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FINCEN'S CUSTOMER DUE DILIGENCE AND BENEFICIAL OWNERSHIP RULE

FinCEN's new rule will require financial institutions to establish written procedures reasonably designed to identify and verify the identities of beneficial owners of legal entity customers. The authors discuss the coverage of the rule, addressing the definitions of "legal entity customer," "beneficial owner," "account," and requirements for identification and verification. They then turn to the rule's amendments to AML Program requirements and set out practical steps for financial institutions as they prepare for compliance.

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On May 11, 2016, the U.S. Department of Treasury's Financial Crimes Enforcement Network ("FinCEN") published a long-awaited final rule, Customer Due Diligence Requirements for Financial Institutions (the "Final Rule").¹ The Final Rule, which impacts anti-money laundering ("AML")-related obligations imposed

on financial institutions under the authority of the Bank Secrecy Act ("BSA"), was the culmination of a four-year rulemaking process. The Final Rule explicitly codifies customer due diligence ("CDD") requirements for covered financial institutions, and imposes a new requirement to obtain and verify the identity of beneficial owners of legal entity customers. The Final Rule imposes significant new compliance burdens on financial institutions.

¹ FinCEN, Final Rule, Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29398 (May 11, 2016).

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While the Final Rule technically took effect on July 11, 2016, compliance is not mandatory until May 11, 2018 (the “Applicability Date”).² As of the date of this publication, covered financial institutions are more than half-way through the two-year period provided by FinCEN to come into compliance with the Final Rule. As financial institutions covered by the Final Rule, in particular banks, continue to prepare for implementation of the Final Rule, there are some practical steps that institutions can consider taking to avoid pitfalls in the Final Rule’s requirements.

I. BACKGROUND AND PURPOSE OF THE FINAL RULE

The BSA³ authorizes the Secretary of the Treasury to issue regulations requiring certain enumerated financial institutions to keep records and file reports that the Secretary determines “have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism.”⁴ In this regard, the Secretary is authorized to impose anti-money laundering (“AML”) program, recordkeeping, and reporting requirements on financial institutions.⁵ The authority of the Secretary to administer the BSA has been delegated to FinCEN, which has imposed AML program requirements on a certain subset of the “financial institutions” set forth in the BSA.

As noted by FinCEN and the federal banking agencies,⁶ “the corner stone of a strong BSA/AML

compliance program is the adoption and implementation of comprehensive CDD policies, procedures, and processes for all customers, particularly those that present a higher risk for money laundering and terrorist financing. The objective of CDD should be to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to engage.”⁷ Accordingly, FinCEN’s stated goal for promulgating the final rule is to “clarify and strengthen” CDD requirements for banks, brokers, or dealers in securities, mutual funds, and futures commission merchants, and introducing brokers in commodities (collectively, “Covered Financial Institutions”).⁸ FinCEN explained that, “requiring financial institutions to perform effective CDD so that they understand who their customers are and what type of transactions they conduct is a critical aspect of combating all forms of illicit financial activity, from sanctions evasion to more traditional financial crimes, including money laundering, fraud, and tax evasion.”⁹

Notably, the Final Rule introduces a requirement to identify and verify the identity of beneficial owners of certain legal entity customers as part of effective CDD. Increasing transparency into legal entities, including identification of their ultimate beneficial owners, has been a longstanding concern at the Department of Treasury, and the United States has lagged behind other jurisdictions in this area. For example, in 2005, the European Union member states adopted AML-related requirements for financial institutions to identify the beneficial owners of legal entities.¹⁰ As early as 2007, promoting transparency in the ownership of legal entities was a part of the United States’ national anti-money

² The compliance period was extended from one year, as contemplated in FinCEN’s Notice of Proposed Rulemaking, to two years in response to “many comments” from the financial services industry. *Id.* at 29428.

³ 12 U.S.C. §§ 1951–1959, 31 U.S.C. §§ 5311–5314 and 5316–5332.

⁴ 31 U.S.C. § 5311.

⁵ 31 U.S.C. § 5318(h).

⁶ The federal banking agencies are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the National Credit Union Administration, and the Federal Deposit Insurance Corporation.

⁷ Federal Financial Institutions Examination Council, Bank Secrecy Act/Anti-Money Laundering Examination Manual, 56, (2014), *hereinafter* the “FFIEC Manual.”

⁸ *Id.* While other types of financial institutions are subject to anti-money laundering requirements under the Bank Secrecy Act, FinCEN did not indicate in the Final Rule whether it was contemplating extending the requirements of the Final Rule beyond Covered Financial Institutions.

⁹ FinCEN, *supra* note 1, at 29399.

¹⁰ Council Directive 2006/60/, art. 10, 2005 O.J. (L309).

laundering strategy.¹¹ As originally posed in 2007, Treasury’s plans to address non-transparency in ownership of legal entities included outreach efforts to state authorities to explore legislative or administrative options to require the disclosure of ownership information in the company registration process.¹² While Treasury has continued to pursue this approach, including through legislative proposals, it has never gained traction and has been rejected by a number of states. Therefore, notwithstanding the requirements that the Final Rule imposes on Covered Financial Institutions, non-transparent shell companies continue to be able to incorporate in the United States.¹³

In its most recent evaluation of the United States, the Financial Action Task Force (“FATF”), an international body for setting minimum global standards for AML, has noted that the lack of a requirement for financial institutions to capture beneficial ownership information, as well as the lack of requirements to collect beneficial ownership information under state corporate formation

laws, constitute a “fundamental” gap in the U.S. AML regime.¹⁴ It is in this context, under intense international pressure to combat financial crime facilitated by the non-transparent use of legal entities, that FinCEN implemented the Final Rule.

As noted in the preamble to the Final Rule, FinCEN believes that requiring Covered Financial Institutions to obtain beneficial ownership information, in conjunction with providing for more explicit CDD requirements, will result in the following:

- enhanced availability of beneficial ownership information regarding legal entities for law enforcement;
- increased ability of financial institutions, law enforcement, and the intelligence community to identify assets of terrorist organizations, drug kingpins, and other national security threats, which strengthens compliance with sanctions programs aimed at disrupting the operations of such persons;
- increased ability of financial institutions to assess and mitigate risk (and thereby comply with existing BSA authorities);
- improved tax compliance;
- better consistency in implementing and enforcing CDD regulatory expectations across and within industry sectors; and
- enhanced financial transparency of legal entities.¹⁵

II. REQUIREMENTS OF THE FINAL RULE

In order to meet the above objectives, the Final Rule essentially establishes CDD as a fifth “pillar” of required BSA/AML compliance programs.¹⁶ Within this fifth

¹¹ U.S. Department of Treasury, U.S. Department of Justice, and U.S. Department of Homeland Security, 2007 National Money Laundering Strategy at 8 (“The organization and registration of certain business entities... can be accomplished in all State jurisdictions with minimal public disclosure of personal information regarding controlling interests and ownership. The current lack of transparency prevents financial institutions from identifying suspicious transactions, and hinders law enforcement investigations and prosecutions. Using a State-registered business entity as a front is one way that money launderers get access to U.S. banks and other domestic financial institutions.”).

¹² *Id.*

¹³ Letter from Jacob J. Lew, Treasury Secretary to Paul D. Ryan, Speaker, U.S. House of Representatives (May 5, 2016), available at <https://www.treasury.gov/press-center/press-releases/Documents/Lew%20to%20Ryan%20on%20CDD.PDF>. On June 28, 2017 twin bills were introduced in the U.S. House of Representatives and U.S. Senate that would require corporations and limited liability companies formed in the United States to disclose their beneficial owners. See H.R. 3089, 115th Cong (2017) and S. 1453, 115th Cong (2017). Generally, the proposed legislation directs the Treasury Department to issue regulations requiring companies formed in states that do not already require basic disclosure to submit information about their beneficial owners. The bills would also include a requirement to update changed beneficial ownership information and to submit an annual report of beneficial owners. If passed, this legislation would reduce the ability to incorporate non-transparent shell companies in the United States.

¹⁴ FATF, Mutual Evaluation of the United States, 4 (Dec. 1, 2016).

¹⁵ FinCEN, *supra* note 1, at 23399-29400.

¹⁶ As applicable to Covered Financial Institutions, the AML program requirements now include, at a minimum: (1) a system of internal controls; (2) independent testing; (3) designation of a compliance officer or individual(s) responsible for day-to-day compliance; (4) training for appropriate personnel; and (5) appropriate risk-based procedures for conducting ongoing CDD to understand the nature and purpose of customer relationships, ongoing monitoring to identify and report suspicious transactions, and,

pillar, the Final Rule sets out four required “core” elements of CDD: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships to develop a customer risk profile; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information.¹⁷ The first item, customer identification and verification, was a requirement for Covered Financial Institutions previous to the issuance of the Final Rule.¹⁸ The second element, however, is new. FinCEN takes the position that the third and fourth items have been implicit in the preexisting requirement to report suspicious activity, and that the Final Rule was simply making these requirements explicit.¹⁹

Beneficial Ownership

The Final Rule imposes a requirement that Covered Financial Institutions establish and maintain written procedures reasonably designed to identify and verify the identities of beneficial owners of legal entity customers.²⁰ The procedures should enable institutions to identify the beneficial owners of each legal entity customer at the time a new account is opened, and must establish risk-based practices for verifying the identity of each beneficial owner identified to the extent practical

and reasonable.²¹ The requirements apply to “new accounts” opened by “legal entity customers” on or after the Applicability Date.²² Covered Financial Institutions are not required to obtain and verify beneficial ownership information for existing legal entity customers unless the customer opens a new account on or after the Applicability Date. Although FinCEN considered and declined to impose a categorical retroactive requirement to existing accounts of legal entity customers, it did note that the absence of such a requirement would not preclude financial institutions from collecting beneficial ownership information on existing customers on a risk basis.²³ This statement, in conjunction with FinCEN’s clarification that the Final Rule represents minimum standards to which federal functional regulators may add their own requirements, suggests that Covered Financial Institutions may consider risk-based criteria that trigger obtaining beneficial ownership on existing accounts when conducting ongoing monitoring.²⁴ Covered Financial Institutions are also subject to the risk that functional regulators could scrutinize such criteria.

Definition of Beneficial Owner

The Final Rule defines “beneficial owner” as each of the following: (1) each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer and (2) a single individual with significant responsibility to control, manage, or direct a legal entity customer.²⁵ Thus, the number of individual beneficial owners identified for any legal entity customer may vary from one to five. Under the ownership prong, there may be from zero to four beneficial owners. Under the control prong, at least one beneficial owner must be identified.

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on a risk basis, to maintain and update customer information. *See, e.g.*, 12 C.F.R. § 1020.201(b)(1-5) (setting forth BSA/AML compliance program requirements for banks). Prior to the final rule, BSA/AML program requirements for Covered Financial Institutions did not explicitly include the fifth element.

¹⁷ FinCEN, *supra* note 1.

¹⁸ *See, e.g.*, 31 C.F.R. § 1020.210(a); 31 C.F.R. § 1020.220 (customer identification program requirements for banks).

¹⁹ FinCEN, *supra* note 1. FinCEN explained that financial institutions must understand the nature and purpose of a customer relationship, and conduct monitoring for suspicious activity, in order to meet the preexisting requirement to report a “transaction [that] has no business or apparent lawful purpose, or is not the sort in which the particular customer would normally be expected to engage.” *See* 31 C.F.R. 1020.320(a)(2)(iii) (suspicious activity reporting requirements for banks).

²⁰ 31 C.F.R. § 1010.230; FinCEN, *supra* note 1, at 29404.

²¹ FinCEN, FIN-2016-G003, Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions, FAQ 4 (July 19, 2016).

²² “New accounts” means accounts opened at a covered financial institution by a legal entity customer on or after the Applicability Date. 31 C.F.R. § 1010.230(g).

²³ FinCEN, *supra* note 1, at 29404.

²⁴ *Id.*

²⁵ 31 C.F.R. § 1010.230(d); FinCEN, *supra* note 1, at 29409. To the extent a trust owns, directly or indirectly, 25% or more of the equity interests of a legal entity customer, the beneficial owner identified under the ownership prong is the trustee. 31 C.F.R. § 1010.230(d)(3).

FinCEN made a number of noteworthy statements regarding the ownership prong in the preamble to the Final Rule. First, it noted that the language “directly or indirectly” reflects FinCEN’s intention that legal entity customers identify individuals with ultimate beneficial ownership, and not “nominees” or “straw men.”²⁶ FinCEN noted that while it is generally the responsibility of the legal entity customer to identify its ultimate beneficial owners, it may be appropriate for covered financial institutions that know, suspect, or have reason to suspect that a legal entity customer has structured equity holdings for purposes of evading the 25 percent reporting threshold to file suspicious activity reports.²⁷ Second, FinCEN noted that the 25 percent threshold is the “baseline regulatory benchmark,” and that a Covered Financial Institution may apply a lower standard or identify other individuals not within the definition of beneficial owner based on its own assessment of risk.²⁸ Due to the federal banking agencies’ expectations that financial institutions apply enhanced due diligence to high-risk customers, Covered Financial Institutions may consider establishing risk-based criteria for identifying individual beneficial owners with less than 25 percent ownership interests.²⁹ However, it should be emphasized that there is no legal requirement to do so, and institutions that choose to establish such criteria may be subject to examiners’ review and criticism of their methodology and judgments.

Under the control prong, the legal entity customer is required to identify one individual with “significant responsibility to control, manage, or direct a legal entity customer.” FinCEN provides a number of non-exclusive examples of such individuals. These include an executive officer or senior manager, such as, for example, the Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member,

²⁶ FinCEN, *supra* note 1, at 29410; FinCEN, *supra* note 21, FAQ 1. However, FinCEN has also stated that, absent knowledge of facts calling into question the accuracy of beneficial ownership information provided by legal entity customers, Covered Financial Institutions are not responsible for determining whether any individual is a beneficial owner. FinCEN, *supra* note 1 at 29411.

²⁷ *Id.* at 29410. Because FinCEN and the federal functional regulators generally have enforcement authority over Covered Financial Institutions and not legal entity customers who are “responsible” for providing beneficial ownership information, it is unclear how the “responsibilities” of the legal entity customers will be enforced.

²⁸ *Id.*

²⁹ FFIEC Manual at 57.

General Partner, President, Vice President, or Treasurer, or any other individual who regularly performs similar functions.³⁰ FinCEN stated that it intentionally proposed a broad definition to provide legal entity customers a wide range of options from which to choose,³¹ and subsequently explained its expectation that “the control person identified must be a high-level official in the legal entity, who is responsible for how the organization is run, and who will have access to a range of information concerning the day-to-day operations of the company.”³² The Final Rule does not require Covered Financial Institutions to confirm that the individual identified under the control prong has the requisite authority. Nonetheless, Covered Financial Institutions might provide in their procedures minimum levels of authority that are acceptable for purposes of identifying a beneficial owner under the control prong. Finally, to the extent an individual is both a 25 percent owner and exercises significant managerial control, the same individual may be identified as a beneficial owner under both definitional prongs.³³

Definition of Legal Entity Customer and Related Exclusions

As noted above, the new beneficial ownership requirements apply to “legal entity customers.” A legal entity customer means a “corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account.”³⁴ FinCEN clarified that this definition would include, in addition to corporations and limited liability companies, limited partnerships, business trusts that are created by a filing with a state office, any other entity formed in a similar manner, and general partnerships. It would also include similar entities formed under the laws of foreign countries.³⁵ The definition would not include trusts (other than statutory trusts created by a filing with the Secretary of State) because trusts are created by contract and not a filing. FinCEN noted, however, that, in practice, financial institutions generally identify and verify the identity of the trustee who opens the account, and they

³⁰ 31 C.F.R. § 1010.230(d)(2).

³¹ FinCEN, *supra* note 1, at 29411.

³² FinCEN, *supra* note 21, FAQ 12.

³³ *Id.* at 29452.

³⁴ 31 C.F.R. 1010.230(e)(1).

³⁵ FinCEN, *supra* note 1, at 24912.

should continue to use a risk-based approach to obtaining information regarding other persons involved in the trust for purposes of knowing their customers.³⁶ In addition, FinCEN noted by way of example that sole proprietorships or unincorporated associations would not fall within the definition of legal entity customer, “even though such businesses may file with the Secretary of State in order to, for example, register a trade name or establish a tax account.”³⁷ The principle utilized by FinCEN to draw this distinction is that neither sole proprietorships nor unincorporated associations are entities with “legal existence separate from the associated individual or individuals that in effect creates a shield permitting an individual to obscure his or her identity.”³⁸

While the above principle is easily articulated, it may not be as easy to apply in practice. The principle, as well as the definition of “legal entity customer,” requires familiarity with state incorporation requirements and processes, as well as corporate law regarding whether certain types of entities have separate legal existence from associated individuals. The application may be even more difficult when evaluating foreign corporate law. Additionally, it is not known whether and to what extent Covered Financial Institutions may rely on their customers’ representations with respect to legal entity status. Thus, when drafting policies and procedures that govern the type of legal entity customers that will be subject to the beneficial ownership requirements, Covered Financial Institutions may want to consult with counsel knowledgeable in the relevant state or foreign law.

The Final Rule provides for a number of exclusions from the definition of legal entity customer. Briefly, these include, but are not limited to: governmental entities; publicly traded firms; entities registered with the SEC under Section 12 of the Securities Exchange Act or as investment companies, investment advisors, exchange or clearing agencies or commodity or swap dealers; public accounting firms; state-regulated insurance companies; pooled investment vehicles operated or advised by financial institutions that are excluded from the definition of legal entity customer; entities designated as financial market utilities by the

Financial Stability Oversight Council; foreign financial institutions established in a jurisdiction where the regulator requires beneficial ownership information; foreign governmental agencies that do not engage in commercial activity; and legal entities opening private banking accounts as defined under Section 312 of the USA PATRIOT Act.³⁹

Finally, FinCEN identified a number of legal entity customers that, due to their nature, the ownership prong would either be inapplicable or impractical to apply. These include non-profit corporations (which typically lack equity owners) and pooled investment vehicles advised or operated by financial institutions that are not exempt from the definition of legal entity customer.⁴⁰ Such customers are subject only to the control prong of the beneficial ownership requirement.⁴¹

Definition of Account and Related Exclusions

As noted above, a “legal entity customer” is defined as one that opens “an account.” For purposes of the Final Rule, FinCEN used the definition of “account” found in rules implementing Customer Identification Program (“CIP”) requirements.⁴² Thus, “account” means a formal banking relationship established to provide or engage in services, dealings, or other financial transactions, including a deposit account, a transaction or asset account, a credit account, or other extension of credit.⁴³ “Account” also includes a relationship established to provide a safety deposit box or other safekeeping services, or cash management, custodian, and trust services.⁴⁴

The adoption of this definition from the CIP requirements has a number of consequences for banks. First, it means that, for banks, the following are not subject to the Final Rule’s beneficial ownership requirements because they are specifically excluded from the definition of “account” applicable to CIP requirements: (1) products or services in which a formal banking relationship is not established, such as check-cashing, wire transfers and trust services; (2) accounts

³⁶ *Id.* Beneficiaries and other participants in a trust may also need to be identified and screened on a risk basis for purposes of complying with U.S. sanctions regulations administered by the Department of Treasury’s Office of Foreign Assets Control.

³⁷ *Id.*

³⁸ *Id.*

³⁹ For a full list of entities excluded from the definition of legal entity customer, *see* 31 C.F.R. 1010.230(e)(2).

⁴⁰ 31 C.F.R. § 1010.230(2)(e)(2)(xvi).

⁴¹ *Id.*

⁴² *See, e.g.*, 31 C.F.R. 1020.220 *et. seq.* (Customer identification programs for banks).

⁴³ FinCEN, *supra* note 1 at 29412; 31 C.F.R. § 1020.100(a).

⁴⁴ *Id.*

acquired from other institutions; and (3) accounts opened for purpose of participating in an employee benefit plan under ERISA.⁴⁵ Second, FinCEN and federal functional regulators have issued guidance with respect to intermediated account relationships, setting out numerous instances in which CIP requirements apply to the intermediary that opens an account with the Covered Financial Institution and not to the intermediary's underlying customers. FinCEN stated that, to the extent existing guidance provides that, for purposes of CIP rules, a financial institution should treat an intermediary (and not the intermediary's underlying customers) as its customer, the financial institution should treat the intermediary as its customer for purposes of the Final Rule.⁴⁶ Third and finally, the adoption of the definition and guidance from CIP requirements means that, where a Covered Financial Institution's CIP policies and procedures delineate the types of business arrangements that qualify as "accounts" for CIP purposes, those policies and procedures could be leveraged to govern the types of business arrangements between Covered Financial Institutions and legal entity customers that would trigger the Final Rule's applicable beneficial ownership requirement.

Finally, FinCEN exempted Covered Financial Institutions from the beneficial ownership requirements when opening accounts for legal entity customers in cases where the accounts will be used solely for certain activities. These include private label credit card accounts with a credit limit of up to \$50,000 to the extent they are opened at the point of sale to provide credit products for the purchase of retail goods and services. They also include (1) accounts used solely for the purchase and financing of postage, (2) commercial accounts used solely to finance insurance premiums, and (3) accounts solely used to finance the purchase or leasing of equipment, provided that for each type of account payment is made directly by the financial institution to the relevant provider.⁴⁷

Identification Requirement

The Final Rule requires Covered Financial Institutions to maintain CDD procedures that enable

them to identify the beneficial owner(s) of each legal entity customer at the time a new account is opened, unless the account or customer is exempted. Covered Financial Institutions must obtain this information from the individual opening the account on behalf of the legal entity customer, and may do so by (1) using a certification form, which FinCEN provided as Appendix A to the Final Rule or (2) obtaining from the individual the information required by the certification form by another means, provided the individual certifies, to the best of the individual's knowledge, the accuracy of the information.⁴⁸

While use of the certification form is optional, the language of the Final rule requires all information requested on the form to be obtained regardless of whether it is used. The form itself requires the individual who opens the account to identify beneficial owners and to certify that the information provided is "complete and correct" to the best of the individual's knowledge.⁴⁹ The form calls for each beneficial owner's name, date of birth, residential or business address, social security number (for U.S. persons) or passport number and country of issuance, or other similar identification number (for foreign persons).⁵⁰ The Final Rule does not list specific individuals who would be appropriate to certify an entity's beneficial owners, although FinCEN does suggest that it would be "appropriate" for higher-level employees, such as the secretary or other officer of a corporation, a member or manager of an LLC, or a partner of a partnership to do so. Nonetheless, FinCEN declined to specify that it would not be appropriate for a low-level employee to do so.⁵¹

FinCEN also indicated that the beneficial ownership information provided at account opening must be "current."⁵² In this regard, FinCEN clarified that Covered Financial Institutions must identify and verify the legal entity customer's beneficial owner(s) each time a new account is opened on or after the Applicability Date, and not simply the first time such an account is opened.⁵³ Thus, Covered Financial Institutions may

⁴⁵ 31 C.F.R. § 1020.100(a)(2).

⁴⁶ FinCEN, *supra* note 1, at 29416.

⁴⁷ *Id.* at 29417-29418. The above exemptions do not apply to transaction accounts through which a legal entity customer can make payments to, or receive payments from, third parties. Identification and verification of beneficial owners may also be required in situations involving cash refunds. *Id.* at 29418.

⁴⁸ 31 C.F.R. § 1010.230 (b)(1).

⁴⁹ Appendix A to 31 C.F.R. § 1010.230.

⁵⁰ *Id.* This is the same information called for with respect to individuals in the CIP requirements for banks. 31 C.F.R. § 1020.220(a)(2).

⁵¹ FinCEN, *supra* note 1 at 29404.

⁵² *Id.* at 29406.

⁵³ *Id.*

consider whether, and how, to update beneficial ownership information each time a new account is opened, to the extent the information differs from that already on file. Records of identification information must be kept for five years after the account is closed.⁵⁴

Verification Requirement

The verification requirement in the Final Rule requires Covered Financial Institution's CDD procedures to include risk-based procedures to verify the identity of each beneficial owner to the extent reasonable and practicable.⁵⁵ The required verification is of the identity of each individual listed as a beneficial owner (i.e., to verify the individual's existence), and *not* his or her status as a beneficial owner.⁵⁶ At a minimum, the verification procedures must contain the elements of verification required under the CIP regulations. For banks, these procedures may include both documentary and non-documentary methods of verification, and must enable the bank to form a reasonable belief that it knows the true identify of each beneficial owner.⁵⁷

If documentary verification is used, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard must be obtained.⁵⁸ Unlike CIP requirements, however, the financial institution may rely on photocopies or other reproductions of identity documents. However, FinCEN noted that, given the risks of forgery or unreliability of photocopies, Covered Financial Institutions should conduct their own risk-based analyses of the types of photocopies or reproductions they will accept.

If relying on non-documentary procedures, the Covered Financial Institution must address situations where an individual is unable to provide an unexpired, government-issued document, the institution is unfamiliar with the document presented, and where there is increased risk that verification cannot be conducted. For both documentary and non-documentary methods, Covered Financial Institutions verification procedures must address situations where, based on risk, the institution will obtain additional information to verify the customer's identity. The verification procedures

must also include procedures for responding to circumstances in which the institution cannot form a reasonable belief it knows the true identity of the beneficial owner.⁵⁹ Covered Financial Institutions are required to keep a description of any documents and non-documentary methods relied on for verification purposes, as well as the resolution of each substantive discrepancy, for five years after the record is made.⁶⁰

Of note, Covered Financial Institutions are generally under no obligation to verify that the individual(s) identified as beneficial owner(s) are, in fact, beneficial owners.⁶¹ Instead, institutions may rely on the beneficial ownership information supplied by their customers without independently verifying that the information is accurate, provided that the financial institution has no knowledge of facts that would reasonably call into question the reliability of such information.⁶² FinCEN did not further explain what sorts of situations would rise to this standard. Covered Financial Institutions therefore may consider whether their procedures governing identification and verification should, on a risk-basis, address situations in which the reliability of beneficial ownership information may be called into question, or establish factors or criteria for assessing reliability of the information provided.

Use of Beneficial Ownership Information

Although not included in the regulations governing beneficial ownership, FinCEN made a number of observations in the preamble to the Final Rule regarding how it "expects" Covered Financial Institutions to use beneficial ownership information. Generally, FinCEN expects "beneficial ownership information to be treated like CIP and related information, and accordingly used to ensure that covered financial institutions comply with other requirements," including Office of Foreign Assets Control ("OFAC") and currency transaction reporting requirements.⁶³ Generally, OFAC administers U.S. sanctions against foreign persons that prohibit U.S. persons from engaging in most dealings with sanctions

⁵⁴ 31 C.F.R. § 1010.230(h)(1)(i).

⁵⁵ 31 C.F.R. § 1010.230(b)(2).

⁵⁶ FinCEN, *supra* note 1, at 209407.

⁵⁷ 31 C.F.R. § 1010.230(b)(2); 31 C.F.R. § 1020.220(a)(2).

⁵⁸ *See, e.g.*, 31 C.F.R. 1020.220(a)(2) (for banks).

⁵⁹ *Id.*

⁶⁰ 31 C.F.R. § 1010.230(h).

⁶¹ As noted above, corporate registries are generally not required pursuant to U.S. law. Therefore, it would appear that Covered Financial Institutions would have significant difficulties verifying that the individuals identified as beneficial owners are in fact beneficial owners in many cases.

⁶² FinCEN, *supra* note 1, at 29407.

⁶³ *Id.* at 29409.

targets, often known as Specially Designated Nationals and Blocked Persons (“SDNs”). In addition, U.S. persons are prohibited from most dealings with entities that are owned 50 percent or more, in the aggregate, by one or more SDNs.⁶⁴

Thus, FinCEN specified that Covered Financial Institutions should use beneficial ownership information to ensure that they do not open or maintain an account, or otherwise engage in prohibited dealings with entities targeted by OFAC.⁶⁵ Practically, this would require Covered Financial Institutions to screen beneficial ownership information against lists of sanctions targets maintained by OFAC and aggregate the ownership interests of any matches. Even where the interests of SDNs do not aggregate to 50 percent, Covered Financial Institutions’ OFAC-related policies may need to be amended to address situations in which an SDN or other sanctions target owns material equity interests in a customer or is identified as a beneficial owner under the “control” prong.

In addition to OFAC screening, FinCEN stated that Covered Financial Institutions should also develop risk-based procedures to determine whether or when additional screening of beneficial owners through negative media search programs would be appropriate.⁶⁶ Institutions that do not do so already may want to consider conducting negative media screening for the beneficial owners of certain high-risk customers, such as, for example, shell companies with no physical presence or little independent economic value that are incorporated in bank secrecy jurisdictions, as part of their onboarding procedures.

Finally, FinCEN stated that it expects Covered Financial Institutions to use beneficial ownership information for purposes of complying with guidance regarding the aggregation of currency transaction reports.⁶⁷ While Covered Financial Institutions should generally recognize the distinctness of the corporate form, the guidance provides that where a financial institution determines, based on all the available facts and circumstances, that multiple businesses with a

common owner are not being operated independently, those businesses’ currency transactions should be aggregated for currency transaction reporting purposes.⁶⁸ FinCEN noted that beneficial ownership information may provide financial institutions with information they previously did not have when conducting this facts- and circumstances-based analysis. To the extent businesses under common ownership are not being operated independently, the Covered Financial Institution may determine that aggregation is appropriate.⁶⁹

Reliance on Other Financial Institutions

The Final Rule provides that a Covered Financial Institution may rely on another financial institution to conduct CDD for shared customers, provided that (1) reliance on the other financial institution is reasonable under the circumstances; (2) the other financial institution is subject to an AML program requirement and is regulated by a federal functional regulator; and (3) the other institution enters into a contract certifying annually that it has implemented its AML program and will conduct the required CDD.⁷⁰

AML Program Amendments

The Final Rule amends the AML program requirement for Covered Financial Institutions by incorporating a “fifth pillar” consisting of appropriate, risk-based procedures for conducting ongoing CDD. These procedures must include but are not limited to: (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 update customer information. “Customer information” includes information regarding beneficial owners of legal entity customers.⁷¹

Understanding the Nature and Purpose of the Relationship

As explained by FinCEN, a customer risk profile, which is developed based on understanding the nature and purpose of customer relationships, refers to the information gathered about a customer at account opening used to develop a baseline against which customer activity is assessed for suspicious activity

⁶⁴ OFAC, Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property Are Blocked (Aug. 13, 2014).

⁶⁵ FinCEN, *supra* note 1, at 29409.

⁶⁶ *Id.*

⁶⁷ *Id.* See also FinCEN, FIN-2012-G001, Currency Transaction Report Aggregation for Businesses with Common Ownership (Mar. 16, 2012).

⁶⁸ *Id.*

⁶⁹ FinCEN, *supra* note 1 at 29409.

⁷⁰ 31 C.F.R. 1010.230(j).

⁷¹ 31 C.F.R. § 1020.210(b)(5).

reporting.⁷² This information may include self-evident information, such as the type of customer or type of account, service, or product. In addition, the risk profile “may, but need not, include a system of risk ratings or categories of customers.”⁷³ FinCEN also noted that, depending on the facts and circumstances, other relevant facts, such as annual income, net worth, domicile, principal occupation or business, or, in the case of longstanding customers, transaction history, may impact the risk profile.⁷⁴

FinCEN did not specifically require that Covered Financial Institutions integrate their customer risk profile into transaction monitoring systems (which typically identify unusual transactions), as long as the risk profile is used to determine whether particular transactions are suspicious.⁷⁵ Thus, it appears that FinCEN’s expectation is that, at a minimum, the risk profile is used *after* a transaction is flagged as unusual, either via transaction monitoring or some other method, such as an employee referral. However, in most instances, it seems unlikely that FinCEN and the federal banking agencies would not expect a customer’s risk profile to influence the level of transaction monitoring. Finally, given that Covered Financial Institutions must now collect beneficial ownership information for certain customers, that information could, in appropriate circumstances, be considered relevant for purposes of developing a customer risk profile.

Conducting Ongoing Monitoring

The Final Rule requires Covered Financial Institutions to conduct ongoing monitoring to identify and report suspicious activity and, on a risk basis, to maintain and update customer information.⁷⁶ The Final Rule provides that customer information “shall include information regarding the beneficial owners of legal entity customers.”⁷⁷ According to FinCEN, the obligation to update customer information is event-driven, in that it is “only triggered when a Covered Financial Institution detects information in the course of normal monitoring that is relevant to assessing or reevaluating risk posed by the customer.”⁷⁸ Examples of

such information provided by FinCEN include significant and unexplained changes in the customer’s activity or information indicating a change in possible beneficial ownership.⁷⁹ FinCEN clarified that, because the updating requirement is event-based, it does not expect scheduled, regular updating of customer information.⁸⁰ While banks and other Covered Financial Institutions may want to consider whether risk-based periodic updating of customer information is an expectation of their functional regulators, they should expect regulatory scrutiny of any procedures they implement in this regard.

FinCEN also clarified that the requirement to update customer information applies to customers with new accounts and customers with existing accounts on the Applicability Date.⁸¹ Given that the Final Rule provides that “customer information shall include” beneficial ownership information, the requirement to update customer information could be read as a requirement to update (or obtain) beneficial information for legal entity customers each time customer information is updated. While FinCEN refused to categorically exclude updating beneficial ownership information in conjunction with an event-triggered update, it did clarify that “we expect monitoring-triggered updating of beneficial ownership information (as with other customer information) only to occur on a risk basis when material information about a change in beneficial ownership is uncovered during the course of a bank’s normal monitoring (whether of the customer relationship or of transactions).”⁸²

III. PRACTICAL STEPS TOWARD IMPLEMENTATION

As noted above, there is less than one year — or less than half of the time provided to come into compliance with the Final Rule — until the Applicability Date. Many Covered Financial Institutions may therefore be well on their way to making the required adjustments. Industry practice regarding collection of beneficial ownership information varied greatly prior to the issuance of the Final Rule. Moreover, each institution must account for its own particular risks and circumstances when preparing for implementation. Therefore, the steps that are appropriate to take, and amount of preparation required from one institution to the next, will vary.

⁷² FinCEN, *supra* note 1 at 29398.

⁷³ *Id.*

⁷⁴ *Id.* at 29420.

⁷⁵ *Id.* at 29422.

⁷⁶ 31 C.F.R. § 1020.210(b)(5).

⁷⁷ *Id.*

⁷⁸ FinCEN, *supra* note 1 at 29420.

⁷⁹ *Id.* at 29399.

⁸⁰ *Id.* at 29421.

⁸¹ *Id.*

⁸² *Id.*

Nonetheless, below are steps that Covered Financial Institutions might consider (or may already be taking), as they prepare for the Applicability Date. As the Applicability Date arrives and institutions are examined for compliance with the Final Rule, additional guidance from Covered Financial Institutions' federal functional regulators, such as modifications to the FFEIC BSA/AML Examination Manual, may be provided.

- **Understand Key Compliance Requirements and Map them to AML Program and Policies:** Appropriate personnel within Covered Financial Institutions might be tasked with ensuring that they understand the key compliance requirements of the Final Rule. Both the new beneficial ownership requirements, as well as previously implicit CDD requirements that were codified in the Final Rule, should be incorporated into an institution's written AML program, and mapped onto the appropriate implementing policies and procedures.
- **Determine Impacted Lines of Businesses and Products to Prioritize for Implementing Beneficial Ownership Requirements:** As Covered Financial Institutions prepare, in particular for the beneficial ownership requirements, one of the initial tasks might be an assessment of impacted business lines or products for purposes of prioritizing and allocating resources. The beneficial ownership requirements, which represent the most significant compliance burden, apply to "legal entity customers." Covered Financial Institutions might leverage this definition to determine which business lines to prioritize. For purposes of implementing the beneficial ownership requirements, Covered Financial Institutions might de-prioritize lines of business or products offered solely to natural persons, such as, for example, personal loans, credit cards, or checking and savings accounts, upon conducting an analysis to ensure that legal entity customers are not offered such products or services.
- **Determine Needs for New or Enhanced Policies, Procedures, Technologies, or Vendors:** Once impacted products and business lines are identified, Covered Financial Institutions might evaluate whether the processes and procedures of those business lines require modification. In addition, Covered Financial Institutions may want to identify the systems, technologies, and vendors where enhancements will be required in order to implement the revised policies and procedures.
- **Account-Opening Procedures for Legal Entity Customers:** One area where changes are likely to be

required is account-opening procedures. Among other things, Covered Financial Institutions might consider whether to use the certification form, or, if not, how to otherwise obtain the required information. In addition, based on FinCEN's expectations regarding use of beneficial ownership information, Covered Financial Institutions might consider how this information needs to be stored or provided to other various functions, such as BSA/AML compliance, OFAC compliance, or currency transaction reporting systems/personnel. For these purposes, coordination among technology solutions may be required. In addition, institutions may consider whether to incorporate in account-opening procedures criteria for assessing reliability of beneficial ownership information.

- **Put in Place a Team of Relevant Stakeholders:** Once business lines, policies, procedures, technologies, and vendors where changes will be needed are identified, Covered Financial Institutions might consider creating a working group or committee consisting of stakeholders from each impacted area to develop business and technology plans to implement the necessary changes.
- **Address and Document Questions Raised by the Final Rule:** There are a number of instances in the Final Rule where institutions may consider applying more stringent processes and procedures than called for by the baseline requirements of the Final Rule. Some of these areas are addressed earlier in this article. Appropriate personnel, such as those personnel tasked with understanding key compliance requirements in conjunction with the working group of relevant stakeholders, may want to consider how to address some of these instances, and develop and document their conclusions. It should be emphasized again that there is no legal requirement to apply more stringent procedures than those set forth in the Final Rule, and banks and other Covered Financial Institutions that choose to do so should expect their procedures and judgments to be subjected to regulatory scrutiny.
- **Updating IT Capabilities:** As noted by FinCEN in commentary to the Final Rule, one reason for providing a two-year compliance period was the necessity for Covered Financial Institutions to update information technology systems. Covered Institutions might assess whether current systems have the capabilities to satisfy the rules or, if not, allow for sufficient time to roll out changes or new systems.
- **Governance/Project Management:** Once necessary modifications are identified, Covered

Institutions might consider the need to set up a project management or project governance structure with timelines, milestones for completion, and reporting structures. Covered Institutions might consider incorporating escalation procedures for work streams that become delayed or are otherwise not progressing as planned. Finally, as the Applicability Date becomes closer, Covered Financial Institutions may want to consider governance structures that permit consideration of escalating delays or other issues to regulators well in advance of the Applicability Date.

- **Test Environments:** Ideally, modifications would be run in test environments prior to the Applicability Date.
- **Training and Audit:** As with any modifications to an institution's BSA/AML program, policies and procedures, training and independent testing procedures may need to be modified to address and incorporate the modifications.

IV. CONCLUSION

As noted above, the Final Rule is intended to move the United States toward compliance with international standards in the area of obtaining beneficial ownership information of legal entities as part of AML compliance measures. While the Final Rule helps to accomplish this aim, as of the Applicability Date, absent further congressional action, there will generally be no other reliable source of beneficial ownership information, such as state-maintained corporate registries, outside of that maintained by Covered Financial Institutions pursuant to the Final Rule. It is therefore likely that FinCEN and the federal banking agencies, as well as law enforcement, will consider Covered Financial Institutions' compliance with the Final Rule's beneficial ownership requirements to be of high importance. Due to the significant new obligations imposed by the Final Rule, Covered Financial Institutions would be well-served to dedicate attention, time, and resources sufficient to come into compliance. ■