

# Client Alert

International Trade & Litigation Practice Group

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## FinCEN Issues Final Rule on Customer Due Diligence Requirements for Legal Entity Customers

On May 11, the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN) published its Final Rule (Rule) requiring covered financial institutions, including, banks, broker-dealers, mutual funds, and money services businesses, to establish enhanced customer due diligence (CDD) measures under the Bank Secrecy Act (BSA).

The Rule has two primary components. First, it requires covered financial institutions to collect and verify information about the individuals – known as beneficial owners – who own or control any 'legal entity customers' of the financial institution. Second, the Rule establishes a fifth pillar of anti-money laundering programs by requiring that covered financial institutions develop customer risk profiles and conduct ongoing monitoring to identify suspicious activity, and, if necessary, update relevant customer information. Covered financial institutions must comply with the Rule by May 11, 2018.

Below we summarize the key components of the Rule and describe additional related announcements from the Treasury Department.

### Beneficial Owner Requirement – Collecting and Verifying Information

Covered financial institutions are required to establish and maintain written procedures designed to identify natural persons who own or control each of their legal entity customers. Subject to certain narrow exceptions, legal entity customers include any corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed in a foreign jurisdiction.

The natural persons who own *or* control these legal entity customers are beneficial owners for whom covered financial institutions must collect and verify identifying information. Ownership and control are defined as follows:

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1. *Ownership.* Each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer.
2. *Control.* A single individual with significant responsibility to control, manage, or direct a legal entity customer, including: (i) An executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or (ii) Any other individual who regularly performs similar functions.

While the number of individuals will vary from entity to entity, the rule does require covered financial institutions to identify at least one beneficial owner under the control test. Up to four beneficial owners could be identified under the ownership test. Note that information regarding *each* beneficial owner must be collected and verified under the Rule.

Covered financial institutions must identify and verify beneficial owners at the time an account is opened. At Appendix A, FinCEN provides a form which covered financial institutions can use to identify beneficial owners. The Rule also permits covered financial institutions to obtain the information contained in Appendix A through other means, so long as an individual certifies, to the best of the individual's knowledge, the accuracy of the information provided.

Covered financial institutions must use a risk-based approach to verify the identity of the beneficial owners. At a minimum, covered financial institutions must verify the identity of beneficial owners much as it would through its customer identification program. Importantly, a covered financial institution can rely on the information provided by a legal entity customer regarding the identity of the beneficial owner(s), unless the institution has knowledge of a fact that would reasonably call into question the reliability of such information. Finally, subject to certain conditions, covered financial institutions can rely on the performance of these requirements by other covered financial institutions.

The beneficial ownership requirement is a significant addition to the anti-money laundering regime and will require covered financial institutions to update processes and systems throughout their operations before the implementation date of May 11, 2018.

## **Customer Risk Profile Requirement – A Fifth Pillar of an Anti-Money Laundering Program**

As set forth in the BSA, an effective anti-money laundering program has four pillars: system of internal controls to assure ongoing compliance, an independent audit function, a designated compliance officer, and an ongoing training program. The Rule adds a fifth pillar by requiring certain financial institutions to conduct, through a risk-based approach, ongoing customer due diligence. The fifth pillar is comprised of two key elements:

1. *Customer Risk Profile.* Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile.
2. *Monitoring and Updating.* Conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information (including beneficial owner information).

With respect to developing a customer risk profile, FinCEN's note clarifies that a customer risk profile refers to information gathered about a customer at account opening which is used as a baseline against which customer activity is assessed for suspicious activity reporting. FinCEN further noted that the customer profile does not need to include a system of risk ratings or categories of customers.

With respect to monitoring the account and updating the customer risk profile, FinCEN requires that when, in the course of normal monitoring, a covered financial institution identifies activity that is relevant to assessing the customer risk profile, it must update customer information, including beneficial ownership information. This requirement applies to all legal entity customers including those that exist on the May 11, 2018.

## **Key Uncertainties Regarding the Final Rule**

While the Rule harmonizes and clarifies certain requirements, covered financial institutions will face some uncertainties with respect to their obligations under the Rule, as discussed below:

- *Ownership Threshold for Beneficial Owners.* As a concession to private sector commenters, FinCEN declined to impose a 10 percent equity interest threshold on the definition of beneficial ownership. However, in FinCEN's note to the Rule, it indicated that the 25 percent threshold is a 'baseline regulatory benchmark' and that it anticipates covered financial institutions may determine that a lower threshold is applicable in certain circumstances, consistent with the risk based approach of the Rule. Thus, it appears that the 25 percent threshold may also be subject to a risk-based analysis.
- *Collecting Beneficial Ownership Information from Existing Customers.* The circumstances under which beneficial ownership information should be obtained from existing customers is unclear. The Rule and related FinCEN note require covered financial institutions to update the beneficial ownership information of existing customers, when, through normal course monitoring, it detects information relevant to re-assessing a customer's risk profile. Determining when this threshold is met will include a level of uncertainty.
- *Beneficial Ownership Information Supplied by the Legal Entity Customer.* As noted above, the Rule permits covered financial institutions to rely on the information provided by the legal entity customer, except when it has knowledge of a fact that would reasonably call into question the reliability of such information. Covered financial institutions are sure to face uncertainties with respect to establishing when such information should be called into question.

## **Related Treasury Department Announcements**

Along with the release of the Rule, Secretary of the Treasury, Jacob Lew, sent a letter to Congressional leaders urging Congress to pass legislation requiring legal entity customers to reveal their beneficial owners at the time of their creation. In addition, the Secretary encourage Congressional leaders to close a loophole which allows foreign-owned, single-member limited liability companies, to operate without obtaining an employer identification number from the IRS.

## Conclusion

As FinCEN continues to bolster its rules implementing the BSA, financial institutions should expect that compliance scrutiny will follow to ensure proper implementation and adherence to their rules. Please do not hesitate to contact our team with any questions or concerns.

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