owners or to establish ownership, control and structure of an entity for public bodies and very large corporations when they open an account for them.[26]

Unsophisticated Entities

FINTRAC takes the position that a reporting entity such as a financial institution must determine the level of risk associated with their customer based on the information it gathers and retains in accordance with the Act, the Regulation and its own internal policies and procedures. As such, if a financial institution cannot obtain and confirm the information required, financial institution can:

- obtain the name of the most senior managing officer of the corporation, trust or other entity;
- take reasonable measures to ascertain the identity of the most senior managing officer of the corporation, trust or other entity; and
- treat that corporation, trust or other entity as high-risk and undertake more frequent monitoring of the entity including the updating of client identification information and any other appropriate enhanced measures.

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[23] *Policy Interpretations, supra* note 13.

[24] *Beneficial Ownership Requirements*, *supra* note 11.

[25] *Regulation, supra* note9 at Section 62(2)(m).

[26] *Policy Interpretations, supra* note 13.

How to Identify an Individual

In accordance with Section 64(1) of the Regulation, an individual's identity may be ascertained in several ways, the most common of which is by referring to original, valid, current (unexpired) government issued ID containing the name and photograph of the individual.[27] However, the Regulation allows for other manners of ascertaining identity, including reference to an identification document issued upon request by a government entity which contains the name and photograph of the individual, or the individual's name and address or name and date of birth,[28] by referring to the name, address, and date of birth contained in the individual's credit file provided that the file is located in Canada and has been existence for at least three years, or relying on another foreign bank, credit union, life insurance company, trust or loan company, securities dealer or related financial entity's records in this regard.[29] Interestingly, the individual only need be present while being identified in the presence of the person identifying the individual if the government issued photo identification method is used.[30]

If none of the foregoing is possible, the financial entity can do any two of the following:

> ***(i) referring to information from a reliable source that includes their name and address, and verifying that the name and address are those of the person,***
>
> ***(ii) referring to information from a reliable source that includes their name and date of birth, and verifying that the name and date of birth are those of the person, or***
>
> ***(iii) referring to information that includes their name and confirms that they have a deposit account or a credit card or other loan account with a financial entity, and verifying that information.[31]***

This "dual process method" must see the financial instruction obtain the information from two different sources, and the source cannot be the individual being identified or the financial institution.[32] For example, FINTRAC states that examples of information that may be used in the dual process method include the federal, provincial, territorial and municipal levels of government, crown

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[27] *Regulation, supra* note 9 at Section 64(1)(a).

[28] *Ibid* at Section 64(1)(b) and 64(1)(c).

[29] *Ibid* at Section 64(1)(e).

[30] FINTRAC, "Ascertaining Identification", Online: (2017) < http://www.fintrac-canafe.gc.ca/guidance-directives/overview-apercu/FINS/2-eng.asp?s=11>[*Identification*].

[31] *Ibid* at Section 64(1)(d).

[32] *Ibid* at Section 64(1.3).

corporations, financial entities or utility providers.[33]

The financial entity may rely on an agent or mandatary to ascertain the individual's identity pursuant to a written agreement or arrangement with the financial institution or other reporting entity.[34] For example, FINTRAC has stated that "where an existing client wishes to renew a loan, and their identity was previously ascertained – so long as the financial entity (with the obligation to ascertain the client's identity) has no doubts about the information previously used to ascertain the identity of the client, and a related record was kept,"[35] there is no need to identify the individuals again, subject to the ongoing monitoring requirements of the Regulation (to keep information updated and monitored based on the risk level of the client determined pursuant to Section 9.6(2) of the Act and Section 71(1) of the Regulation).

The requirements of the Regulation are thorough and in this author's experience, can often cause delays in the completion of financings due to misunderstandings. However, FINTRAC publishes interpretation notices and policy interpretations on its website, which provide guidance on a wide variety of specific scenarios. With access to the guidance provided by FINTRAC, real estate practitioners can look forward to smoother completion of the AML forms required by lenders.

CANADA (A.G.) *V.* FEDERATION OF LAW SOCIETIES

A paper being presented to lawyers would not be complete without a look at how the Act and Regulations relate to our business. The Supreme Court of Canada decision in *Canada (A.G.) v. Federation of Law Societies*[36] answered the question as to whether required compliance with the Act and the Regulations were contrary to solicitor-client privilege and Sections 7 (depravation of liberty) and 8 (unreasonable searches and seizures) of the *Charter*[37]. In some respects, the answer was yes.

The Court examined several sections of the Act. Firstly, under the Act, FINTRAC is entitled to "examine the records and inquire into the business and affairs" of certain entities, which included the ability to search computers and make paper copies of documents. The Act did contemplate a claim for solicitor-

[33] *Identification, supra* note 31.

[34] *Ibid* at Section 64.1(1)-(3).

[35] *Identification, supra* note 31.

[36] 2015 SCC 7, [2015] 1 S.C.R. 401.

[37] *The Canadian Charter of Rights and Freedoms*, Part I of the Constitution Act, 1982, being Schedule B to the Canada Act 1982 (U.K.), 1982, c.11.

client privilege in respect of FINTRAC searches, but a lawyer was required to seal, identify and retain a purported privileged document, and to claim privilege to a court within fourteen days.[38] Secondly, certain entities are to verify the identity on whose behalf they act as financial intermediaries; and issue a detailed receipt of funds record for transactions over $3,000 unless the funds have come from a financial entity or public body and keep such records for five years (to be produced upon 30 days' notice from FINTRAC).[39] Finally, entities are subject to fines and imprisonment for violation of the Act.

The Supreme Court held that sections of the Act regarding the ability to examine records and inquire into the business and affairs was to be read down to exclude lawyers and law firms. Moreover, the section of the Act allowing FINTRAC the right to search law offices was struck down completely.[40]

[38] *Ibid* at para. 19.

[39] *Ibid* at paras. 14-17.

[40] *Ibid* at para 67.