FinCEN Proposes Heightened Customer Due Diligence Requirements for Financial Institutions

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The U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") recently issued proposed rules to clarify and strengthen customer due diligence ("CDD") requirements under the Bank Secrecy Act for banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities (collectively, "covered financial institutions").[1] While the bulk of the proposed rules simply codify requirements that already exist as part of anti-money laundering programs, FinCEN has included one new requirement: unless subject to an exemption, covered financial institutions must identify and verify the beneficial owners of legal entity customers (the "look-through requirement"). A beneficial owner generally includes any natural person who owns 25% or more of a legal entity or who has significant control over a legal entity. In the case of complex, multi-level legal structures, the look-through requirement may present significant compliance challenges for covered financial institutions.

Comments on the proposed rules are due on October 3, 2014.

HISTORY OF THE RULEMAKING

FinCEN first introduced the look-through requirement in March 2012. In response, FinCEN received comments from a wide array of industry participants—from mutual funds and money services businesses to banks and securities firms—on the practical costs and compliance challenges associated with the look-through requirement. To address these concerns, Treasury held five public hearings in cities across the U.S. In formulating the current proposal, FinCEN has incorporated participants' recommendations on how to minimize the burden associated with collecting beneficial ownership information. Among other things, the proposed rules address ambiguities that had surrounded the "beneficial owner" and "legal entity customer" definitions and clarify that, in some circumstances, covered financial institutions may reasonably rely on other financial institutions to conduct due diligence on shared customers.

FOUR ELEMENTS OF CUSTOMER DUE DILIGENCE

FinCEN believes that CDD consists, at a minimum, of four elements:

1. Identifying and verifying the identity of customers
2. Identifying and verifying the identity of beneficial owners of "legal entity customers"
3. Understanding the nature and purpose of customer relationships

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[1] *See* 79 Fed. Reg. 45151 (Aug. 4, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-08-04/pdf/2014-18036.pdf.

4. Conducting ongoing monitoring to maintain and update customer information to identify and report suspicious transactions

According to FinCEN, the first element of CDD is already satisfied by the existing customer identification programs ("CIPs") of covered institutions. The third and fourth elements do not impose new requirements and, instead, codify existing supervisory and regulatory expectations for covered financial institutions. It is the second element that is the focus of this memorandum because of the new compliance burden it presents for covered financial institutions.

IDENTIFYING AND VERIFYING THE IDENTITY OF BENEFICIAL OWNERS OF "LEGAL ENTITY CUSTOMERS": THE LOOK-THROUGH REQUIREMENT

The look-through requirement is the only element of the proposed rules that imposes a new obligation upon covered financial institutions. Covered financial institutions must "look through" the organizational identities of "legal entity customers" (which include corporations, limited liability companies, partnerships or other similar business entities, whether formed under U.S. state or federal law or the law of a foreign jurisdiction) to identify and verify the beneficial owners of the legal entity. Trusts are not considered legal entity customers.

Covered financial institutions can satisfy the look-through requirement by obtaining, at the time a new account is opened, a standard certification form from the individual opening the account on behalf of the legal entity customer. The form would require the individual to (a) identify and provide basic information for any beneficial owners of the legal entity customer and (b) certify the veracity of the information provided. The look-through requirement would permit covered financial institutions to rely on the representations of this individual and, in certain circumstances, to rely on other financial institutions for purposes of complying with the beneficial ownership requirement, including obtaining the standard certification form.[2] In response to concerns over requiring covered financial institutions to engage in complex beneficial ownership analyses, FinCEN has clarified that the proposed rules would require covered financial institutions to verify only the *identity* of the individual named as beneficial owner (by collecting a driver's license or similar identification document), but not the individual's *status* as beneficial owner (particularly in light of the absence of an independent source of beneficial ownership information, such as a state registry).

FinCEN has proposed a two-pronged definition of "beneficial owner" for the purpose of the proposed rules.

- *Ownership Prong* – The ownership prong labels each individual who, directly or indirectly, owns 25% or more of the equity interests (such as shares of stock in a corporation or membership interests in a limited liability company) of a legal entity customer as a beneficial owner. Even though the ownership prong is set at a 25%

[2] A covered financial institution will not be liable for the failure of a relied-upon covered financial institution to adequately fulfill its beneficial ownership responsibilities, provided it can demonstrate that its reliance was reasonable and that is has obtained the required contracts and certifications.

threshold, FinCEN recognizes that some financial institutions may determine, based on their own risk assessments, that a lower threshold, such as 10%, is warranted.

- *Control Prong* – The control prong labels each individual with significant responsibility to control, manage or direct a legal entity customer (including an executive officer or senior manager or any other individual who regularly performs similar functions) as a beneficial owner.

Each prong functions as an independent test, and covered financial institutions would be required to identify any individuals satisfying the criteria for either prong. A maximum of four people may be identified under the ownership prong, and if no one individual owns 25% or more of the equity interests, the covered institution may identify no individuals under the ownership prong. Under the control prong, covered financial institutions are required to identify one individual. If one individual satisfies both sets of criteria, he or she may be identified as a beneficial owner under both prongs.

Beneficial Owners Must Be Natural Persons

The beneficial owners identified in standard certification forms must be *natural persons*. In the event that a legal entity customer is owned or controlled by one or more other legal entities, the proposed rules require customers to "look through" those other legal entities to determine which natural persons own 25% or more of the equity interests of the legal entity customer. FinCEN has acknowledged the challenge of identifying such individuals where, as a result of a complex ownership structure, it is necessary to look through several levels of ownership. However, FinCEN believes that allowing covered financial institutions to rely on the representations of the individual completing a standard certification form substantially alleviates this burden.

Effective Date, Applicability for New Accounts Only and No General Duty to Update

In the interest of providing covered financial institutions with adequate time to implement new CDD requirements, FinCEN has proposed an effective date for the proposed rules of one year from the date the final rules are issued.

The beneficial ownership requirement would apply only with respect to legal entity customers that open *new* accounts with covered financial institutions *after* the effective date of the proposed rules. There would be no requirement to "look back" to obtain beneficial ownership information from existing customers.

Covered financial institutions would not be required to periodically update the beneficial ownership information obtained under the proposed rules, but should update CDD information, including beneficial information, as appropriate on the basis of a customer's risk profile. Factors relevant to a determination of how often CDD and beneficial ownership information should be updated include the type of business the managed by the customer, indications of possible misuse of a shell company, or changes in address or signatories on the account.

Treatment of Intermediaries and Pooled Investment Vehicles

The proposed rules address how "intermediaries"—entities that maintain accounts for the primary benefit of others—should be diligenced. If an intermediary is the customer of a covered financial entity, and the covered financial entity has no customer identification obligation with respect to the intermediary's underlying clients, the financial institution should treat the intermediary (and not the intermediary's underlying clients) as its legal entity customer. For example, a broker-dealer that maintains an omnibus account for an intermediary may treat the intermediary, and not the underlying clients, as its legal entity customer. However, a covered financial institution's anti-money laundering program *should* contain procedures for assessing the money laundering risk posed by an intermediary's underlying clients.

FinCEN recognizes the challenges associated with identifying potential owners of non-exempt pooled investment vehicles whose ownership structures fluctuate regularly, such as hedge funds, and is considering whether such vehicles should be exempt from the look-through requirement, or, alternatively, whether covered financial institutions should only be required to identify beneficial owners of such vehicles under the "control" prong of the "beneficial owner" definition.

Exemptions

The proposed rules exempt two categories of entities from the look-through requirement by excluding them from the "legal entity customer" definition. The first category includes those entities that are currently exempt under FinCEN's existing CIP rules, such as regulated financial institutions (including banks and broker-dealers), publicly held companies traded on certain U.S. stock exchanges, and certain U.S. government agencies and related bodies.

In addition, FinCEN proposes to expressly exclude entities for which beneficial ownership information is generally available from other credible sources. Accordingly, beneficial ownership information would not be required for the following entities opening a new account:

- certain U.S. public reporting entities under the Securities Exchange Act of 1934 (the "Exchange Act")
- majority-owned domestic subsidiaries of an entity listed on a U.S. stock exchange
- U.S. investment companies and investment advisors that are registered with the SEC
- exchanges or clearing agencies registered under Section 6 or 7A of the Exchange Act
- any other entity registered with the SEC or under the Exchange Act
- registered entities, commodity pool operators, commodity trading advisors, retail foreign exchange dealers, or major swap participants registered with the CFTC
- public accounting firms registered under Section 102 of the Sarbanes-Oxley Act
- charities or nonprofit entities that file annual information returns with the IRS

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For more information, please contact any member of our Financial Institutions, Private Funds, or Capital Markets and Securities groups.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017-3954
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower One
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000