



Banking Emerging Technology Clients: A How-To for Sponsor Bank Due Diligence on Nontraditional Companies

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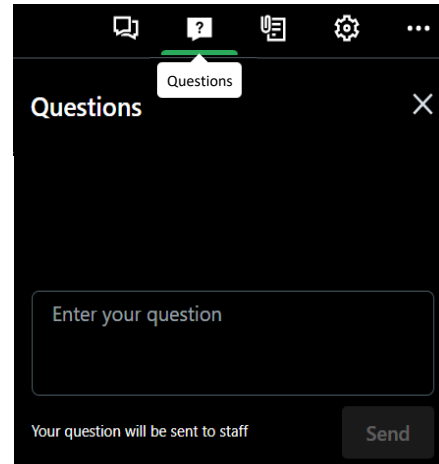
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Before We Begin



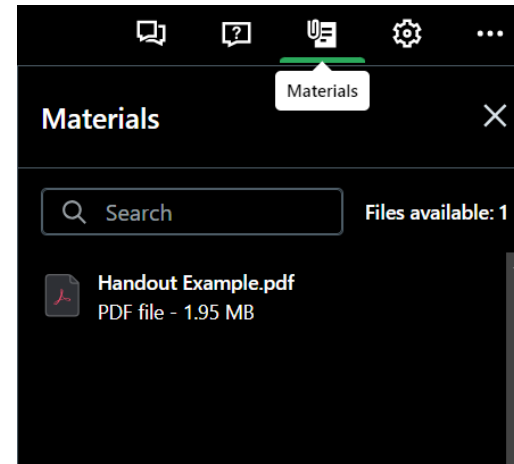
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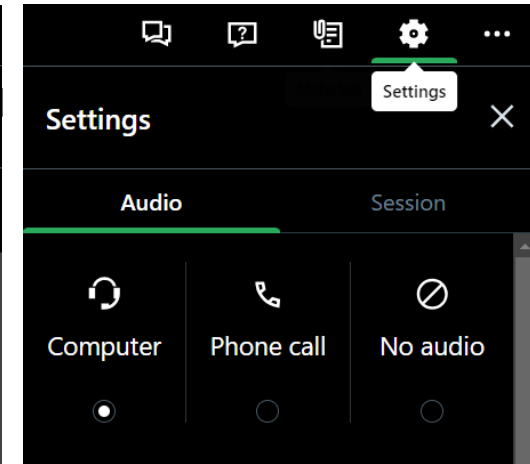
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Learning Objectives

By the end of this course, attendees will learn:

- How to adapt due diligence practices to align with today's stringent regulatory climate, including Know Your Customer (KYC), Anti-Money Laundering (AML), and consumer protection mandates
- The sponsor bank due diligence process through real-world examples and discussions on evolving legal frameworks
- Insights and tools needed to secure compliant partnerships in the emerging technologies landscape



Key AML Regulation in the United States

1. Bank Secrecy Act (BSA) of 1970

- Cornerstone of U.S. AML laws
- Requires financial institutions to keep certain records, file specific reports, and maintain procedures for identifying and reporting suspicious activities
- **Key Requirements:**
 - Suspicious Activity Reports (SARs) and Continuing Activity Reports (CARs)
 - Currency Transaction Reports (CTRs)
 - Recordkeeping
 - Establishes AML Program requirements for banks and other financial institutions

Key AML Regulation in the United States

2. USA PATRIOT Act of 2001

- In response to September 11th attacks
- Expanded BSA's requirements and introduced provisions to combat terrorist financing
- **Key Requirements:**
 - Customer Identification Program (CIP) / KYC Regulation
 - Enhanced Due Diligence (EDD)
 - Terrorist Financing Regulations – Report suspicious activity (SAR) related to terrorism and ensure they are not on any sanctions lists

Key AML Regulation in the United States

3. Office of Foreign Asset Control (OFAC) Regulations

- Enforces U.S. economic and trade sanctions against foreign countries and individuals that threaten U.S. interests (e.g., regimes, terrorist, drug traffickers)
- **Key Requirements:**
 - All U.S. persons and businesses must check their customers against the Specially Designated Nationals (SDN) List, which includes individuals and entities with whom U.S. persons and businesses are prohibited from conducting transactions
 - Institutions must block transactions with SDN list entities or individuals immediately upon discovery
 - Institutions must report transactions (“blocking report”) with individuals or entities listed on the SDN List within 10 business days of the block.

Who Is Required to Comply With AML Regulation?

Financial Institutions – defined as the following per BSA:

- Banks
- Broker/dealers
- Money Service Business (MSB)
- A telegraph company
- Casino
- Card club (gaming club/gaming room)
- A person subject to supervision by any state or federal bank supervisory authority
- A futures commission merchant
- Introducing broker in commodities
- Mutual fund
- A jeweler/dealer in precious metals, stones, or jewels (they are considered an MSB if they meet specific criteria)

Non-FIs and Their Role in AML

- Non-financial institutions are not required by U.S. regulation to have an AML program.
- However, many banks are requiring their business customers to have an AML program that complies with BSA/AML regulation. Includes businesses, such as:
 - Third-party payment providers (i.e., Square, Stripe, etc.)
 - Banking as a Service (BaaS) providers (i.e., mobile banking providers)
 - Car dealerships
 - Staffing companies
 - Cryptocurrency exchanges

AML Program – Five Pillars of an AML Program

1. Establish a Designated Compliance Officer
2. Implement Internal Policies and Procedures
3. Employee AML Training
4. Independent Testing of the AML Program
5. Customer Due Diligence (CDD)

In June 2024, FinCEN proposed a new rule to strengthen and modernize financial institutions AML programs that would include a “sixth pillar” of AML: Risk Assessments.

AML Program – Pillar I Compliance Officer

- The BSA/AML compliance officer plays a pivotal role in adhering to and ensuring AML compliance
- Must be designated by the company
- Must be capable of thoroughly understanding and implementing policies and procedures
- Often seen as reporting up to general counsel
 - However, best practice is to separate these two functions as the BSA officer should have independence and a direct line up to the board of directors.

AML Program – Pillar II Internal Controls

Written policies and procedures

- AML Program Policy – requirement
- Additional procedural documents are helpful and best practice:
 - KYC guidelines
 - Transaction monitoring procedures
 - Suspicious Activity Reporting and procedures
 - OFAC procedures
- Allows team members to refer back to procedural documents for guidance in their compliance role. Assists with training onboarding employees.

Team governance

- Compliance team meeting cadence to discuss ongoing investigations, risk areas, etc.
- Meetings and/or reports with sr. leadership and board of directors
 - How often are they updated? What information is provided?
 - Methods used (i.e., email, reports, slide decks, etc.)
 - How are they reached in a compliance emergency?

**KYC and Transaction monitoring tools –
Are they internal or external? What is their purpose?**

AML Program – Pillar III Training

- AML training should be provided annually to all employees and the board of directors
- Training should cover:
 - Legal AML framework
 - Institution's internal policies and procedures
 - How to identify suspicious activity
 - Examples of red flags
 - Reporting obligations of the company
 - Penalties for non-compliance
- Specialized training can be provided to compliance team members

AML Program – Pillar IV Independent Review

- **Needs to be an independent review of the AML program**
 - Internally by employees who are not in a compliance function
 - Lack of necessary resources to support an internal review
 - Third-party independent reviewer with deep knowledge of required regulations
- **Identifies gaps and/or weaknesses in an AML program**
 - Provide insight on areas of the AML program that may be violating U.S. regulation
 - Recommend best practices for improving an AML program

AML Program – Pillar V Customer Due Diligence (CDD)

○ CDD Final Rule

- Requires financial institutions to identify and verify the identity of natural persons (beneficial owners) of legal entity customers who own, control, and profit from companies when those companies open accounts
- **Covered financial institutions are required to establish and maintain written policies and procedures to:**
 - Identify and verify the identity of customers
 - Identify and verify the identity of the beneficial owners (if a customer is an organization)
 - Understand the nature and purpose of customer relationships to develop risk profiles
 - Conduct ongoing monitoring to identify and report suspicious activity and update customer info

AML Program – KYC: What Is Required?

- **Required KYC Data per U.S. Regulation**

- | | |
|---------|----------------------------|
| 1. Name | 3. Address |
| 2. DOB | 4. Tax ID (SSN, EIN, Etc.) |

- **Best practices**

- Third-party tools for verification of name, DOB, SSN, government issued ID, adverse media, etc.
- Customer KYC updates
- Risk-based approach
- Periodic reviews
- Event-driven updates

- **Verification per U.S. Regulation**

- Must include risk-based procedures to verify the identity to the extent reasonable and practicable.
- Must enable FI to form a reasonable belief that it knows the true identity of the customer
- Can use documentary or non-documentary methods

AML Program – Risk Assessment

- Will likely be the sixth pillar of AML
- FinCEN proposed rule in June 2024
 - Requires financial institutions to conduct a risk assessment to assess AML risks and use the risk assessment to create a risk-based AML program
- Best practices for a risk assessment
 - Create a “quick reference guide” that explains the methodology as an attachment to the risk assessment. This will help regulators, employees, stakeholders, better understand risk scoring
 - Include a process chart of flow of funds as an example for products/services offered
 - Give real life examples of what the risk might look like for each risk category
 - Indicate what controls are implemented to mitigate risk
 - Assess future risks and list any mitigating controls being implemented currently

OFAC Recordkeeping Updates

- FinCEN final rule – took into effect in March 2025
- Aligns with April 2024 regulation updates to extend statute of limitations for civil and criminal violations of OFAC sanctions.
- Adhering to regulation updates:
 - Update recordkeeping policies – All records for transactions subject to OFAC sanctions must now be kept at least 10 years.
 - For blocked assets: retention requirements begin when the transaction is unblocked. Therefore, it is possible if the assets are never unblocked, the institution would keep the records indefinitely.
 - Update compliance workflows and tools to capture this OFAC update.
 - Regularly audit and stress-test OFAC compliance programs.
 - Enhance employee training on maintaining records.

Sponsor Bank Due Diligence

- More sponsor banks are requesting their business customers have AML programs that are independently reviewed
 - Pressure from regulators (FinCEN, OCC, FDIC, etc.) to scrutinize their business clients more closely
 - Corporate Transparency Act and increasing global AML efforts, such as EU directives, pushing banks to demand more due diligence from their global customers
 - De-risking strategies by banks to avoid the need or pressure to offboard their business customers
 - Banks particularly concerned with business that deal with:
 - High-value goods
 - Third-party payments
 - Cryptocurrency transactions
 - Cross-border payments

Questions to Ask Customers to Secure Partnerships

1. Have you created an AML risk assessment to assess the risk posed by your customers, products and services, and geographic locations serviced?
2. What are your mitigating controls to reduce your AML related risks?
3. What KYC and transaction monitoring tools are used?
4. Have you created an AML program?
5. Have employees been trained to detect and report suspicious activity?
6. Have you assessed what percentage of revenue has been lost to fraud?
 - This may provide better insights as to their transaction monitoring activities and/or their risk level comfort

Banking High Risk Customers – Due Diligence

1. Rigorous pre-onboarding due diligence
2. Independent compliance assessment
3. Robust BSA/AML and sanctions controls
4. Tiered risk monitoring framework
5. Contractual compliance provisions
6. Regulatory engagement strategy

Recent News: AML Violations and Fines

Coinbase – Cryptocurrency Exchange

- **Regulatory Action**
 - Coinbase fined **\$100 million** by NY State Department of Financial Services in January 2023
- **Violations**
 - Inadequate AML program between 2018-2019
 - Weak customer due diligence, accounts opened with insufficient checks
 - Over **100,000 unreviewed transaction alerts**
 - Exposure to potential money laundering, child exploitation, drug trafficking
- **Settlement Details**
 - \$50 million fine
 - \$50 million commitment to improving compliance infrastructure

Recent News: AML Violations and Fines

TD Bank, N.A. – American subsidiary of Canadian multinational TD Bank Group

- **Regulatory Action**
 - In October 2024, TD Bank pleaded guilty to violating BSA and conspiracy to commit money laundering
- **Violations**
 - Failure to maintain an effective AML program
 - Senior executives were aware of and ignored compliance deficiencies
 - Allowed over \$400 million from fentanyl sales by one customer to be laundered through its accounts
- **Penalties Imposed**
 - \$1.8 billion to the Department of Justice
 - \$1.3 billion to the Financial Crimes Enforcement Network

Managing a Regulatory Outreach

- Immediate scope clarification and legal triage
- Internal notification and documentation preservation
- Regulatory response protocols
- Audit and oversight demonstration
- Regulator relationship management
- Board reporting and training

Due Diligence From a VC Perspective

- Financial health and projections
- Churn/retention
- IP assignments
- Founder stories
- Founder background checks
- Product roadmap
- Legal diligence (including regulatory compliance)

Relevant Services & Key Offerings

Arnall Golden Gregory LLP

- **Partner Due Diligence and Risk Underwriting Support**
- **Contract Drafting and Negotiation**
- **BSA/AML and Compliance Program Review**
- **Regulatory Outreach and Enforcement Response**
- **Audit and Governance Advisory**
- **Bank-Readiness and Licensing Strategy**
- **Risk Remediation and Regulatory Defense**

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