Client Alert

May 16, 2016

FinCEN Finalizes Customer Due Diligence Rule for Legal Entity Customers

On May 11th, 2016, the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Department of the Treasury, published a Final Rule (the "Rule") on customer due diligence after a four-year rulemaking process. The Rule requires covered financial institutions, including banks, money services businesses, broker-dealers, mutual funds, and commodities brokers, to enhance their customer due diligence procedures by collecting and verifying information about the individuals who own or control the legal entity customers of the financial institution. These individuals are referred to in the Rule as "beneficial owners." The Rule also adds a "fifth pillar" to the minimum requirements of an anti-money laundering ("AML") compliance program by explicitly requiring financial institutions to develop and update customer risk profiles and customer information and to conduct ongoing AML monitoring. As a concession to numerous commenters, the Rule provides a two-year compliance deadline instead of the one-year deadline in the proposed rule (the "Proposed Rule").

The Rule is the culmination of a rulemaking proceeding that began in March 2012 with an advance notice of proposed rulemaking and continued with the Proposed Rule issued in August 2014. The rulemaking appeared to receive fresh impetus following the Panama Papers and other data leaks alleging the use of shell entities to evade financial reporting obligations.

At each stage of the rulemaking process, FinCEN received numerous comments from financial industry stakeholders challenging or expressing concerns about certain aspects of the rulemaking. The Rule makes some notable changes from the Proposed Rule. In particular, the Rule accepts that, in general, financial institutions do not need to verify whether individuals listed as beneficial owners in fact hold the requisite ownership interest or exert significant control over the entity. Financial institutions typically need only collect and verify the information for the individuals listed by the legal entity customer. The Rule also excludes more categories of legal entity customers from the Rule, meaning that financial institutions do not need to collect beneficial owner information for these excluded entities. Importantly, however, foreign financial institutions that are customers of covered financial institutions are not categorically excluded from the Rule.

THE BENEFICIAL OWNER INFORMATION OBLIGATION

Section 326 of the USA PATRIOT Act grants authority to FinCEN to prescribe "minimum standards" for covered financial institutions in identifying and verifying customer information when customers open accounts. FinCEN accordingly issued a rule in 2003 setting forth requirements for a customer identification program (the "CIP Rule"), but the CIP Rule focused on the individual or entity opening an account, and did not require financial institutions to identify and verify information for the beneficial owners of legal entity customers.

The Rule closes this gap with respect to legal entity customers. Financial institutions must now "establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers…."[1] To determine who is a "beneficial owner," financial institutions must use both an ownership test and a control test. Under the ownership test, financial institutions must collect information pertaining to individuals who, "directly or indirectly," have at least a 25 percent interest in the equity of the legal entity customer.[2] FinCEN

[1] 31 C.F.R. § 1010.230(a), as added at 81 Fed. Reg. 29,398, 29,451 (May 11, 2016).

[2] § 1010.230(d)(1), as added at 81 Fed. Reg. 29,451.

rejected proposals to lower the equity interest threshold to 10 percent because it believed that a lower threshold would be unduly burdensome. Under the control test, financial institutions must collect and verify information for a single individual who has "significant responsibility to control, manage, or direct a legal entity customer," such as a CEO, President, or similar "executive officer or senior manager."[3] Regarding verification of the collected information, at a minimum, financial institutions must use the risk-based verification procedures provided under the CIP Rule,[4] except that financial institutions can rely on reproductions, such as photocopies, instead of original documentation.[5] An even more important difference from the CIP Rule, and a significant concession to industry commenters, is that financial institutions "may rely on the information supplied by the legal entity customer regarding the identity of its beneficial owner or owners, provided that it has no knowledge of facts that would reasonably call into question the reliability of such information."[6] In other words, generally speaking, financial institutions do not have to inquire into whether a named beneficial owner is actually an individual who holds a 25 percent or greater share of the entity or is a senior executive.

The Rule defines a "legal entity customer" as an entity that files a public document with a Secretary of State, or similar state official or office, including any similar entity formed under the laws of a foreign jurisdiction.[7] Financial institutions are not required to collect beneficial owner information for a number of "legal entity customers," including banks, bank holding companies, certain pooled investment vehicles, state-regulated insurance companies, financial market utilities (as designated by the Financial Stability Oversight Council), and foreign financial institutions (to the extent a foreign regulator collects beneficial owner information relating to the ownership of the foreign financial institution).[8]

In addition to the "legal entity customer" exclusions, the Rule exempts certain activities, meaning that even if an entity is a "legal entity customer," the financial institution does not need to collect beneficial owner information if that entity customer is engaged in exempted activities. Of particular note, financial institutions do not need to collect beneficial owner information for credit accounts opened at the point of sale that can be used solely to purchase goods and services from the retailer, such as private-label credit cards, so long as the credit limit does not exceed $50,000.[9]

The Rule still leaves some uncertainty, or flexibility, regarding a financial institution's beneficial owner obligations.

- Although the Rule declined to impose a 10 percent equity interest threshold on the definition of a "beneficial owner," FinCEN left the door open to circumstances where a financial institution might need to collect information for beneficial owners who have less than a 25 percent interest. In the Supplementary Information, FinCEN notes that it "anticipates that some financial institutions may determine that they should identify and verify beneficial owners at a lower threshold in some circumstances."[10]

[3] § 1010.230(d)(2), as added at 81 Fed. Reg. 29,452.

[4] *See* 31 C.F.R. § 1020.220(a)(2) for these procedures as applicable to banks.

[5] § 1010.230(b)(2), as added at 81 Fed. Reg. 29,451.

[6] *Id.* Financial institutions may provide a certification form included in the Rule to legal entity customers for use in identifying beneficial owners. *See* 81 Fed. Reg. 29,454-57.

[7] *See* § 1010.230(e)(1), as added at 81 Fed. Reg. 29,452.

[8] *See generally* § 1010.230(e)(2), as added at 81 Fed. Reg. 29,452.

[9] *See* § 1010.230(h)(1)(i), as added at 81 Fed. Reg. 29,452. The Rule imposes limitations on these exemptions where the product at issue facilitates payments to third parties or cash refunds. *See* § 1010.230(h)(2), as added at 81 Fed. Reg. 29,452.

[10] 81 Fed. Reg. at 29,410.

- FinCEN declined to specifically define what it means by "indirect" ownership and "effective" control of the legal entity; FinCEN intends these terms to be broadly applicable to reflect the multitude of ownership and management structures.[11]

- Although financial institutions obtained an important concession in being able to rely on beneficial owner information provided by the entity, the circumstances under which FinCEN might determine that a financial institution has "knowledge of facts" that "reasonably call into question" the beneficial owner information submitted by the entity remain to be seen.[12]

- The Rule sends a somewhat mixed message about whether the Rule applies to existing accounts and whether financial institutions have an ongoing obligation to update or re-verify beneficial ownership information. On the one hand, FinCEN declined to impose a "categorical" obligation to collect and verify beneficial owner information for accounts opened prior to the Rule's May 11, 2018 compliance deadline because it recognized that doing so would be unduly burdensome.[13] On the other hand, FinCEN left the possibility open that it "may be appropriate" for financial institutions in certain circumstances to collect beneficial owner information, presumably even for accounts opened prior to the compliance deadline.[14] Similarly, while indicating that beneficial owner requirements should be considered a "snapshot" in time, FinCEN noted an expectation that financial institutions would update beneficial owner information learned through a financial institution's "normal monitoring of facts relevant to assessing the risk posed by the customer."[15]

- The Supplementary Information to the Rule explicitly leaves open the possibility that federal prudential regulators can impose additional AML-related requirements on financial institutions. According to FinCEN, federal prudential regulators "have authority to establish AML program requirements in addition to those established by FinCEN," and that FinCEN's requirements "represent a floor [and] financial institutions may do more in circumstances of heightened risk."[16] Many commenters urged FinCEN to remove these statements from the Proposed Rule because they could result in uncertainty about financial institution obligations. Although FinCEN acknowledged this concern, it nevertheless pointed to the jurisdictional reality of other federal regulators having authority with respect to setting AML requirements appropriate to specific identified risks.[17]

THE "FIFTH PILLAR" OF AN AML PROGRAM

Section 352 of the USA PATRIOT Act sets forth the so-called "four pillars" of an effective AML program: policies and procedures, a designated compliance officer, an ongoing training program, and an independent audit function. The Rule stipulates a "fifth pillar" relating to the obligation of a financial institution to conduct customer due diligence. This customer due diligence pillar has two elements: (1) "understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile" and (2) "conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information," including the beneficial owner information.[18]

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[11] *See* 81 Fed. Reg. at 29,411-12.

[12] *See* § 1010.230(b)(2), *supra* n.6.

[13] *See* 81 Fed. Reg. at 29,404.

[14] *See id.*

[15] 81 Fed. Reg. at 29,410.

[16] 81 Fed. Reg. at 29,404.

[17] *See id.*

[18] *See* § 1020.210(b)(5), as added at 81 Fed. Reg. 29,457, as applicable to banks. Other covered financial institutions have identical obligations in separate provisions of the Code of Federal Regulations.

Some commenters objected to this fifth pillar on jurisdictional grounds by asserting that it was not stipulated under the USA PATRIOT Act. But FinCEN responded that, by its terms, Section 352 sets forth the "minimum" elements of an AML program and that FinCEN has the authority to issue regulations that go beyond the minimum elements specified in the USA PATRIOT Act. FinCEN minimized the practical effect of codifying the "fifth pillar" by stating that identifying and verifying customer information were already included in the requirement to maintain policies and procedures, and that maintaining a customer risk profile and conducting ongoing monitoring were already implied obligations relating to a financial institution's obligations to report suspicious activity.[19] FinCEN believes that there is value in making these obligations explicit to ensure consistent understanding of regulatory requirements for all financial institutions.[20]

The primary compliance challenge for financial institutions with respect to the fifth pillar is likely to be the obligation to update customer information as part of the ongoing monitoring process. It will be an ongoing challenge to identify information and transactional activities which, to a regulator, would result in an obligation to update customer information, including beneficial owner information.

OTHER TREASURY DEPARTMENT ACTIONS

In conjunction with the release of the Rule, Treasury Secretary Jacob Lew sent a letter to Congressional leaders urging them to build on the Rule by passing legislation that would require companies to "disclose the real person behind a company at the time of its creation." The Department of the Treasury also proposed a rule to require foreign-owned "disregarded entities," including foreign-owned, single-member limited liability companies, to obtain an employer identification number from the IRS. Secretary Lew said the purpose of the rule is to assist the IRS in determining the tax liability of such foreign-owned entities and sharing the tax information with foreign jurisdictions.

OUR TAKE

FinCEN's Rule harmonizes and clarifies existing requirements for financial institutions and underscores the priorities that the Treasury Department places on disrupting illicit financing channels. As FinCEN continues to strengthen the rules that implement the Bank Secrecy Act, we can expect that additional compliance scrutiny will follow.

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[19] *See* 81 Fed. Reg. at 29,398.

[20] *See* 81 Fed. Reg. at 29,401.

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