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FinCEN Takes Aim At Commercial Property Amid Ukraine War

By **Valentina Pasquali**

Law360 (January 27, 2023, 7:25 PM EST) -- Financial institutions are bound to boost scrutiny of commercial real estate clients' disclosures and transactions after the U.S. Financial Crimes Enforcement Network warned them of the "likely" presence of sanctioned Russian nationals and companies in the sector.

FinCEN, a bureau of the U.S. Department of the Treasury, issued the 11-page alert Wednesday, noting that the network's analysis of financial institutions' reports of suspicious transactions shows designated Russians and their associates may be eyeing the multilayered, complex and often cross-border nature of many large commercial property deals to shield their funds from U.S. and international sanctions.

"Commercial real estate transactions tend to be complicated and opaque, with use of shell companies and trusts and other legal entities that could conceal who the real principals behind the transactions are. So that makes it attractive," Dan Stipano, a Davis Polk & Wardwell LLP partner and former deputy chief counsel for the Office of the Comptroller of the Currency, told Law360.

"The other thing is that commercial real estate tends to be pretty stable. If your money is parked in a commercial real estate project, you probably are not going to lose all your money," he said.

With its alert, FinCEN laid out the potential exposure of financial institutions involved in providing loans, financing, insurance and other support to commercial real estate deals to Russian attempts to evade sanctions.

"The practical effect of this is that banks will be even more on the lookout for potentially suspicious transactions involving commercial real estate, and that would mean some form of enhanced due diligence," Stipano said. "[That might mean] asking more questions at the outset, but also monitoring what happens going forward with the project."

A Heightened Profile

Since Russia invaded Ukraine almost a year ago and the U.S. and its allies responded with far-reaching sanctions on Russia's largest industries and politically connected elites, FinCEN has ratcheted up efforts to get financial institutions to scrutinize ensuing attempts to move Russian funds under the radar.

Nearly 1,900 Russian individuals, entities, aircraft and vessels have been hit with sanctions since late February 2022, according to data that global sanctions screening firm Castellum.AI shared with Law360.

FinCEN previously identified residential and commercial real estate as being among the high-value assets and goods, such as jewelry and luxury vehicles, that would be attractive to Russians looking to evade the financial restrictions.

That March 2022 alert built on six years of efforts to home in on the vulnerability of the high-end residential real estate market to exploitation by foreign corrupt officials, drug traffickers and other financial criminals. The bureau did this primarily by imposing rolling requirements, called Geographic Targeting Orders, or GTOs, on title insurance firms in targeted U.S. markets to identify the ultimate owners of legal entities that purchase luxury condos or homes.

FinCEN's latest publication, however, is the first to focus single-handedly on commercial properties.

"It's building on a previous alert, but it is significant because historically FinCEN has not applied regulations or obligations related to commercial real estate," said Braddock Stevenson, of counsel at Paul Hastings LLP and a former deputy associate director of FinCEN's Enforcement Division. "The fact that they are continuing to focus on commercial real estate … lends to the issues that they are seeing."

The bureau's ongoing work to build a national database of **legal entities' beneficial owners** will also eventually bolster oversight of the commercial real estate sector, which relies heavily on such corporate structures.

Under the Microscope

As such, commercial real estate operators, in their dealings with banks and other financial institutions, should expect more questions about any possible foreign owners, third-party owners or the exact individuals behind trust owners, Stevenson said.

"It's going to change the scrutiny," he said. "I think these transactions are definitely more scrutinized because the expectation out there is that banks and intermediaries and other financial institutions are scrutinizing them."

Wednesday's alert lists several broad strategies or products that sanctioned Russians might use to invest in U.S. real estate.

They are: funneling the funds through pooled investment vehicles or shell companies and trusts; hiding their identity behind that of family members, business partners, friends or other frontmen; and putting money toward solid but low-profile projects in the multifamily housing, retail, office, industrial or hospitality sectors that are less likely to attract the attention of U.S. authorities or the public.

The alert also outlines nine more specific transactional red flags that, especially when occurring in combination, a financial institution might consider indicative of possible money laundering through commercial real estate.

For example, lenders, loan syndicators, insurance companies and other financial institutions might want to give a second look to any offshore-based "private investment vehicle" backed by foreign investors, especially anyone connected with sanctioned Russian politicians and oligarchs, or a foreign trust that owns U.S. commercial properties through various legal entities registered in different overseas jurisdictions.

Jamal El-Hindi, a former FinCEN deputy director and now counsel at Clifford Chance LLP, told Law360 the bureau's reference to "offshore vehicles" behind commercial real estate is likely to prompt stricter monitoring of relevant investment flowing into the U.S. from countries that have not imposed sanctions on Russian interests, since they are more likely to function as conduits for Russian sanctions evasion.

Ultimately, because many legitimate commercial real estate transactions take exactly the complex, murky, international forms outlined by FinCEN, the alert serves more as "a list of problems" financial institutions should think hard about than one of ready-made solutions, according to Peter Hardy, a Ballard Spahr LLP partner and former assistant U.S. attorney in Philadelphia.

"The banks are already looking hard, but stuff like this will make them look even harder in particular instances where they are examining something," he said.

Hardy agreed that real estate professionals and their representatives should stand ready to answer more questions from financial institutions. He also said they should follow the "golden rule" of digging into "anything that feels weird" about a commercial property deal rather than "stop looking."

"This is a master-of-the-obvious comment. It's easy to articulate, but it's hard to carry out in practice," Hardy said.

A Learning Curve

Following the alert's publication, financial institutions will typically increase training of their compliance and frontline staff, such as relationship managers, on the ins-and-outs of commercial real estate transactions, several attorneys said.

In particular, they may want to drill down further on overlaid ownership structures and the fluid nature of pooled investment vehicles, according to Matthew Bisanz, a partner in Mayer Brown LLP's financial services regulatory and enforcement practice.

"It's really hard for a bank to be in a position to understand the economics of a pooled investment vehicle, as those can change," Bisanz said. "A fund might present a limited partnership agreement that shows today there are 100 investors all with 1% … and tomorrow 99 of those investors sell."

In the alert, FinCEN zeroed in on how sanctioned Russians and their associates may hide behind multiple levels of legal entities or pooled investment vehicles to dilute their direct stakes in U.S. commercial real estate assets well below the 25% threshold. That's the floor at which financial institutions are already obligated to identify beneficial owners under the bureau's own customer due diligence rule, or CDD.

"Even if banks lower their threshold below 25% to 10%, which is common with respect to financial institutions' CDD requirements for high-risk customers, investors seeking to evade sanctions may lower their interest in a fund to just below that threshold to avoid the bank's detection," the bureau said in the alert. "These investors may in fact be general partners that have actual control of the fund, but their ownership interest will fall under a bank's bespoke CDD ownership threshold."

FinCEN's warning may prompt banks to lower their CDD floor further, to 5% or less, in the case of foreign-linked or otherwise high-risk commercial real estate clients, according to multiple sources.

Representatives of commercial real estate operators responsible for providing information and responding to financial institutions' questions separately need to ensure that any material representation they make about links to foreign investors is fully aboveboard.

That obvious fact has become all the more urgent since a provision of the Anti-Money Laundering Act, which was enacted in January 2021, now enables federal prosecutors to seek the seizure or forfeiture of any assets of more than $1 million whose control by foreign politicos and their proxies has been "knowingly" concealed or misrepresented from a relevant financial institution, according to Paul Hastings' Stevenson.

A Harbinger of What's Next

FinCEN's first formal, targeted foray into the commercial real estate market might also be a sign of things to come. The bureau is expected to publish a proposal over the next two to three months to regulate the broader real estate sector for anti-money laundering purposes.

The forthcoming notice of proposed rulemaking follows an early request for public input that FinCEN put out in December 2021 laying out a series of questions about which market players should fall under the new regime and what requirements they should face.

"There was another major question in there, which was, 'If we are going to do this, should this be just the residential real estate market, or should it be both the residential and the commercial real estate market?'" said Ballard Spahr's Hardy.

"One thing that occurred to me [about the alert] beyond FinCEN's stated purpose of emphasizing again the role of Russian oligarchs … this may be part of an effort to sow the seeds for a proposed rulemaking that actually includes the commercial real estate market," he said.

--Editing by Philip Shea and Jill Coffey.
