Clients&FriendsMemo

FinCEN Issues Final Rules for Customer Due Diligence Requirements

May 13, 2016

On May 11, 2016, the Financial Crimes Enforcement Network ("FinCEN") issued the final version of its long-awaited "Customer Due Diligence Rules" under the Bank Secrecy Act.[1] The final rules impose a new requirement on "covered financial institutions" – which include banks, broker-dealers, mutual funds, and futures commission merchants and introducing brokers in commodities – to identify the beneficial owners who own or control certain legal entity customers at the time a new account is opened. In addition, they amend the anti-money laundering ("AML") program requirements for covered financial institutions to include risk-based procedures for conducting ongoing customer due diligence.

While these rules have been under development for years, their release by FinCEN coincides with the recent disclosure of the "Panama Papers" and multi-pronged efforts by the Obama Administration to combat money laundering, terrorist financing, and tax evasion.[2] Financial institutions subject to the new Customer Due Diligence Rules will be required to update their AML compliance programs accordingly no later than May 11, 2018.

I. Customer Due Diligence for New Accounts

The new Customer Due Diligence Rules apply when an account is opened by a new or existing "legal entity customer" – including 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. In such instances, a covered financial institution will be required to identify and verify the natural person (or persons) who own or control the legal entity customer.

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1 31 C.F.R. §§ 1010, 1020, 1023, *et al.*, Customer Due Diligence Requirements for Financial Institutions – Final Rule (May 11, 2016), *available at* https://www.fincen.gov/redirect.html?url=https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

2 Press Release, The White House, Fact Sheet: Obama Administration Announces Steps to Strengthen Financial Transparency, and Combat Money Laundering, Corruption, and Tax Evasion (May 5, 2016), https://www.whitehouse.gov/the-press-office/2016/05/05/fact-sheet-obama-administration-announces-steps-strengthen-financial.

A. Beneficial Ownership Identification and Verification

For each new account[3] that a legal entity customer opens, the covered financial institution must identify its beneficial owner(s) under either of the following criteria:

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 the legal entity customer (the "ownership prong"); or
2. A single individual with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager (such as a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer), or any other individual who regularly performs similar functions (the "control prong").

The number of individuals that satisfy the definition of "beneficial owner," and therefore must be identified and verified, may vary. Covered financial institutions must identify at least one individual as a beneficial owner under the control prong for each legal entity customer[4] and, depending on the ownership structure of the legal entity, covered financial institutions may identify zero to four individuals under the ownership prong. If a trust owns, directly or indirectly, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner for the purposes of the ownership prong shall be the trustee. Additionally, certain pooled investment vehicles, along with nonprofit corporations that have filed organizational documents with state authorities, are subject only to the control prong of the beneficial ownership requirement.

Covered financial institutions may elect to identify beneficial ownership by either obtaining a certification from the individual opening the account on behalf of the legal entity customer, or by obtaining the information from the customer through other means (so long as the individual certifies the accuracy of the information). To assist in this process, FinCEN attached a form, "Certification Regarding Beneficial Owners of Legal Entity Customers," as an appendix to the final rules.[5]

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[3] For the purposes of this rule, "new account" means each account opened at a covered financial institution by a legal entity customer on or after the applicability date. The definition of account varies by financial institution. For banks, for example, FinCEN has defined "account" to mean 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, or a relationship established to provide a safety deposit box or other safekeeping services, or cash management, custodian, and trust services. *See* 31 C.F.R. 103.121.

[4] While the control prong only requires a covered financial institution to identify one individual, a covered financial institution may also identify additional individuals as part of its customer due diligence if it deems appropriate on the basis of risk.

[5] *See* Appendix A to 31 C.F.R. § 1010.230, Certification Regarding Beneficial Owners of Legal Entity Customers.

Upon identifying the beneficial owner(s) of a legal entity customer, a covered institution will also be required to verify that information using risk-based procedures to the extent reasonable and practicable. At a minimum, these procedures must contain the elements required for verifying the identity of individual customers under a financial institution's customer identification program.[6] In undergoing this verification process, the final rules clarify that covered financial institutions may rely on information supplied by the legal entity customer regarding the identity of its beneficial owner(s), provided they do not have knowledge of facts that would reasonably call into question the reliability of such information.

FinCEN permits covered financial institutions to rely on another financial institution's (including an affiliate's) performance of the beneficial owner identification and verification process. This reliance is permitted so long as: (1) such reliance is reasonable under the circumstances; (2) the other financial institution is subject to a rule implementing 31 U.S.C. 5318(h) and is regulated by a federal functional regulator; and (3) the other financial institution enters into a contract requiring it to certify annually to the covered financial institution that it has implemented its AML program, and that it will perform (or its agent will perform) the specified requirements of the covered financial institution's procedures to comply with the beneficial owner identification and verification requirements.

B. Recordkeeping Requirements

The final rules also require covered financial institutions to document and retain certain records relating to the beneficial owner identification and verification process. Identifying information regarding the legal entity customer, including the FinCEN certification (if obtained), must be retained for five years after the date the account is closed. Any information relating to the beneficial ownership verification process, including a description of any documents reviewed, non-documentary steps taken, or information relied on, as well as how any substantive discrepancies were resolved, must be documented and retained for five years.

C. Limitations and Exemptions

FinCEN excluded 16 categories of entities from the definition of legal entity customer, including banks and financial institutions, investment advisers, exchange or clearing agencies, and other heavily-regulated entities registered with the Securities and Exchange Commission or the Commodity Futures Trading Commission. Also excluded are insurance companies, non-U.S.

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6 *See* 31 C.F.R. §§ 1020.220, 1023.220, 1024.220, 1026.220.

financial institutions established in a jurisdiction whose regulator maintains beneficial ownership information, and non-U.S. governmental entities engaging in non-commercial activities.[7]

In addition, covered financial institutions are exempt from the beneficial owner identification and verification requirements for new accounts opened by legal entity customers for certain limited purpose activities. This includes certain accounts opened at the point-of-sale to provide credit products for the purchase of retail goods and services (up to $50,000), and accounts opened to finance the purchase of postage, insurance premiums, or the leasing of equipment.

II. Ongoing Due Diligence Requirements for Existing Accounts

In addition to the requirement to identify and verify the beneficial owner(s) of certain legal entities that open new accounts, the Customer Due Diligence Rules formalized the requirement that covered financial institutions incorporate ongoing customer due diligence obligations in their AML compliance programs.

Prior to issuance of the final rules, the Bank Secrecy Act required covered financial institutions to implement a risk-based AML compliance program that has been approved by the institution's board of directors.[8] Up to now, AML compliance programs were generally required to contain four "pillars": (1) a system of internal controls to ensure ongoing compliance; (2) independent testing for compliance; (3) an individual designated as responsible for coordinating and monitoring day-to-day compliance; and (4) training for appropriate personnel. While ongoing customer due diligence was an essential component of complying with the Bank Secrecy Act's suspicious activity reporting requirements, it was not formally a required element of an AML compliance program.

The new Customer Due Diligence Rules have effectively created a fifth pillar which will now be officially required. Covered financial institutions will be required to include "appropriate risk-based procedures for conducting ongoing customer due diligence" in their AML compliance programs. Specifically, these procedures must include, but are not limited to:

- Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
- Conducting ongoing monitoring to identify and report suspicious transactions and to maintain and update customer information (which includes information regarding the beneficial owners of legal entity customers).

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7 *See* 31 C.F.R. § 1010.230(e)(2) for the complete list of excluded entities.

8 31 U.S.C. § 5318(h).

FinCEN has emphasized that these provisions do not impose a categorical requirement that covered financial institutions must update customer information on a continuous or periodic basis; rather, the updating requirement is event-driven and should occur as a result of normal monitoring.

III. The Beginning of a New Due Diligence Regime

FinCEN's release of the Customer Due Diligence Rules neatly (and perhaps not coincidentally) coincides with the Panama Papers database that has surfaced online.[9] Just days before the rules' release, the White House stated that the Panama Papers brought the issues of illicit financial activity and tax evasion into the spotlight, and highlighted the Customer Due Diligence Rules as a measure taken to address those issues. With this global demand for greater transparency of financial activity, privacy and protection offered by entity-based ownership is very likely a thing of the past.

Covered financial institutions should not be surprised if their functional regulators (*e.g.*, any federal banking agency or the Securities and Exchange Commission) expand upon FinCEN regulations. In issuing the Customer Due Diligence Rules, FinCEN emphasized that its rules were merely the "minimum regulatory standards" that should apply across the financial industry. FinCEN reminded the industry that the federal functional regulators have authority to establish AML program requirements that expand beyond those established by FinCEN according to risk or vulnerabilities specific to the financial institutions they regulate.[10] Non-governmental organizations such as Transparency International already announced that the Customer Due Diligence Rules do not go far enough, and should, for example, also require covered financial institutions to collect beneficial ownership information to accounts established before the rules' implementation date.[11] Non-governmental organizations also asserted that the 25 percent ownership threshold for identifying beneficial owners is too high, and should be lowered to 10 percent. Federal functional regulators may well decide that the risks in their constituents require that they impose these stricter requirements, or others, in addition to the Customer Due Diligence Rules.

Moreover, institutions other than those covered by Customer Due Diligence Rules could soon find themselves subject to their own beneficial owner verification requirements. For example, the Customer Due Diligence Rules come on the heels of FinCEN's proposed rules that would include

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[9] According to the International Consortium of Investigative Journalists, the database contains information on almost 320,000 offshore entities that are part of the Panama Papers and the Offshore Leaks investigations. The data covers nearly 40 years up to the end of 2015 and links to people and companies in more than 200 countries and territories. Users can search the database by name, company, address or jurisdiction. *See* https://offshoreleaks.icij.org/.

[10] 81 Fed. Reg. 29404 (May 11, 2016).

[11] Press Release, Transparency International, *US Treasury Issues New Rules on Customer Due Diligence, But Gaps Remain and More Action Needed* (May 6, 2016), *available at* http://www.transparency.org/news/pressrelease/us_treasury_issues_new_rules_on_customer_due_diligence_but_gaps_remain_and.

investment advisers in the Bank Secrecy Act's definition of "financial institutions," requiring them to establish AML programs and report suspicious activity.[12] Similarly, FinCEN has recently used geographic targeting orders to temporarily require title insurance companies to identify the beneficial owners behind companies who purchase luxury residential real estate in cash.[13]

IV. Conclusion

The release of the final Customer Due Diligence Rules, while not unexpected, will require significant time and effort to incorporate into AML compliance programs. Covered financial institutions have two years – until May 11, 2018 – to comply. In addition, in light of mounting international pressure for enhanced transparency in financial transactions, those not covered by the new rules should be on alert for the coming of enhanced beneficial owner identification requirements from their respective regulators.

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[12] *See* Jodi L. Avergun, Raymond Banoun, Dorothy D. Mehta & Douglas H. Fischer, *FinCEN Continues Aggressive Anti-Money Laundering Trend*, Law360, Aug. 31, 2015, http://www.law360.com/articles/696778/fincen-continues-aggressive-anti-money-laundering-trend.

[13] Press Release, FinCEN, *FinCEN Takes Aim at Real Estate Secrecy in Manhattan and Miami* (January 13, 2016), *available at* https://www.fincen.gov/news_room/nr/html/20160113.html.