THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 32 No. 9 September 2016

FINCEN'S FINAL BENEFICIAL OWNERSHIP RULE

FinCEN's Final Rule will require certain U.S. financial institutions to collect beneficial ownership information about their prospective legal entity customers, a sweeping change that the authors describe as a substantial advance in financial transparency objectives. The authors begin their discussion of the rule by describing existing customer identification programs, the 2010 Interagency Guidance on beneficial ownership, and geographic targeting orders. They then turn to the rule and other administration initiatives to promote financial transparency. They conclude with an analysis of the rule and beneficial ownership reporting.

By Michael Nonaka and Lucille C. Andrzejewski *

In her last remarks to Congress before resigning as Director of the Financial Crimes Enforcement Network ("FinCEN"), Jennifer Shasky Calvery championed the various initiatives announced by the Obama Administration in early May that are designed to augment financial transparency and curb money laundering.[1] Among these initiatives are proposed legislation that would require a company at the time of formation to submit information regarding its beneficial owners and FinCEN's final rule ("Final Rule") amending the customer due diligence ("CDD") requirements applicable to U.S. financial institutions to include beneficial ownership information collection.[2] Placing these initiatives on equal footing alongside the proposals announced by the Administration understates the significant effect that FinCEN's Final Rule will have on the financial services industry, as it ranks as one of the most consequential regulatory developments to be promulgated by FinCEN in the past 15 years.[3]

Financial institutions have long wrestled with how best to conduct due diligence with respect to their legal entity customers, including how to incorporate aspects of

[1] *Stopping Terror Finance: A Coordinated Government Effort, Hearing Before the United States House of Representatives Committee on Financial Services Task Force to Investigate Terrorism Financing*, 114th Cong. 5 (2016) (statement of Jennifer Shasky Calvery, Director, Financial Crimes Enforcement Network).

[2] U.S. Department of the Treasury, Press Release, *Treasury Announces Key Regulations and Legislation to Counter Money Laundering and Corruption, Combat Tax Evasion* (May 5, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0451.aspx (hereinafter "Treasury Press Release").

[3] FinCEN, Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016).

* *Michael Nonaka is a partner in the financial institutions group at Covington & Burling LLP in Washington, DC. Lucille C. Andrzejewski is an associate in the financial institutions group at the firm. Their e-mail addresses are mnonaka@cov.com and landrzejewski@cov.com.*

IN THIS ISSUE

RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

beneficial ownership information collection in account opening processes. However, without a single federal rule unifying beneficial ownership requirements across various financial services industry participants, beneficial ownership has been a particularly vexing aspect of anti-money laundering ("AML") compliance for the industry. Practices in the area have ranged from some banking organizations adopting procedures that are close in scope and magnitude to the compliance requirements in the Final Rule, and others merely noting the AML risk from legal entity customers in enterprise-wide AML risk assessments. FinCEN acknowledged that this divergence in practices has been the source of some frustration in the financial services industry because of the potential for institutions to do less due diligence for legal entity customers as one way to attract customers.[4] The Final Rule will help establish standard expectations among financial institutions, their customers, and their regulators for this aspect of CDD. Moreover, the rule will produce volumes of information available to financial institutions to augment their understanding of customers and to regulators and law enforcement agencies to assist with financial crime detection and prevention.

Prior to the Final Rule, FinCEN guidance addressed the AML risks associated with non-transparent legal entity customers in only narrow respects. For example, on January 13, 2016, FinCEN announced two geographic targeting orders ("GTOs") that impose enhanced information collection requirements on title insurance companies with respect to certain cash purchases of high-end real estate in Manhattan and Miami-Dade County.[5] These orders were issued out of a growing concern in recent years regarding the use of shell companies to purchase real estate.[6] In a seven-part series, *Towers of Secrecy: Piercing the Shell Companies, The New York Times* described the increasing pervasiveness of shell companies in the real estate industry.[7] The GTOs serve to enhance beneficial ownership transparency in a segment of the financial services industry that may not be subject to comprehensive AML requirements administered by FinCEN.[8]

However, the Manhattan and Miami-Dade GTOs increase beneficial ownership reporting for only a narrow class of transactions in two jurisdictions. They also are set to expire on August 27, 2016. Moreover, FinCEN's authority to issue GTOs is limited only to transactions involving cash or monetary instruments.[9] For these reasons, FinCEN has never viewed GTOs as a lasting means to enhancing transparency on a broad basis across the U.S. financial services industry.[10] The Final Rule, on the other hand, is much broader in scope, requiring the collection and verification of beneficial owner information of certain legal entity customers on-boarded by banks, securities brokers or dealers, futures

---

[4] Lalita Clozel, *Banks Successfully Lobbied on Beneficial Ownership Rule: Top Fincen Official*, American Banker (May 18, 2016).

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

[6] Shell companies often use nominees to sign paperwork, concealing the true identities of the individuals who are purchasing real estate. Shell companies purchase almost half of the homes worth at least $5 million nationwide. Louise Story, *U.S. Will Track Secret Buyers of Luxury Real Estate,* N.Y. Times (Jan. 13, 2016), *available at* http://www.nytimes.com/2016/01/14/us/us-will-track-secret-buyers-of-luxury-real-estate.html?_r=0.

footnote continued from previous column…

[7] *Towers of Secrecy: Piercing the Shell Companies*, N.Y. Times, http://www.nytimes.com/news-event/shell-company-towers-of-secrecy-real-estate (last visited July 14, 2016).

[8] In April 2003, FinCEN issued an advance notice of proposed rulemaking to explore the promulgation of AML requirements for persons involved in real estate closings and settlements, but the bureau opted to not pursue this rulemaking until it had a better understanding of the illicit activities and risks in the sector. 68 Fed. Reg. 17,569 (Apr. 10, 2003).

[9] 31 U.S.C. § 5326(a).

[10] Remarks, Jennifer Shasky Calvery, Director of FinCEN, at ACAMS AML and Financial Crimes Conference in Hollywood, Florida (Apr. 12, 2016) ("This step is a pilot effort in two jurisdictions that are popular destinations for luxury buyers . . . . This pilot effort will help us gather information while furthering our incremental, risk-based approach to regulating this industry."), *available at* https://www.fincen.gov/news_room/nr/pdf/20160412.pdf.

commission merchants, and introducing commodities brokers, and mutual funds.[11]

Even though the Final Rule represents a substantial expansion of the U.S. AML framework's provisions for beneficial ownership reporting and a key FinCEN development, it also has its limitations. There are a sizable number of transactions for which beneficial ownership will not be collected or reported, such as financial services transactions that do not involve a bank, securities broker-dealer, or other type of institution covered by the Final Rule. The legislation that the Administration proposed in conjunction with issuance of the Final Rule would further expand the scope of beneficial ownership reporting beyond the parameters of the Final Rule by authorizing the Department of the Treasury to require legal entities formed or qualified to do business within the United States to file beneficial ownership information with the federal government.[12] This comprehensive approach to financial transparency was spurred by the Panama Papers discovery that a law firm in Panama had used shell companies to conceal assets.[13]

The evolution of beneficial ownership reporting from GTOs to Final Rule to proposed legislation signifies a broadening in scope that policymakers have deemed necessary to effectively combat money laundering and terrorist financing. Indeed, Director Shasky Calvery referred to the Final Rule as just "one piece of the financial transparency puzzle" with the proposed legislation representing the other piece.[14] However, given the uncertainty of legislation in the Congress in this election year, particularly financial services legislation, the likelihood of the other piece of the financial transparency puzzle being completed is low. The Final Rule may have to stand on its own for some time before accompanying legislation is enacted. This article analyzes the Final Rule, the trajectory of beneficial ownership information guidance and legal requirements, and their effects on the financial services industry.

Section I of this article briefly summarizes the CDD requirements applicable to financial institutions under the Bank Secrecy Act ("BSA") and FinCEN's implementing regulations. Section II describes FinCEN's guidance regarding beneficial ownership collection, including the GTOs issued for high-end real estate in Manhattan and Miami, and culminating with the Final Rule. Section III summarizes the other initiatives announced by the Obama Administration in conjunction with the issuance of the Final Rule, such as Treasury's draft legislation requiring beneficial ownership information reporting. Finally, section IV analyzes these developments from the perspective of AML regulation, including in particular the effect of the Final Rule on financial institutions.

I. CUSTOMER DUE DILIGENCE REQUIREMENTS IN THE BANK SECRECY ACT AND FINCEN REGULATIONS

Regulated banks and other types of financial institutions are required to establish and implement a written customer identification program ("CIP").[15] A bank's CIP must be appropriate for the bank's business and its size. Banks also must establish risk-based identity verification procedures for each customer "to the extent reasonable and practicable" that enable the bank to form a reasonable belief that it knows the true identity of the customer.[16] The regulation requires that banks develop identity verification procedures with respect to risks relevant to the bank, including, for example, the type of account, methods for opening accounts, and the identifying information available. The regulation sets forth minimum requirements for identity verification procedures: the bank is required to (1) collect certain customer information; (2) verify this customer information; and (3) develop procedures for scenarios in which the bank cannot form a reasonable belief of the true identity of a customer.

---

[11] 31 C.F.R. § 1010.230(f).

[12] *Amending the Bank Secrecy Act to Require Reporting and Recordkeeping on Beneficial Ownership of Legal Entities,* https://www.treasury.gov/press-center/press-releases/Documents/20160506%20BO%20Legislation.pdf.

[13] Scott Shane, *Panama Papers May Inspire More Big Leaks, if Not Reform*, N.Y. Times (May 29, 2016).

[14] *Stopping Terror Finance: A Coordinated Government Effort, Hearing Before the United States House of Representatives Committee on Financial Services Task Force to Investigate Terrorism Financing*, 114th Cong. 5 (2016) (statement of Jennifer Shasky Calvery, Director, Financial Crimes Enforcement Network) ("The [Final Rule] focuses on financial institutions knowing who their legal entity customers are, regardless of where those entities are formed, as part of due diligence at the time of account opening. The proposed legislation focuses on making sure that legal entities formed in the United States are more transparent to law enforcement regardless of where they conduct their financial activity.").

[15] 12 C.F.R. § 1020.220(a).

[16] 12 C.F.R. § 1020.220(a)(2).

When a customer opens a new account, a bank must obtain:

- the customer's name;
- if the customer is an individual, his or her date of birth;
- the customer's address, which is:
  - — a residential or business street address for an individual;
  - — an Army Post Office ("APO") or Fleet Post Office ("FPO") for individuals without a residential or business street address; or
  - — for persons other than an individual (*e.g.*, corporations, trust, partnerships), the principal place of business, local office, or other physical location;
- The customer's identification number, which is:
  - — a taxpayer identification number for U.S. persons; or
  - — one or more of the following, for non-U.S. persons: (1) passport number with country of issuance; (2) taxpayer identification number; (3) alien identification card number; or (4) any other government-issued document with a number and country of issuance that evidences residence or nationality and includes a photograph or similar safeguard; and
- if the customer is a foreign business or enterprise without an identification number, government-issued documentation that proves the existence of the customer.[17]

Banks also are required to develop customer verification procedures as part of a CIP that obligate the bank to verify the identity of the customer based on the information collected above within a reasonable time after the bank opens the customer's account. The CIP is required to include a description of the methods the bank will use to verify a customer's identity, including the use of documents (*e.g.*, government-issued documentation, articles of incorporation) or non-documentary methods (*e.g.*, contacting the customer, obtaining information from a consumer reporting agency).

Finally, the CIP is required to include procedures for the bank to follow when it cannot form a reasonable belief that it knows the true identity of a customer. The procedures must describe when the bank should refrain from opening an account; if an account is opened, the terms under which the customer may use the account while the bank is attempting to verify the identity of the customer; if the bank attempts to verify the customer's identity and fails, the time when the bank should close the account; and, in accordance with applicable laws and regulations, when the bank should file a Suspicious Activity Report ("SAR").[18]

A bank's CIP should also prompt the bank to collect additional information for non-individual customers when the bank cannot verify the customer's true identity using its other verification methods. In these circumstances, the bank must obtain information about the individuals who will have authority or control over the account.[19] This requirement, in conjunction with the other CIP requirements, requires a bank to gather basic information about its customers, including, in some circumstances, beneficial owners. However, this aspect of CDD has been superseded by the Final Rule discussed in more detail in the next section of this article.

II. FINCEN GUIDANCE REGARDING BENEFICIAL OWNERSHIP COLLECTION

This section describes the recent history of FinCEN's guidance in the area of beneficial ownership information collection, including a discussion of the guidance issued by FinCEN and other regulators in 2010, the GTOs, and the Final Rule.

2010 Interagency Guidance

In order to provide banking organizations insight about the CDD requirements and how they relate to obtaining beneficial ownership information, FinCEN, along with several other federal regulators, issued interagency guidance on March 5, 2010.[20] The guidance reiterated that a bank's CDD processes should be based

[17] 12 C.F.R. § 1020.220(a)(2)(i).

[18] *Id.* at (a)(2)(iii).

[19] *Id.* at (a)(2)(ii)(C).

[20] FinCEN, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, Securities and Exchange Commission, Joint Release, *Guidance on Obtaining and Retaining Beneficial Ownership Information* (Mar. 5, 2010) (hereinafter "Interagency Guidance").

on its BSA/AML risk and should focus on high-risk customers. The guidance cautioned banks about situations where beneficial owners of accounts are concealed because of nominal account holders and indicated that identification of these beneficial owners may be important in detecting suspicious activity. FinCEN and the agencies issuing the guidance also stated that a financial institution's CDD procedures should be reasonably designed to identify beneficial owners, as appropriate, based on its evaluation of risk. The guidance includes several examples of procedures, including:

- obtaining information regarding an agency relationship between an agent and a beneficial owner;
- obtaining information about structure or ownership of a legal entity that is not publicly traded in the United States; and
- obtaining information about the trust structure, where the customer is a trustee, to reasonably understand the structure of the trust and determine any other individuals or entities that have control over the funds or who have power to remove the trustee.

If the bank identifies an account that poses heightened risk, the Interagency Guidance indicates that the account should be subject to enhanced due diligence ("EDD") reasonably designed to enable compliance with the requirements of the BSA.[21] EDD may, in certain circumstances, include identification and verification of beneficial ownership.

Finally, the Interagency Guidance describes the CDD requirements applicable to private banking accounts and correspondent accounts. These requirements include beneficial ownership information collection.[22]

Geographic Targeting Orders

In an effort to collect information on the use of shell companies to purchase luxury residential real estate in two high-end markets — Manhattan and Miami-Dade County — FinCEN issued two GTOs that require U.S. title insurance companies to identify the beneficial owners of companies that engage in cash purchases of real estate that exceed a threshold amount. In its press release announcing the GTOs, FinCEN indicated that it is "seeking to understand the risk that corrupt foreign officials, or transnational criminals, may be using premium U.S. real estate to secretly invest millions in dirty money."[23]

Under the BSA, the Director of FinCEN is authorized to issue an order imposing recordkeeping and reporting requirements on domestic financial institutions or non-financial trades or businesses within a specific geographic area.[24] To issue a GTO, the Director must find that reasonable grounds exist for concluding that the recordkeeping and reporting requirements are necessary to carry out the purpose of the BSA and prevent evasions thereof.[25] The GTO may only cover transactions in a geographic area.[26]

The two most recent GTOs only apply to title insurance companies that received notice from FinCEN of their qualification as a "covered business." If the transaction qualifies as a "covered transaction," these title insurance companies are required to report to FinCEN beneficial ownership information of legal entities that engage in cash purchases of luxury residential real estate in Manhattan and Miami-Dade County. Both GTOs went into effect on March 1, 2016, and, without amendment or extension, will expire on August 27, 2016 (a period of 180 days). In Miami-Dade County, in order to meet the definition of a "covered transaction," the total purchase price of the property must be in excess of $1 million. In Manhattan, the threshold is $3 million. The purchaser must also buy the property without a loan from a bank or any other "similar form of external financing," and must purchase, at least in part, the property using currency or a cashier's check, certified check, traveler's check, or money order in any form.

If the purchase qualifies as a "covered transaction," the title insurance company is required to fill out a Form 8300 and file it with FinCEN within 30 days of closing. The Form 8300 must include the identity of: (1) the individual who is primarily responsible for representing the purchaser; (2) the purchaser (the legal entity); and (3) the beneficial owner of the purchaser. The beneficial owner is defined as "each individual, who, directly or

[21] Interagency Guidance, at 4.

[22] *See* 31 C.F.R. §§ 1010.620(b)(1); 1010.610(b)(1).

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

[24] 31 U.S.C. § 5326(a); 31 C.F.R. § 1010.370; Treasury Order 180-01 (delegating authority to issue orders to FinCEN).

[25] 31 C.F.R. § 1010.370(a).

[26] 31 C.F.R. § 1010.370(d)(4).

indirectly, owns 25% or more of the equity interests of the purchaser." When a title insurance company is required to report the identity of an individual, it must obtain and record a copy of satisfactory identification, including, for example, a driver's license or a passport. If the purchaser is an LLC, the title insurance company is required to provide the names, addresses, and taxpayer identification numbers of all members. In addition to reporting the required information to FinCEN, the title insurance companies must also retain records for at least five years from the end date of the effective period — taking into account any extensions — and must make such records available to FinCEN and any other appropriate agency upon request.[27]

There is evidence that GTOs have been deployed successfully for law enforcement purposes. For example, the *South Florida Business Journal* found that a GTO issued for Miami led to 22 arrests and pending arrests of co-conspirators in money laundering schemes with ties to the Sinaloa cartel.[28] However, GTOs have their limitations. GTOs are limited to a geographic area and do not apply to transactions conducted via wire transfer or with uncertified personal checks. The Final Rule helps to fill in these gaps in beneficial ownership information.

FinCEN's Beneficial Ownership Rule

FinCEN has been working toward implementing a Final Rule that would require financial institutions to collect beneficial ownership information for legal entity customers since 2012, when it issued an advance notice of proposed rulemaking on the subject.[29] On August 4, 2014, FinCEN issued a notice of proposed rulemaking.[30] The proposed rule generated over 130 comments, and the industry expressed concerns that the proposed rule "substantially underestimated" implementation and compliance costs, a criticism that would be reiterated several times throughout the rulemaking process.[31]

On May 5, 2016, FinCEN issued the Final Rule.[32] The rule requires covered financial institutions to identify and verify the beneficial owner of a legal entity customer at the time a new account is opened. The Final Rule also amends AML program requirements for covered financial institutions to establish a fifth "pillar" for an AML program.[33] This fifth pillar memorializes existing CDD requirements and articulates new expectations regarding the development of customer risk profiles and implementation of monitoring to identify and report suspicious activity, and, on a risk basis, to update customer information.

The Final Rule applies to "covered financial institutions," a defined term that includes:

- 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.[34]

Insurance companies, non-bank loan companies, mortgage brokers, and money services businesses are not covered financial institutions for these purposes and thus are not subject to the beneficial ownership and risk-based CDD requirements in the Final Rule.

A covered financial institution is required to establish and maintain written procedures reasonably designed to identify and verify the beneficial owners of legal entity customers.[35] Some legal entity customers are excluded,

---

[27] *Id.*

[28] Nina Lincoff, *Doral Dragnet Findings Used in Money-Laundering Probe*, South Florida Business Journal (Apr. 8, 2016), *available at* http://www.bizjournals.com/southflorida/news/2016/04/08/doral-dragnet-findings-used-in-money-laundering.html.

[29] 77 Fed. Reg. 13,046 (Mar. 5, 2012).

[30] 79 Fed. Reg. 45,151 (Aug. 4, 2014).

[31] 80 Fed. Reg. 80,308-09 (Dec. 24, 2015); *see also* Ian McKendry, *Beneficial Ownership Plan Will Cost Banks Up to $1.5B, Treasury Says* (Dec. 23, 2015), http://www.americanbanker.com/news/law-regulation/beneficial-ownership-plan-will-cost-banks-up-to-15b-treasury-says-1078505-1.html.

footnote continued from previous column…

[32] 81 Fed. Reg. 29,398 (May 11, 2016).

[33] The four pillars of an AML program are policies, procedures, and internal controls; a designated compliance officer; employee training; and independent testing. *See, e.g.*, 31 C.F.R. § 1024.210(b).

[34] 12 C.F.R. § 101.605(e)(1).

[35] A "legal entity customer" is defined as a corporation, limited liability company, or other entity created by filing a public document with a secretary of state or similar office; a general

including banking organizations; entities that have 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.[36]

The Final Rule creates a two-prong test to determine whether an individual is a beneficial owner. Individuals are beneficial owners if they satisfy either the "ownership prong" or the "control prong." Under the ownership prong, a beneficial owner includes each individual who, directly or indirectly, owns 25 percent or more of the equity interests of the legal entity customer. Under the control prong, a 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).[37] A covered financial institution is required to identify at least one beneficial owner 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 one beneficial owner under the control prong to up to four individuals with 25 percent equity interests plus the one beneficial owner under the control prong.

In addition to those entities excluded from the definition of a "legal entity customer," the Final Rule also exempts certain accounts 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.[38]

The Final Rule requires a covered financial institution to establish and maintain written procedures that are reasonably designed to identify and verify the identity of 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. The Final Rule includes as an appendix a model certification form that satisfies these requirements, but institutions are free to satisfy the requirements through other means.[39]

Covered financial institutions also must verify the identity of each beneficial owner by using risk-based procedures.[40] The Final Rule states that, at a minimum, these verification procedures must contain the elements required under the existing CIP regulation — namely, collection of customer information and use of documents or non-documentary methods for verification.[41] However, an institution is not required to implement for purposes of compliance with the Final Rule the exact same procedures that it uses to satisfy standard CIP requirements. Verification is required to be completed within a reasonable time after account opening.

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 model 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.[42] If another financial institution, including an affiliate, maintains these records, the covered financial institution generally may

footnote continued from previous page…

partnership; and any similar entity formed under the laws of a foreign jurisdiction that opens an account. 31 C.F.R. § 1010.230(d).

[36] Note that 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, described *infra*.

[37] 81 Fed. Reg. 29,398 (May 11, 2016).

[38] *Id.* at 29,452 (to be codified at 31 C.F.R. § 1010.230(h)).

[39] *Id.* at 29,451 (to be codified at 31 C.F.R. § 1010.230(a)).

[40] *Id.* at 29,452 (to be codified at 31 C.F.R. § 1010.230(b)).

[41] *Id.* at 29,451 (to be codified at 31 C.F.R. § 1010.230(b)).

[42] *Id.* at 29,451-52 (to be codified at 31 C.F.R. § 1010.230(i)).

rely on the performance of that financial institution to satisfy its own obligations.[43]

In response to industry comments, the Final Rule allows covered financial institutions to 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.[44] This reliance principle was incorporated in the Final Rule as a response to public comments stating that verification of a beneficial owner, who might not be present at account opening, would pose considerable operational challenges.

Fifth "Pillar" for AML Programs

The Final Rule also creates a fifth "pillar" for 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.[45] The rule establishes a fifth "pillar" that memorializes existing CDD requirements and augments these requirements to establish risk-based procedures for conducting ongoing CDD, 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.[46]

These amendments require covered financial institutions to understand the nature and purpose of their customer relationships, and to develop a risk profile for each customer. This customer risk profile represents the cumulative information gathered by the institution during the account-opening process and is used to develop a baseline against which activity is assessed for SAR reporting purposes. For example, a covered financial institution must file a SAR 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 clear that this new requirement does not impose an obligation to update on a continuous or periodic basis.[47] Instead, the requirement to update customer information is "event-driven" and is triggered by information that arises in the normal course of monitoring.[48]

III. OTHER ADMINISTRATION INITIATIVES TO PROMOTE FINANCIAL TRANSPARENCY

The Final Rule was accompanied by other announcements of legislative and regulatory initiatives. By proposing additional legislation, the Treasury Department signaled that it is not finished addressing the issue of beneficial ownership. In particular, Treasury announced that it provided draft beneficial ownership legislation to Congress.[49] If enacted, this legislation would require all companies formed in the United States to report beneficial ownership information at the time of formation.[50] Moreover, the same proposed legislation would amend FinCEN's GTO authority to explicitly allow FinCEN to collect information regarding "funds."[51] The Department of the Treasury's press release noted that this amendment would only clarify FinCEN's ability to collect wire transfer information.[52]

The Department of the Treasury also proposed regulations for foreign-owned "disregarded entities." If implemented, these entities, which would include foreign-owned, single-member LLCs, would be required to obtain an employer identification number ("EIN") from the IRS. In addition to allowing the IRS to determine the tax liability of these entities, if this

[43] *Id.* at 29,452 (to be codified at 31 C.F.R. § 1010.230(j)).

[44] *Id.* at 29,451 (to be codified at 31 C.F.R. § 1010.230(b)(2)).

[45] FDIC, Supervisory Insight, *Understanding BSA Violations*, https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin06/article03_bsa.html (last updated Dec. 14, 2006).

[46] 81 Fed. Reg. 29,457-58 (May 11, 2016) (to be codified at 31 C.F.R. §§ 1010.210(b), 1023.210(b), 1024.210(b), 1026.210(b)).

[47] 81 Fed. Reg. 29,399.

[48] *Id.*

[49] Treasury Press Release.

[50] *Amending the Bank Secrecy Act to Require Reporting and Recordkeeping on Beneficial Ownership of Legal Entities,* § 5333(d), (e), *available at* https://www.treasury.gov/press-center/press-releases/Documents/20160506%20BO%20Legislation.pdf.

[51] *Id.* at § 5333(d).

[52] Treasury Press Release.

regulation is implemented, the IRS could share this information with other tax authorities.[53]

IV. ANALYSIS OF FINAL RULE AND BENEFICIAL OWNERSHIP INFORMATION

Although the Final Rule, like any milestone regulatory development, has its share of critics,[54] the beneficial ownership requirements in the rule will have a lasting effect on financial services organizations' CDD processes and U.S. law enforcement agencies' ability to combat money laundering and terrorism financing. Even if the Department of the Treasury's proposed legislation is years away from becoming law or never becomes law, the Final Rule will substantially advance U.S. policymakers' financial transparency objectives.

At their most basic level, the requirements call for covered financial institutions to identify and verify the identity of beneficial owner(s) of a legal entity customer.[55] The increased information collection and verification requirements in the Final Rule are simply stated and largely an extension of existing CDD requirements, and the template certification included as an appendix to the rule furthers the notion that compliance can be effected with relative ease.[56] However, the Final Rule is estimated to cost financial services organizations between $1.3 billion and $2.5 billion over the next 10 years, including substantial initial expenditures for the installation of compliance processes and systems.[57] For many banking organizations in particular the Final Rule will require a complete overhaul of customer application systems, changing the way that organizations evaluate and onboard customers. These systems changes will generate a sizable volume of information that, prior to the Final Rule, either would not have been collected or would not have been collected in a form that can readily be analyzed by the organization.

Although it has attracted less attention than the beneficial ownership provisions of the Final Rule, the rule's establishment of the fifth pillar of AML compliance will have a substantial impact on the architecture of AML regulation. For example, banking agencies' examination of AML compliance historically has proceeded on the basis of the four pillars.[58] The addition of the fifth pillar may lead to changes to examination processes. The requirement for continuous, event-driven monitoring and updating of customer risk profiles, as well as potential systems for risk ratings and categories of customers, will change how financial institutions are expected to view their customers.

The exceptions in the Final Rule apply to a broad range of legal entity customers, including other regulated financial institutions, issuers of common stock listed on a major stock exchange, and subsidiaries of such companies, and serve to limit the impact of the Final Rule on CDD processes. The legal entity customers that are not exempt from the Final Rule — such as small businesses, certain complex investment vehicles, and many foreign companies — will require the most resources for compliance purposes. The amount of information on record at a financial institution regarding these entities, for which publicly available information exists in significantly less quantity when compared to companies that, for example, issue publicly traded shares, will greatly increase. This will help financial institutions develop much more robust customer profiles for these legal entity customers.

In comparison to FinCEN's previous approach of requiring beneficial ownership reporting in either limited scenarios such as GTOs or in connection with certain financial products (*e.g.*, private banking accounts and correspondent banking services), the Final Rule greatly expands the universe of this information, even if it does not establish a systematic information collection process like the one that would be created by the proposed legislation. The rule will generate volumes of beneficial ownership information that financial institutions may make available to U.S. law enforcement agencies through SARs or information sharing.[59] Detractors

[53] I.R.S. Bull., 2016-21, *Notice of Proposed Rulemaking Treatment of Certain Domestic Entities as Separate from Their Owners as Corporations for Purposes of Sections 6038A* (May 23, 2016), https://www.irs.gov/irb/2016-21_IRB/ar19.html; *see also* Treasury Press Release.

[54] Lalita Clozel, *Beneficial Ownership Rule Riddled with Loopholes, Experts Say*, American Banker (May 13, 2016) (characterizing the Final Rule's 25% threshold for beneficial ownership information collection and prospective application as loopholes).

[55] The Final Rule does not require a financial institution to verify that a particular individual is in fact a beneficial owner of a legal entity customer. 81 Fed. Reg. 29,407 n.42 (May 11, 2016).

[56] 31 C.F.R. § 1010.230, App. A.

[57] 81 Fed. Reg. 29,432 (May 11, 2016).

[58] Federal Financial Institutions Examination Council, BSA/AML Examination Manual, p. 28 (Feb. 27, 2015).

[59] 31 C.F.R. §§ 1020.314, 1020.520.

assailed the Final Rule for not requiring retroactive application of the collection and verification requirements, but such an approach would have been plagued with substantial implementation challenges. The Final Rule requires meaningful and extensive changes to CDD processes that, with the two-year implementation period, will produce actionable information.

V. CONCLUSION

The two-year implementation period for the Final Rule was granted because of the complexity of the process changes required, and the period also means that many of the effects of the Final Rule will not be ascertained until 2018 at the earliest when the rule becomes effective. And, the full extent of the Final Rule may not be identified with precision until some years after the rule has been effective, systems have been implemented, financial institutions have been examined for compliance with the rule, and law enforcement agencies have had access to beneficial ownership information generated under the rule. The efficacy of the Final Rule in enhancing financial transparency will be evaluated at these various stages. For now, it is sufficient to say that the Final Rule's sweeping changes to financial institutions' CDD processes and the architecture of AML regulation and supervision will advance financial transparency far beyond its current position. The passage of legislation that furthers financial transparency through more widespread beneficial ownership reporting would help complete the financial transparency puzzle, but the Final Rule nevertheless represents substantial progress when compared to the long lineage of FinCEN regulatory developments in this area. ■

The Review of Banking & Financial Services