

FinCEN Releases Final Rule on Beneficial Ownership and Risk-Based Customer Due Diligence

May 10, 2016

Financial Institutions

On May 5, 2016, the Financial Crimes Enforcement Network (“FinCEN”) issued its long-awaited [final rule](#) on beneficial ownership with respect to customer due diligence requirements. The final rule requires covered financial institutions to adopt due diligence procedures to identify and verify a legal entity customer’s beneficial owner(s) at the time a new account is opened.

The final rule also creates a fifth “pillar” for anti-money laundering (“AML”) programs required under FinCEN’s rules for banks. Since passage of the USA PATRIOT Act, the four pillars of an AML program—policies, procedures, and internal controls; independent testing; a designated compliance official; and employee training—have formed the foundation for the federal banking agencies’ examination and enforcement practices with respect to AML compliance. The rule establishes a fifth “pillar” pursuant to which banks will be required to establish risk-based procedures for conducting ongoing customer due diligence, including the development of customer risk profiles and implementation of ongoing monitoring to identify and report suspicious activity and, on a risk basis, to update customer information.

Covered financial institutions are required to comply with the final rule by May 11, 2018.

The final rule was issued by the Obama administration as part of a broader package of reforms intended to counter money laundering, corruption, and tax evasion, although the rule was initially proposed by FinCEN in 2014 after an advance notice of proposed rulemaking was issued in 2012. The long duration of the rulemaking process, as well as the two-year implementation period, reflects the significant legal, compliance, and operational challenges associated with beneficial ownership reporting.

Overview of the Beneficial Ownership Requirements in the Final Rule

The final rule applies to “covered financial institutions”:

- Depository institutions, including insured banks, commercial banks, savings associations, federally-insured credit unions, federally-regulated trust companies, U.S. agencies and branches of a foreign bank, and Edge Act corporations;
- Securities broker-dealers;
- Mutual funds; and
- Futures commission merchants and introducing brokers in commodities.

A “covered financial institution” is required to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers.

Legal Entity Customers’ Beneficial Owners

A “legal entity customer” is, subject to exclusions described below, a corporation, limited liability company, or other entity created by filing 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. With respect to legal entity customers, there are two types of beneficial owners under the final rule: those who satisfy the “ownership prong” and those who satisfy the “control prong.”

- Ownership prong—The term “beneficial owner” includes each individual who, directly or indirectly, owns 25 percent or more of the equity interests of the legal entity customer.
- Control prong—The term “beneficial owner” means a single individual with significant responsibility to control, manage, or direct the legal entity customer (e.g., a Chief Executive Officer, Vice President, or Treasurer).

In general, at least one beneficial owner is required to be identified for each legal entity customer with respect to the control prong. Accordingly, for any legal entity customer there must be between one and five beneficial owners, assuming zero individuals with 25 percent or greater equity interests plus the control prong beneficial owner to up to four individuals with 25 percent equity interests plus the control prong beneficial owner.

The final rule excludes certain legal entity customers from the beneficial ownership identification and verification requirements. These excluded entities include banking organizations; entities that have their common stock listed on the New York, American, or NASDAQ stock exchanges; SEC-registered investment companies and advisers; CFTC-registered entities; state-regulated insurance companies; foreign financial institutions established in jurisdictions that have beneficial ownership reporting regimes; and legal entities with private banking accounts subject to FinCEN rules. Pooled investment vehicles operated by an excluded entity and certain nonprofit corporations are subject to reporting only those beneficial owners who satisfy the control prong.

Certain accounts are also exempt from the identification and verification requirements for beneficial owners. For example, a covered financial institution is not required to satisfy the requirements with respect to opening an account for a legal entity customer that is at the point-of-sale for the purchase of retail goods and/or services at the retailer, or, subject to certain limitations, financing equipment for which payments are remitted directly by the institution to the equipment vendor or lessor. These accounts are not exempt, however, if a legal entity customer can make payments to, or receive payments from, third parties through such an account, or if there is a possibility of a cash refund on the account activity.

Beneficial Ownership Identification and Verification Requirements

The final rule requires a covered financial institution to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of a legal entity customer. The procedures must allow the financial institution to identify all beneficial owners of each legal entity customer at the time of account opening unless an exclusion or exemption applies to the customer or account. FinCEN provides a model certification form that satisfies the

identification requirements, although the financial institution may comply with the requirements through other means.

Covered financial institutions also must verify the identity of each beneficial owner by using risk-based procedures “to the extent reasonable and practicable.” The final rule states that, at a minimum, these verification procedures must contain the elements required under the existing customer identification program—namely, collection of customer information and use of documents or non-documentary methods for verification—except that covered financial institutions are permitted to rely on photocopies for beneficial owners.

Covered financial institutions are required to retain records of the information they obtain regarding beneficial ownership. These records must include, at a minimum: (1) the identifying information obtained (including the certification form, if used); and (2) a description of documents that the financial institution reviewed to verify the beneficial owner’s identity. Covered financial institutions must retain the identification records for five years after the account is closed, and retain the verification records for five years after the record is made. If another financial institution, including an affiliate, maintains these records, the covered financial institution generally may rely on the performance of that financial institution to satisfy its own obligations.

Importantly, covered financial institutions may rely on the information provided by legal entity customers regarding beneficial owners, as long as there is no reason to question the reliability of the information. This reliance principle was incorporated in the final rule as a response to public comments that verification of a beneficial owner, who might not be present at account opening, would pose considerable operational challenges.

Risk-Based Due Diligence Requirements

The final rule also amends the AML program requirement to include risk-based procedures for customer due diligence, including the beneficial owner procedures described above. These amendments will require a covered financial institution to understand the nature and purpose of its customer relationships to develop a customer risk profile. A customer risk profile represents the cumulative information gathered by the institution during the account-opening process that is used to develop a baseline against which activity is assessed for suspicious activity reporting purposes. For example, a suspicious activity report is required to be filed when a customer conducts transactions that are not of the sort the customer would normally be expected to conduct, and the customer risk profile would be used to determine the sorts of transactions normally expected for the customer.

A covered financial institution also is required to conduct ongoing monitoring to identify and report suspicious transactions and to update its customer information. The preamble to the final rule makes it clear that this new requirement does not impose a requirement to update on a “continuous or periodic” basis. Instead, the requirement to update customer information is “event-driven” and is triggered by information that arises in the normal course of monitoring.

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