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More Diligent Customer Due Diligence: FinCEN and Beneficial Ownership

The Financial Crimes Enforcement Network has issued a proposal that could result in a legally binding requirement that banks and securities firms review the beneficial ownership of their corporate customers and of their accounts. Currently an obligation to inquire into beneficial ownership is not mandatory for all customers, but rather recommended for those situations judged to pose a risk of evasion of existing regulations. It appears that this obligation is not good enough, and the result might be a regulation mandating such an inquiry for all customers. Also, such a regulation might be imposed on all financial institutions, not only banks and securities firms.

The proposal ("Proposal") was issued on February 29 by the Financial Crimes Enforcement Network ("FinCEN"), an arm of the US Treasury, under its authority to issue regulations implementing Federal anti-money laundering ("AML") and counter-funding of terrorists ("CFT") statutes.[1] It is an advance notice of proposed rulemaking, a form of notice that Federal agencies may issue when they have not yet decided on a definite proposal for regulatory change but believe that their ideas are sufficiently ripe to benefit from comment by the public. On the basis of the comments, the agency will then in theory be in a better position to fashion a formal proposal with regulatory language for public comment.

Why is FinCEN Doing This?

The Proposal follows (by exactly two years) multiagency guidance issued in 2010 from FinCEN and others that describes customer due diligence, including obtaining beneficial ownership information regarding accounts on a risk basis, as a

[1] The Proposal can be found at 77 Fed. Reg. 13046 (March 5, 2012). FinCEN adopts regulations pursuant to its authority under the Bank Secrecy Act ("BSA"), which is codified at 12 U.S.C. §§ 1829b, 1951–1959 (2006); 18 U.S.C. §§ 1956, 1957, 1960 (2006); and 31 U.S.C. §§ 5311–5314, 5316–5332 (2006) and notes thereto.

cornerstone of any anti-money laundering program.[2] In our view, the Proposal suggests that FinCEN is not satisfied with the extent of existing understanding by banks and securities firms (including mutual funds, futures commission merchants, and introducing brokers in commodities) of their obligations to comply with that guidance. It may also not be comfortable that compliance with the guidance is having the desired effect. Because banks and securities firms are free to exercise their own judgment on a risk basis whether to perform the extra work necessary to scrutinize beneficial owners, it is relatively easy to decide that the extra work is not necessary. The obvious way to address such a problem is to make it mandatory in all cases unless an explicit exception is provided. That approach is the one suggested by the Proposal.

Efficacy of this requirement on a system-wide basis is limited if only banks and securities firms are required to comply with it. FinCEN's proposed change to enhance the Proposal's effectiveness is to impose it on other firms that are "financial institutions" within FinCEN's authority under the BSA: insurance companies, non-bank money lenders, casinos and the like. It may be that one reason for imposing the beneficial-ownership guidelines by regulation is to assure that these organizations, which are not subject to the same degree of Federal supervision as banks and securities firms, are clearly told what they will be expected to do. Thus, there is more to this exercise than mere housekeeping.

Synthesis of CDD Requirements

In the Proposal, FinCEN cites the following elements of an effective customer due diligence ("CDD") program:

i. conducting initial due diligence on customers, which includes identifying the customer and verifying the customer's identity as appropriate on a risk basis, at the time of account opening;

ii. understanding the purpose and intended nature of the account, and expected activity associated with the account in order to assess risk and to identify and report suspicious activity;

iii. subject to certain exceptions, identifying the beneficial owner(s) of all customers, and verifying the beneficial owners' identity pursuant to a risk-based approach; and

iv. monitoring the customer relationship on an ongoing basis and conducting additional CDD, as appropriate, to identify and report suspicious activity.

[2] *See* FIN-2010-G001, "Guidance on Obtaining and Retaining Beneficial Ownership Information", Joint Release of the Financial Crimes Enforcement Network, 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, and Securities and Exchange Commission (March 5, 2010).

Existing CDD Requirements

Banks and securities firms are already required to have robust policies and procedures to conduct CDD and comply with recordkeeping and reporting requirements, such as the filing of suspicious activity reports ("SARs").[3]

Explicit Current Requirements

Explicit requirements include obtaining, and in some cases verifying, customer identification information pursuant to the mandatory customer identification program ("CIP") and filing SARs. Only in limited circumstances must banks and securities firms obtain beneficial ownership information: in the contexts of private banking accounts and correspondent accounts.[4] With respect to certain accounts, banks and securities firms must collect sufficient information to develop a customer risk profile that can be used to identify higher-risk customers and accounts, investigate unusual and suspicious activity, and make an informed decision whether to file a SAR. Also, they must monitor suspicious activities, which is important in assisting criminal investigations and to facilitate tax reporting and investigations.[5]

A CIP must address situations where, prompted by a risk assessment of a new account opened by a customer that is not an individual, additional information about individuals with authority over the account should be obtained.[6]

Banks and securities firms that offer private banking accounts must take reasonable steps to identify the nominal and beneficial owners of such accounts.[7] Those that offer correspondent accounts for certain foreign financial institutions must take reasonable steps to obtain information about the identity of persons with authority to direct transactions through an account that is payable-through, *i.e.*, the sources and beneficial ownership of funds in the account.[8]

Implicit Current Requirements

Implicit requirements that anticipate the CDD requirement are those that FinCEN believes banks and securities firms must follow to achieve compliance with existing regulations. One example is the obligation to conduct adequate ongoing diligence to ensure that customer information is accurate and to determine whether filing a SAR is appropriate, which flows from the BSA/AML requirement to maintain accurate customer risk profiles and risk assessments and to report suspicious activity.[9]

[3] *See, e.g.*, Federal Financial Institution Examination Council Bank Secrecy Act Anti-Money Laundering Examination Manual; Financial Industry Authority, Updated AML Template for Small Firms (Jan. 2010); and National Association of Securities Dealers, Notice to Members 02-21 (Apr. 2002).

[4] *See, e.g.*, 12 C.F.R. §§ 208.62, 211.5(k), 211.24(f), 225.4(f), and 353.3 (2011); and 31 C.F.R. § 1023.320 (2011).

[5] For example, suspicious activity monitoring requirements would facilitate the new tax reporting provisions of the Foreign Account Tax Compliance Act, which requires overseas financial institutions to identify US account holders and to report certain information about their accounts to the Internal Revenue Service. *See* generally, Internal Revenue Service, "Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities," REG-121647-10 (Feb. 8, 2012), *available at* http://www.irs.gov/pub/newsroom/reg-121647-10.pdf.

[6] 13 C.F.R. §§ 1020.220(a)(2)(ii)(C), 1023.220(a)(2)(ii)(C), 1024.220(a)(2)(ii)(C), and 1026(a)(2)(ii)(C) (2011).

[7] 31 C.F.R. § 1010.620(b)(1) (2011).

[8] 31 C.F.R. § 1010.610(b)(1)(iii)(A) (2011).

[9] *See, e.g.*, 31 C.F.R. §§ 1010.610, 1010.620 (2011); 12 C.F.R. § 208.63 (2011), and supra note 4.

Because banks and securities firms must consider potentially suspicious activities in the context of the normal or appropriate activities of a particular customer, it follows that they should understand the nature and purpose of an account or customer relationship to assess the risk presented by the relationship and effectively monitor for suspicious activity. In particular cases, this requirement may mean that beneficial ownership information needs to be obtained.[10]

The contemplated rule would codify these and other similar requirements, requiring banks and securities firms to establish and maintain policies and procedures for ongoing monitoring of all client relationships.

FinCEN may adopt an express customer identification and verification component to CDD requirements, consistent with CIP requirements. Banks and securities firms would then have to identify and, on a risk basis, verify the identity of each customer, to the extent reasonable, so that it can form a reasonable belief that it knows the true identity of each customer. FinCEN believes that this new requirement should not impose substantial burdens, as the identification and verification component would be satisfied by meeting existing CIP obligations.[11] Even though certain customers are exempt from CIP requirements, banks and securities firms still must understand the nature and purpose of the customer's account and must conduct ongoing monitoring.

Contemplated New Requirements

In the ANPR, FinCEN announces that it is considering adding an explicit requirement that beneficial ownership information be obtained unless an explicit exemption is provided.

Scope

Any new CDD rule would apply to banks and securities firms, which are covered by current regulations. FinCEN also believes that it may be appropriate to extend these requirements to all other financial institutions subject to its regulatory authority, such as money services businesses, insurance companies, casinos, dealers in precious metals, stones, and jewels, and non-bank mortgage lenders or originators.

Definition of "Beneficial Owner"

FinCEN would provide a definition of "beneficial owner" applicable generally to all covered institutions and that is more specific that the existing one.[12] It might include either: (1) the individual(s) who, directly or indirectly, owns more than 25 percent of the equity interests in the entity; or (2) in the absence of such individual(s), the person who, directly or indirectly, has at least as great an equity interest in the entity as any other individual, and the individual with greater responsibility for

[10] *See* FIN-2010-G001.

[11] Existing CIP rules require, for example, obtaining the customer's name; for individuals, date of birth, address, and an identification number; for legal entities, a principal place of business, local office, or other physical location and identification number. *See* 31 C.F.R. §§ 1020.220(a)(2)(i)(A), 1023.220(a)(2)(i)(A), 1024.220(a)(2)(i)(A), and 1026.220(a)(2)(i)(A) (2011).

[12] 31 C.F.R. § 1010l.605(a) (2011).

managing or directing the affairs of the entity.[13] In cases where no person or entity owns more than 25 percent of the equity of the customer, it may prove difficult to determine the beneficial owner under the alternate definition, particularly if the account has numerous beneficial owners that hold equal shares in the account, or that hold undifferentiated interests.

Verification

The scope of a possible verification requirement is not yet clear. Verification of a beneficial owner could mean verifying: (i) the identity of the individual identified by the customer as the beneficial owner of the account, and (ii) that the individual identified by the customer as a beneficial owner is indeed the beneficial owner. Item (i) above would involve procedures similar to those required under current CIP rules, *e.g.*, by obtaining a copy of a government-issued identity document of the individual, while a rule requiring Item (ii) might require new and complex diligence, including production of additional documents, on the part of banks and securities firms.

Assets or Identity

In some instances, obtaining information about the beneficial owners of assets in an account may be warranted instead of identifying the beneficial owner of a legal entity account holder. For example, a foreign bank might open an account for the benefit of its customers, perhaps an omnibus account. This requirement also may prove burdensome, however, as banks and securities firms would be constrained by the information that a foreign financial institution, in whose name the account is created, has or is required to obtain by its home regulator regarding the owners of subaccounts or assets.

Agency

FinCEN is also considering how to address beneficial ownership in cases where a customer acts essentially as an agent for another individual. This might be done in order to block efforts to detect the identity of a true account owner. FinCEN is seeking comment on requiring any individual or entity (other than a regulated financial institution) that opens an account to represent that he, she or it is not acting on behalf of any other person. This requirement may pose confidentiality issues, *e.g.*, when a customer acts in a fiduciary capacity in opening an account on behalf of its own client.

Exemptions

FinCEN is considering potential exemptions from a requirement to establish beneficial ownership, *e.g.*, with respect to legal entities that are exempt from identification as customers under the CIP rules (including financial institutions regulated by a federal agency and publicly traded companies). Beneficial ownership information for these entities may not be relevant to the money laundering risks associated with such entities and their beneficial ownership information is readily available to law enforcement and regulators.

[13] FinCEN does not intend to change those instances where financial institutions currently must obtain beneficial ownership information, and would continue to apply the existing definition of a beneficial owner as "an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account." 31 C.F.R. § 1010.605(a) (2011). *See also* 31 C.F.R. §§ 1010.610 and 1010.620 (2011).

Concerns

Expanding any regulatory requirements inevitably will add to costs. The extension of the requirement to obtain beneficial ownership information to all customers and to extend the scope of the obligation to all financial institutions thus would be costly, by definition. Beyond the addition of cost, some new tasks may not be practical. For example, it could be difficult to review entities in an organizational structure to determine the level of beneficial ownership when no person or entity owns an interest in excess of a specified level. This leads to the commonly asked questions in the BSA/AML context of when a financial institution must act effectively as an agent of law enforcement agencies and the extent of that obligation.

Conclusion

FinCEN's ANPR would formalize existing explicit and implicit requirements into a single CDD requirement, but is poised to add significant new requirements. Firms should be aware not only of the existing regulations and guidance giving rise to explicit and implicit regulatory expectations, but also of the forthcoming changes that will likely require significant change to the anti-money laundering programs of financial institutions.

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