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WHITE PAPER

Understanding the Beneficial Ownership Requirement of the FinCEN Rule: Customer Due Diligence Requirements for Financial Institutions

Implementation Date: May 11, 2018

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Background

While FinCEN issued the final rule on Customer Due Diligence (CDD) Requirements for Financial Institutions on May 11, 2016, the remote origins of the rule go back at least to the failed attempt by the federal banking regulators to impose Know Your Customer (KYC) rules in 1998. The more proximate origins of the rule can be found in the areas noted for improvement during the 2006 Financial Action Task Force's (FATF) 3rd Round Mutual Evaluation of the United States where it was recommended, among other things, that ongoing customer due diligence become an explicit obligation. Recommendations were also made to improve the identification of beneficial owners of legal entities and to ensure that adequate beneficial ownership information be accurate and available on timely basis.

When FATF issued its revised Forty Recommendations on combating money laundering and the financing of terrorism in February of 2012, one of the most noticeable changes was a strengthening of the language – "should" now became "should be required by law." The next month, on March 15th of 2012, the US Department of Treasury, through the Financial Crimes Enforcement Network (FinCEN) issued an Advanced Notice of Proposed Rulemaking (ANPR) on Customer Due Diligence Requirements for Financial Institutions. The proposed rule, one element of what Treasury described as a "broader strategy" to enhance financial transparency, would make explicit the CDD requirements implicit in the existing suspicious activity reporting (SAR) requirements of the Bank Secrecy Act (BSA) as well as introduce new requirements for the identification and verification of beneficial owners of legal entities. The other two elements, improving the availability of beneficial ownership information in the US and facilitating the implementation of beneficial ownership standards globally, were to be pursued by Treasury separately. After extensive outreach from FinCEN and comment from industry, the Notice of Proposed Rulemaking (NPR) was issued in August of 2014. The final rule wouldn't be issued until close to two years later, on May 11, 2016, the timing coinciding, apparently, with the release to the public of the database of information on offshore accounts leaked by the International Consortium of Investigative Journalists (ICIJ) that would come to be known as "The Panama Papers." Compliance with the final rule will be required by May 11, 2018.

The Final Rule

The final rule lays out FinCEN's expectations for what it considers the four "core elements" of customer due diligence.

- Customer identification and verification
- Beneficial ownership identification and verification
- Understanding the nature and purpose of customer relationships to develop a customer risk profile
- Ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information

The first element, customer identification and verification, reiterates the existing, explicit requirement under section 326 of the USA PATRIOT Act for covered financial institutions to implement a Customer Identification Program (CIP). The third and fourth elements, understanding the nature and purpose of customer relationships and performing ongoing monitoring are seen by FinCEN as implicit in BSA suspicious activity reporting obligations. The second element, identified by FinCEN as a new obligation and the one that has generated the most comment since the ANPR was first issued, is that of the identification and verification of beneficial owners of legal entities.

Verification of Identity vs. Verification of Status

One of the most important questions posed by the ANPR was how to understand "verification" in the context of the beneficial ownership requirement. Two alternative meanings were presented for comment. The first, described as verification of identity, simply meant that once beneficial ownership information was gathered (initially proposed by means of a standard certification form), identity verification procedures, similar to the procedures of a CIP, would be applied to verify the existence of the individuals listed on the form. The second, described as verification of status, meant that the financial institutions would be required to verify that the individuals declared as beneficial owners, were in fact, owners of the legal entity in question. Given the lack of a uniform requirement to gather beneficial ownership information in the United States, the NPR acknowledged that requiring the verification of status would be unworkable and proposed verification of identity as the way to understand the requirement. The final rule reflects this as well.

Summary of the Beneficial Ownership Verification Requirements

Under the final rule, covered financial institutions will be required to implement written procedures to identify and verify beneficial owners of legal entity customers opening new accounts. Identification will be accomplished by gathering personal identifying information on a standard "Certification of Beneficial Owner(s)" form or other equivalent means. Verification will be accomplished by performing "CIP-like" procedures on the individuals listed on the form.

Why "CIP-like"?

Commenters noted, and FinCEN acknowledged, that in many cases the strict application of an existing CIP may not be possible. First of all, because in many cases the actual beneficial owners may not be present, photocopies of identity documents will now be considered acceptable, with the caveat that "[g]iven the vulnerabilities inherent in the reproduction process, covered financial institutions should conduct their own risk-based analyses of the types of photocopies or reproductions that they

will accept... (p. 41).” Secondly, again because the beneficial owners may not be present, a CIP that relies on a credit report or an identity verification solution falling under Fair Credit Reporting Act (FCRA) requirements may not be able to count on obtaining consent for the use of that information.

Once this information is gathered, financial institutions will need to perform, at a minimum OFAC screening, and FinCEN notes that other risk screening, against adverse media, for example, could be appropriate on a risk basis. The information should be taken into account for CTR aggregation purposes as well.

Reliance on Alternative Sources

Some commenters urged FinCEN to allow the use of alternative sources in collecting beneficial ownership data, such as previously collected KYC information or from IRS Form W-8BEN. FinCEN declined to allow this use, pointing out that to be of most value the information should 1) be current and 2) be certified by an authorized representative of the legal entity. While not mentioned explicitly, this reasoning would seem to apply as well to 3rd party providers of business data that may include beneficial ownership information.

Definition of Beneficial Owner

In the Rule, FinCEN has adopted what they describe as a “two pronged” approach to the definition of beneficial ownership. The ownership prong is meant to include all natural persons with 25% or more direct or indirect equity interest in a legal entity while the control prong is defined as a single individual with significant managerial responsibility (the Rule says “control, manage or direct”) over the legal entity. In the case of the control prong, the person meeting the standard of significant responsibility would be chosen by the legal entity. Based on the 25% ownership requirement and the obligation to provide an owner under the control prong, legal entity customers opening up new accounts would have to provide at least on one (control prong) and up to a total of five individuals (one under the control prong and up to four under the ownership prong) to fulfill the requirements.

The requirement is understood to provide a “snapshot” (p. 49) of beneficial ownership at a point in time while the obligation to update the information would be event driven and should occur as the result of normal account monitoring. There is no requirement to gather beneficial ownership information on existing accounts or for ownership thresholds below 25% or to verify ownership status, although FinCEN notes that financial institutions are not precluded from applying stricter policies on a risk basis.

Implementation

The effective date of the rule is May 11, 2018. Originally FinCEN had proposed a 12-month implementation period, but given the need to modify data systems, customer on-boarding procedures and employee training, that period was extended to 24 months in the final rule.

Some of the changes that may be required include:

Data Systems

- New input screens for data entry
- New database structure to accommodate additional information
- CTR aggregation
- Sanctions and other Risk Screening
- Linking for Suspicious Activity Monitoring and Case Management

Customer On-boarding

- Processes to account for the beneficial owner(s) not being present at account opening
- Document authentication to account for photocopied identity documents
- Alternatives to FCRA regulated identity verification methods

Employee Training

With the new rule, there is potential for significant friction at account opening. To minimize friction, front line staff will need to be trained and customers will need to be educated.

- On the reasons behind the new requirements for information collection
- On the information needed to open legal entity accounts (calculating ownership %, need for personal information of the beneficial owner(s), photocopies of documents etc.)

Considerations on the use of 3rd party data sources to verify beneficial ownership status

In the Rule, FinCEN has emphasized repeatedly the benefits to law enforcement of collecting and verifying the identity of beneficial owners regardless of the ability to verify status. Considering the limitations inherent in the collection of beneficial ownership data and in the absence of an authoritative centralized resource, financial institutions that are contemplating going beyond the requirement to verify

identity may want to weigh the benefits of this approach against the risk of creating exceptions that may be difficult to resolve without requesting additional information from the customer.

Example: A legal entity customer submits a Beneficial Ownership Certification Form that lists five beneficial owners. All of the identities can be verified, but a subsequent search on a 3rd party database fails to verify the ownership status of one or even all of the individuals. Now the financial institution is faced with needing to prove the status of what was provided, even though that was not required by the Rule in the first place. It is likely that the steps to resolve this issue will create unnecessary friction to the customer onboarding experience and additional risks during audits.

However, this is not to say there is never a need to incorporate 3rd party data sources to verify beneficial ownership status into financial institution processes. Depending on a financial institution's risk assessment, customer base, products, and various other factors, it may be necessary at times to consider the 3rd party information during a review. It is even more important to gather 3rd party information when the legal entity customer is incorporated in a jurisdiction that promotes ownership transparency; in this case there is really no excuse not to use 3rd party information to verify status.

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