
FinCEN Releases Long-Awaited Proposal on Customer Due Diligence (CDD) and Beneficial Ownership

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On July 30, the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued proposed regulations that would formalize certain financial institutions' Customer Due Diligence (CDD) requirements and expand the degree to which those institutions must look beyond the nominal account holder to identify the natural persons who own or control certain legal entity customers.

The long-awaited [Notice of Proposed Rulemaking](#) (NPRM) would include a beneficial ownership requirement as one of four key elements of CDD, but the proposed requirement may be more narrow than many feared and appears to be less burdensome to financial institutions than the earlier proposals advanced in FinCEN's February 2012 [Advance Notice of Proposed Rulemaking](#) (ANPRM). Following publication of the ANPRM, Treasury engaged in extensive, nationwide consultation with the industry. The differences between the ANPRM and this proposal suggest that FinCEN took certain industry concerns into account in its drafting process. For example, the proposed rule would not require institutions to verify that named individuals are in fact beneficial owners, and it would not require the institutions to identify an omnibus or other intermediated account's clients or those clients' beneficial owners.

Even so, the proposed beneficial ownership requirement would pose many challenges to covered financial institutions. The proposed rule also would amend FinCEN's anti-money laundering (AML) program rules for "covered financial institutions" (banks, securities broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities) to, in its words, "ensure alignment between existing AML requirements and minimum CDD standards." In addition, the proposed rule says it would add a fifth CDD pillar that would require covered financial institutions to understand the nature and purpose of their customer relationships and conduct ongoing monitoring.

Highlights

- **Beneficial Ownership Requirement:** Covered financial institutions will be required to identify beneficial owners of new legal entity customers, subject to certain exemptions.

- Covered financial institutions will not have to identify beneficial owners of certain types of legal entity customers.
 - Covered financial institutions will not have to identify the beneficial owners of an intermediary's underlying clients if that financial institution has no Customer Identification Program (CIP) obligation with respect to those underlying clients.
 - Covered financial institutions will be able to rely on a standard certification form.
 - Covered financial institutions will be able to rely on the CDD of other financial institutions, consistent with the approach in the existing CIP reliance structure.
- **Other AML Program Requirements:** The proposed rule would add, as an AML program requirement, a new fifth pillar that would require covered financial institutions to understand the nature and purpose of their customer relationships and conduct ongoing monitoring.

Overview and Rationale

From FinCEN's perspective, an effective CDD is composed of four key elements:

1. identifying and verifying the identity of customers;
2. identifying and verifying the identity of beneficial owners of legal entity customers (i.e., the natural persons who own or control legal entities);
3. understanding the nature and purpose of customer relationships; and
4. conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

FinCEN states that the proposed rule is intended to amend its existing rules so that each of these CDD elements is explicitly referenced in a corresponding requirement within FinCEN's program rules. FinCEN asserts that the beneficial ownership requirement is the only new requirement imposed by the rulemaking, whereas the other CDD aspects of the proposed rule merely clarify existing requirements. However, the proposed rule repeatedly emphasizes that it is intended to establish *minimum* CDD standards for covered financial institutions, while noting that other guidance, regulations, or supervisory standards may impose additional requirements to mitigate risk.

Requirement to Identify Beneficial Owners of Legal Entity Customers

Definition of Beneficial Owner

FinCEN has proposed a definition of "beneficial owner" that would include two independent prongs: an ownership prong and a control prong.

Under the proposed beneficial ownership rule, a covered financial institution would have to identify each individual who owns 25 percent or more of the equity interests in the covered financial institution's "legal entity customer" and also one individual who exercises significant managerial

control over the legal entity customer. If no individual owns 25 percent or more of the equity interests, the covered financial institution may identify a beneficial owner under the control prong only. The same individual(s) may be identified under both prongs.

This definition is narrower than the definition proposed in the ANPRM, which would have required financial institutions to identify the single individual “with greater responsibility than any other individual for managing or directing the regular affairs” of the legal entity. FinCEN notes, however, that identifying a natural person beneficial owner may require looking through multiple corporate entities and complex holding legal structures—i.e., piercing the corporate veil, potentially repeatedly.

Definition of Covered Financial Institution

The proposed rule would cover only those financial institutions that currently are subject to FinCEN’s CIP requirement, i.e., banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities. However, FinCEN expressed interest in possibly extending CDD requirements in the future to other types of financial institutions, such as money services businesses, casinos, and insurance companies, in order to promote better AML regulation across the financial system.

Definition of Legal Entity Customer and Exemptions

FinCEN would require covered financial institutions to identify the natural persons who are beneficial owners of their “legal entity customers,” which would include corporations, limited liability companies, and partnerships or other similar business entities (whether formed under the laws of a state or of the United States or of a foreign jurisdiction). The proposed rule would not require financial institutions to identify beneficial owners of legal entities that are exempt under the current CIP rule, nor would it require the identification of beneficial owners of certain other entities whose beneficial ownership is generally available from other credible sources. Customers exempt from the requirement would include, among others: certain charities and nonprofits; most, but not all, trusts; investment advisors; and majority-owned domestic subsidiaries of publicly traded companies.

Intermediated Account Relationships

The proposed rule states that, acknowledging industry concerns about burden and efficiency, covered financial institutions would not have to identify the beneficial owners of an intermediary’s underlying clients if the financial institution has no CIP obligation with respect to those underlying clients. The proposed rule states that it is not intended to overtake the existing requirements for foreign correspondent accounts under Section 312 of the USA PATRIOT Act.

Verification of Identity Rather Than Status

FinCEN acknowledged that industry concerns requiring financial institutions to verify that an

individual identified as a beneficial owner is in fact a beneficial owner would be unduly burdensome. Accordingly, FinCEN clarified that it is not proposing to require financial institutions to verify the *status* of a beneficial owner, only the *identity* of the beneficial owner. Thus, financial institutions may rely on the beneficial ownership information provided by their customers.

Reliance on Other Financial Institutions

The proposed rule would extend the CIP reliance provisions to the new beneficial ownership requirements. Under current rules, one financial institution may rely on another to conduct CIP with respect to shared customers, provided that: (1) such reliance is reasonable; (2) the other financial institution is subject to an AML program rule and is regulated by a federal functional regulator; and (3) the other financial institution enters into a contract and provides annual certifications regarding its AML program and CIP requirements.¹ The proposed rule would permit such reliance for purposes of complying with the beneficial ownership requirement, if those same three conditions are met.

Standard Certification Form

The proposed rule includes a standard certification form that financial institutions would be required to use to document the beneficial ownership of their legal entity customers. The form would require the individual opening the account on behalf of the legal entity customer to certify that the information provided on the form is true and accurate to the best of his or her knowledge. Financial institutions would not necessarily be required to update or refresh information obtained through the certification, though they should do so when appropriate based on risk.

Amendments to Existing AML Program Requirements

To clarify what it characterizes as existing regulatory expectations, FinCEN proposes to amend the AML program rules for covered financial institutions to require:

[A]ppropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

- (i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
- (ii) Conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

FinCEN asserts that it does not intend for these amendments to necessarily require modifications to existing practices or procedures with respect to customer onboarding procedures or suspicious activity reporting. Rather, the proposed rule states that it would merely codify existing supervisory and regulatory expectations as explicit requirements to clarify the minimum standards for CDD.

At the same time, the proposed rule expressly states that it is “adding to these core provisions a fifth pillar” that includes CDD requirements, which would be the most significant modification to AML program requirements in over a decade.²

International Backdrop

The proposed rule is part of a broader US effort to improve compliance with the Financial Action Task Force (FATF) standards on anti-money laundering/countering the financing of terrorism (AML/CFT). In addition to establishing international standards, FATF is an international body that conducts peer reviews (Mutual Evaluations) of jurisdictions’ AML/CFT legal regimes and implementation. Although generally quite positive, the 2006 Mutual Evaluation of the United States deemed US requirements only “partially compliant” with CDD standards, and sharply criticized the United States for lacking a beneficial ownership regime, slapping it with a rating of “non-compliant.”³ As noted above, the four elements of CDD in the proposed rule parallel the CDD measures set forth in the FATF standard. The next Mutual Evaluation of the United States is tentatively scheduled to commence in late 2015/early 2016, and the proposed rule (and final rule if adopted) will be a key part of the review.

Key Differences from ANPRM

The proposed rule’s beneficial ownership requirements are narrower than those contemplated in the ANPRM. Key differences include:

- **A narrower definition of “beneficial owner.”** The earlier definition could have required identification and possibly verification of the single individual “with greater responsibility than any other individual for managing or directing the regular affairs” for the legal entity. FinCEN acknowledged industry concerns that this provision would have required them to engage in a comparative analysis of all owners to determine who, in practice, had the most control.
- **Exceptions for intermediated accounts.** The Proposed Rule clarifies that institutions do not need to identify or verify the beneficial owners of clients of intermediated accounts and pooled investment vehicles. Thus, broker-dealers would not have to identify the ultimate beneficial owners of omnibus accounts that establish subaccounts (provided these accounts meet the elements set forth in 2003 guidance),⁴ and respondent banks in correspondent banking relationships would not have to identify the beneficial owners of their own clients. FinCEN cautioned, however, that institutions may still need to inquire into these intermediary relationships as part of their broader AML obligations. Notably, FinCEN stated that it is still considering whether the beneficial ownership obligations should include owners of certain pooled investment vehicles such as hedge funds.
- **Exemption of certain legal entities.** Beneficial ownership obligations extend only to customers who are foreign or domestic corporations, limited liability companies,

partnerships or similar business entities. FinCEN stated that beneficial ownership information is not required from entities exempt from the CIP definition of “customer” (such as banks), as well as numerous other entities whose beneficial ownership is generally available from other credible sources. Exempt entities include trusts, certain charities and nonprofits, investment advisors, and majority-owned domestic subsidiaries of publicly traded companies, among others.

Public Comments

FinCEN has invited public comments on all aspects of the NPRM, but specifically seeks comments on the following issues: the definitions of “beneficial owner” and “legal entity customer”; proposed exemptions from the beneficial ownership rule; and the treatment of existing accounts, intermediated accounts, pooled investment vehicles, and trusts. The comment period will close 60 days after the NPRM is published in the Federal Register. We expect numerous comments from various industry participants and other observers.

Effective Date

To give financial institutions time to modify existing customer onboarding processes to incorporate the new beneficial ownership requirement, FinCEN has proposed an effective date of one year from the date the final rule is issued.

¹See 31 C.F.R. § 1020.220(a)(6).

² The other pillars are: (1) a system of internal controls to ensure ongoing compliance; (2) independent testing; (3) designation of a Bank Secrecy Act compliance officer; and (4) training for appropriate personnel.

³ The United States was far from alone in its struggle to meet the FATF standards on CDD and beneficial ownership, which subsequently were streamlined and clarified. In the intervening years, several jurisdictions have made progress in their compliance with CDD and beneficial ownership standards, and have criticized the United States for lagging behind.

⁴<http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm>.

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