

# FinCEN Releases Notice of Proposed Rulemaking on Beneficial Ownership Disclosure Requirements:

## Seven Things To Know

On December 7, 2021, the Financial Crimes Enforcement Network (“FinCEN”) invited public comment on its proposed rule (the “Proposed Rule”) implementing the beneficial ownership disclosure requirements of the Corporate Transparency Act (“CTA” or “Act”). Comments to the Proposed Rule are due on February 7, 2022.

As discussed in our prior client alert [here](#), under the CTA, which was passed as part of the 2020 Anti-Money Laundering Act, Congress created a new federal framework for the reporting, disclosure, and use of beneficial ownership information. The CTA aims to combat the illicit use of shell companies to hide the proceeds of crime, and transfer some of the burden of identifying the owners of such companies from financial institutions to the government itself. The Proposed Rule represents one of the first substantial steps in FinCEN’s implementation of the CTA.

This alert summarizes seven key takeaways from the Proposed Rule.

### 1

#### **The Proposed Rule Only Addresses Reporting of Beneficial Ownership Information, and Does Not Address Further Disclosure and Use of Such Information**

The Proposed Rule represents the first of three formal rulemakings planned by FinCEN to implement the CTA.

Specifically, FinCEN will in the coming months undertake separate rulemaking processes regarding (i) access to and safeguards around information in the contemplated beneficial ownership information database and (ii) revisions to FinCEN’s existing customer due diligence (“CDD”) rule.

Although these rulemaking processes are forthcoming, the current Proposed Rule will have an impact on both future rulemakings. As such, interested stakeholders, including financial institutions subject to the CDD rule, may wish to comment now.

### 2

#### **The Proposed Rule Defines “Reporting Company” to Include Trusts and Partnerships**

As we previously noted [here](#), a central issue discussed in the related Advanced Notice of Proposed Rulemaking (“ANPRM”) earlier this year was how FinCEN would define “reporting companies” and specifically, how FinCEN would define “other similar entities” — a previously undefined term.

Citing the CTA’s intentionally expansive scope and recent comments from members of Congress, FinCEN has proposed interpreting “other similar entities” broadly, to include any entity that is created by the filing of a document with a secretary of state or similar office. Consequently, limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships should qualify as “reporting companies,” according to FinCEN. Entities such as general partnerships or joint ventures that are not created through the filing of a document with a secretary of state or similar office will not be required to file reports with FinCEN. Entities that are registered investment companies or subject to specified exclusions from investment company registration, including exclusions used by certain private equity funds, may also qualify for an exemption.

### 3

## The Proposed Rule Does Not Introduce Any New Exemptions to the Definition of “Reporting Company”

Under the CTA, Congress required FinCEN to exempt certain entities from registration, and also enabled FinCEN to exempt additional entities, with the concurrence of the Attorney General and Secretary of Homeland Security. The statutory exemptions are numerous and include U.S. public companies and companies with substantial physical operations in the United States. FinCEN, however, has for now declined to exempt any additional entities beyond the 23 exemptions specified in the CTA.

At the same time, FinCEN has clarified the scope of existing exemptions. Most notably, FinCEN has explained that in order for an entity to rely on the so-called “subsidiary exemption” — which exempts a reporting company if its ownership interests are owned or controlled (directly or indirectly) by another exempted entity — the subsidiary must be owned *entirely* by one (or more) other exempt entities. As such, entities that are partially-owned by an exempt entity cannot benefit from the exemption.

While FinCEN did not discuss in detail why it denied exemptions proposed by the public in response to its earlier ANPRM, FinCEN is not precluded from adding exemptions in the future, including after the final rule’s effective date. FinCEN noted that it will continue to consider whether new exemptions would be appropriate, if prompted.

Accordingly, current non-exempt entities, including entities regulated by other government agencies or foreign governments that believe compliance with the Proposed Rule will be duplicative of existing regulations or overly burdensome, should consider further engagement with FinCEN through the formal comment process or otherwise.

### 4

## The Proposed Rule Defines “Beneficial Ownership” Broadly and Differently From Existing Definitions

As defined in the CTA, a “beneficial owner” is “any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company.” The CTA did not however define what it means to exercise “substantial control” or what “ownership interests” are. Thus, a key question was whether FinCEN would adopt similar or analogous definitions from existing rules or break new ground. As some had expected, FinCEN decided to break new ground.

With respect to the “ownership” prong, for example, FinCEN has taken a comprehensive and functional approach, including in the definition of “ownership interests” both equity and other type of interests, such as capital or profit interests, convertible instruments, warrants, and other options or privileges that enable an individual to acquire equity or capital in a reporting company.

FinCEN has proposed a similarly broad approach with respect to the “substantial control” prong of “beneficial owner.” Specifically, in a further departure from existing regulations, FinCEN has identified three categories or indicators of an individual who exercises “substantial control.” According to FinCEN, an individual exercises “substantial control” for purposes of the CTA if s/he: (i) serves as a senior officer of a reporting company, (ii) has authority regarding the appointment or removal of any senior officer or dominant majority of the board of directors (or similar body) of a reporting company, and/or (iii) exercises substantial influence, direction of, or decision over important matters of a reporting company.

This last catch-all category may require clarification and guidance in the future. It seeks to capture indirect and unorthodox forms of corporate control, including (as described in the Proposed Rule) individuals’ influence over: (i) the scope of a reporting company’s business; (ii) a reporting company’s potential reorganization, dissolution or merger; (iii) a reporting company’s major expenditures; (iv) compensation schemes and incentive programs for a reporting company’s senior officers; and/or (v) a reporting company’s entrance into, termination of, and/or fulfillment of significant contracts.

Although FinCEN explained that, in its view, this broad definition will likely not create onerous burdens for reporting companies, whether that is accurate remains to be seen. This is especially so since FinCEN has indicated that reporting companies should identify (i) *all* individuals with “substantial control” (and not just one such person) and (ii) at least one beneficial owner under the “substantial control” prong regardless of whether any other individuals satisfy the “ownership” prong. It is also possible that substantial controllers could face individual liability for an entity’s failure to report. Given these considerations, stakeholders should consider submitting comments to FinCEN requesting more specific guidance.

In its Proposed Rule, FinCEN has carried over the statutory exceptions to the definition of “beneficial owner.” As a result, nominees, intermediaries, custodians, or agents of another individual, most employees (other than, for example, senior officers), and/or creditors (to the extent the creditor does not have the ability to convert a payment right to any form of ownership interest in the reporting company) are not beneficial owners.

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## 5

### **The Proposed Rule Does Not Address How FinCEN Will Verify Entities Claiming an Exemption**

As summarized in our prior alert [here](#), the CTA exempts a range of companies from the CTA’s reporting requirements, including public companies and companies with substantial onshore operations in the United States. Yet, the CTA left open how precisely FinCEN would verify that entities are properly claiming an exemption.

In its Proposed Rule, FinCEN did not clearly address how entities relying on an exemption are to indicate they are doing so, and in fact implied that it lacked the statutory authority to require an affirmative exemption filing requirement. FinCEN has invited further comment on the appropriateness of permitting exempt entities to *voluntarily* file exemption certifications.

Entities that expect to take advantage of an exemption should pay close attention to this issue. Instead of a voluntary filing requirement, exempt entities may wish to encourage FinCEN to verify exemptions through existing mechanisms, such as through other government agencies and government-maintained databases. For example, FinCEN could verify exemptions for publicly traded companies with the SEC or based on public securities filings, and it could verify exemptions for financial institutions against registration information maintained by state and federal regulators. These alternative approaches may promote FinCEN’s statutory mandate to “minimize burdens on reporting companies . . . in light of the private compliance costs placed on legitimate businesses.”

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## 6

### **The Proposed Rule Articulates the Scope of Reporting Violations, and Allows for Individual Liability**

The CTA includes civil and criminal penalties for the willful failure to provide accurate beneficial owner information or to report such information to FinCEN. Such failures are subject to a civil penalty of up to \$500 for each day a violation continues or has not been remedied, and a criminal penalty of up to \$10,000 in fines and/or up to two years imprisonment.

Notably, the Proposed Rule provides for the possibility of individual liability for reporting violations. Specifically, the Proposed Rule indicates that, even though only a reporting company is directly responsible for submitting beneficial ownership information, a person can either directly or indirectly influence that process. Thus, FinCEN has proposed that individuals involved in the reporting process can be held liable if they willfully provide false or fraudulent information to be filed, if they willfully direct or control another person not to file a report when required, or if they are in substantial control of a reporting company when it fails to report complete or updated beneficial ownership information.

This penalty exposure highlights the need for clear reporting guidance from FinCEN regarding issues that are not clear, including as to the definition of “substantial control.”

## FinCEN Invites Further Comment Regarding Disclosing Intermediate Legal Entity Owners

FinCEN has invited further public comment about the Act's application to intermediate legal entity owners that may not otherwise satisfy the definition of a reporting company.

The CTA does not specifically require a reporting company to disclose each intermediate legal entity in its chain of ownership, particularly if those intermediate entities are themselves not reporting companies. Acknowledging this separation, FinCEN has elected to seek further comments on the issue. Firms, particularly multi-national firms with a limited presence in the U.S. and otherwise regulated in their home jurisdictions, may wish to comment on this issue.

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### Next Steps

The statutory deadline for FinCEN to promulgate a final beneficial ownership information rule is January 1, 2022. Under the existing rulemaking, however, FinCEN will miss that deadline.

FinCEN has proposed that existing reporting companies must report their beneficial ownership information within one year after the final rule's effective date — this may be the date of publication of the final rule, or some later date, but in all events existing companies are unlikely to face a reporting deadline until well into 2023. Reporting companies established after the final rule is effective must report their beneficial ownership information within 14 days after creation.

FinCEN has not articulated a timeline for the publication of its next two rules implementing the CTA.

While financial institutions, in particular, may view FinCEN's forthcoming rulemakings as more directly relevant, there is likely greater flexibility in the rulemaking process at this stage rather than later. Thus, commenting now will be of broad relevance to those interested in the CTA's overall regulatory framework, including forthcoming revisions to the CDD requirements and financial institutions' access to the beneficial ownership database to be maintained by FinCEN.

For further information on the Proposed Rule or the CTA more generally, please contact the members of Covington's Financial Institutions and Tax practices.

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