

CLIENT UPDATE

FINCEN PROPOSES ENHANCED CUSTOMER DUE DILIGENCE REQUIREMENTS

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On July 30, 2014, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") issued proposed rules to codify and strengthen existing customer due diligence requirements for banks, securities broker-dealers, mutual funds and futures commission merchants and introducing brokers in commodities (collectively, "covered financial institutions"). Of greatest significance, the proposed rules would require covered financial institutions to identify, and verify the identity of, natural persons who are the beneficial owners of certain legal entity customers (the "look-through requirement"), unless an applicable exemption applies. FinCEN does not propose to expand the universe of covered financial institutions to include other types of financial institutions, but the agency raises the prospect of extending the requirements to other financial institutions in the future.

FinCEN first advanced the look-through requirement in a 2012 Advance Notice of Proposed Rulemaking ("ANPR"), which generated substantial comment from a concerned private sector and prompted an extended dialogue between industry participants and FinCEN. As a result of this process, FinCEN has clarified and narrowed several aspects of the look-through requirement, including more clearly defining "beneficial owner." In addition, under the proposed rule, covered financial institutions would be permitted to rely on customer representations for the purposes of identifying underlying beneficial owners. Nonetheless, as FinCEN acknowledges, the new requirement will pose compliance challenges

for covered financial institutions, which, in some cases, may need to look through multiple levels of ownership to find natural person beneficial owners.

THE PROPOSED LOOK-THROUGH REQUIREMENT

As noted, the most significant new requirement in the proposed rule is the obligation to take explicit steps to identify and verify beneficial owners of legal entities, as described below. Importantly, the new requirement would only apply prospectively – to legal entity customers that open new accounts with covered financial institutions starting one year after a final regulation is adopted. FinCEN acknowledged that applying the obligations to existing accounts would be “a substantial burden.”

Beneficial Ownership

Under the proposed rule, there are two prongs to the definition of “beneficial owner.” Under the ownership prong, a beneficial owner is each individual “who, directly or indirectly, ... owns 25 percent or more of the equity interests of a legal entity customer.” Under the control prong, a beneficial owner is an individual “with significant responsibility to control, manage or direct a legal entity customer,” including an executive officer, senior manager or other individual who regularly performs similar functions.

Each prong operates independently, and, therefore, a covered financial institution would be required to identify (and verify) any individuals who satisfied either prong. For example, in a situation in which a legal entity is owned equally by four natural persons and managed by a separate person, a covered financial institution would need to identify each (four 25% owners under the ownership prong, and the manager under the control prong). In cases where an individual meets the definition of both the ownership and control prongs, that person could be identified as a beneficial owner under both prongs.

Legal Entity Customers

The proposed rule would define legal entity customers generally to include corporations, limited liability companies, partnerships and other similar business entities, whether formed under U.S. state or federal law or the law of a foreign jurisdiction. By contrast, covered financial institutions would not need to apply the look-through requirement to trusts, except for trusts that are created through a filing with a state (*e.g.*, statutory business trusts).

Exemptions

Various types of legal entities would be excluded from the look-through requirement. To begin with, covered financial institutions would not be required to obtain beneficial ownership information from entities exempt from the definition of “customer” under FinCEN’s customer identification program (“CIP”) rules. Those entities include certain federally regulated financial institutions (*e.g.*, banks and broker-dealers), certain U.S. publicly listed companies (and certain of their majority owned subsidiaries) and certain U.S. government agencies and related entities (*e.g.*, a U.S. public pension plan).

FinCEN also proposes to exempt other entities: (i) certain U.S. public reporting entities under the Securities Exchange Act of 1934 (the “Exchange Act”); (ii) U.S. investment companies registered with the Securities and Exchange Commission (the “SEC”); (iii) investment advisors registered with the SEC; (iv) exchanges, clearing agencies or other entities registered with the SEC under the Exchange Act; (v) registered entities (*e.g.*, a board of trade, derivatives clearing organization, swap execution facility or swap data repository), commodity pool operators, commodity trading advisors, retail foreign exchange dealers and major swap participants registered with the Commodity Futures Trading Commission (“CFTC”); (vi) public accounting firms registered under the Sarbanes-Oxley Act; and (vii) certain charities and nonprofit entities that file annual information returns with the Internal Revenue Service. FinCEN believes beneficial ownership information about these entities generally is available from other credible sources.

Treatment of Intermediaries and Pooled Investment Vehicles

Under the proposed rule, a covered financial institution generally would treat an intermediary – and not the intermediary’s third-party clients – as the legal entity customer for purposes of the proposed rule. Thus, a broker-dealer that maintains an omnibus account for another financial institution generally would not need to apply the look-through requirement to underlying owners of that account.

In the proposal, FinCEN also acknowledges the potential difficulty of applying the look-through requirement to pooled investment vehicles, such as hedge funds. For this reason, FinCEN indicates it is considering whether pooled investment vehicles should be exempt from the look-through requirement. In the alternative, FinCEN is considering whether to permit covered financial institutions to apply only the “control” prong with respect to pooled investment vehicles and avoid application of the “ownership prong” of the beneficial owner test. In other words, the covered financial institution would only be

required to identify (and verify) the controlling persons of a pooled investment vehicle (e.g., the general partner) but not the passive investors in the pooled investment vehicle (e.g., the limited partners).

Identification and Verification of Beneficial Owners

In its proposal, FinCEN acknowledged industry concerns regarding the difficulty of verifying that a natural person is, in fact, a beneficial owner of a legal entity. Accordingly, FinCEN is not proposing that covered financial institutions verify the status of beneficial owners; rather, a covered financial institution is only required to verify the identity of the beneficial owners.

FinCEN has proposed that covered financial institutions use a standard certification form to obtain beneficial ownership information. The form would require the individual opening a new account on behalf of a legal entity customer (i) to identify any beneficial owners and provide those individuals' names, dates of birth, street addresses and identification numbers and (ii) to certify the veracity of the information provided.

Covered financial institutions would be permitted to rely on the information provided in these forms. Covered financial institutions would verify the identity of the named individuals in the forms using existing risk-based CIP practices.

Updating Beneficial Ownership Information

FinCEN did not propose specific requirements to update the beneficial ownership information; however, a covered financial institution would be expected to keep the beneficial ownership information "as current as possible," as deemed appropriate based on its risk assessment. A covered financial institution would consider a range of factors in determining whether and when to update the beneficial ownership information.

Reliance on Other Financial Institutions

As with existing CIP rules, covered financial institutions would be permitted to rely on other covered financial institutions to comply with the beneficial ownership requirements. As with the CIP rules, reliance would be permitted if (i) it is reasonable, (ii) the other covered financial institution is subject to an anti-money laundering program rule and is regulated by a federal functional regulator and (iii) the other covered financial institution enters into a contract and provides annual certifications regarding its anti-money laundering program and performance of the beneficial ownership requirements.

OTHER ASPECTS OF THE PROPOSED RULES

In addition to proposing specific requirements for collecting beneficial ownership information on legal entity customers, the proposed rules would require covered financial institutions to (i) understand the nature and purpose of an account and (ii) conduct ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

FinCEN clarifies that the second requirement would not include a categorical requirement to “refresh” customer information, including beneficial ownership information, obtained during the account opening process. Rather, covered financial institutions would be expected to update information as necessary, when a covered financial institution becomes aware of relevant information based on risk-based monitoring.

FinCEN contends these requirements, which are proposed as amendments to FinCEN’s existing anti-money laundering program rules, would not require modification of existing practices and procedures. Rather, according to FinCEN, the amendments would only codify existing requirements and supervisory expectations. For instance, FinCEN contends that, because of existing suspicious activity reporting obligations, financial institutions already are implicitly required to understand the nature and purpose of customer relationships and conduct ongoing monitoring, which are essential steps in the process of identifying suspicious activity.

REQUEST FOR PUBLIC COMMENT

FinCEN invites comments on all aspects of the proposed rules and specifically seeks comments on a number of issues, including the proposed definitions of “beneficial owner” and “legal entity customer” and the proposed beneficial owner certification form. The comment period closes 60 days after publication of the proposed rules in the Federal Register.

Although the proposed rule is narrower than the ANPR – for example, by including a narrower definition of beneficial owner and creating exemptions for certain legal entities – it represents a significant change in the anti-money laundering obligations of covered financial institutions and, for this reason, is likely to draw significant scrutiny and comment.

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Please do not hesitate to contact us with any questions.

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