ALERT MEMORANDUM

Treasury Announces Final Customer Due Diligence Rule and New Financial Transparency Legislation

May 16, 2016

On May 5, 2016, the U.S. Department of the Treasury released the final version of its customer due diligence rule imposing additional anti-money laundering ("AML") diligence obligations on financial institutions pursuant to the Bank Secrecy Act.[1] The Treasury Department also announced that it would propose legislation to establish beneficial ownership reporting requirements for U.S. companies and regulations to extend tax information reporting requirements to certain currently exempt foreign-owned U.S. "disregarded entities," and, in a parallel announcement, the U.S. Department of Justice announced that it would propose legislation to enhance its AML and anticorruption enforcement powers. The Obama Administration described these as important measures to increase financial transparency by targeting key points of access to the international financial system.

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Key features of the final customer due diligence rule:

- Applies to banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities.
- Imposes requirements on the covered financial institutions to identify and verify the identity of certain legal entity customers' "beneficial owners," defined as: (i) each individual directly or indirectly owning 25% or more of the entity's equity interests, and (ii) a single individual with significant responsibility to control, manage or direct a legal entity customer.

[1] The Bank Secrecy Act ("BSA") refers to the Currency and Financial Transactions Reporting Act of 1970, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001), and other legislation.

- Formalizes regulatory expectations regarding the core elements of customer due diligence, including with respect to ongoing monitoring over the course of the customer relationship.
- Beneficial ownership diligence is not required for certain types of legal entity customers, including certain publicly traded companies, pooled investment vehicles, regulated financial institutions and trusts.
- Certain other entities, including other pooled investment vehicles and nonprofits, are only subject to beneficial owner diligence under the "control prong" (and not the "ownership prong").
- Compliance deadline two years from the date of the rule's issuance (May 11, 2018).

I. The Final CDD Rule

The final customer due diligence rule (the "Final CDD Rule")[2] released by the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") formalizes regulatory expectations regarding the core elements of customer due diligence and introduces a new requirement for covered financial institutions to identify and verify the identity of the beneficial owners of legal entity customers, closing a perceived gap in U.S. money laundering defenses.

Covered Financial Institutions

The Final CDD Rule applies to banks, brokers or dealers in securities, mutual funds and futures commission merchants and introducing brokers in commodities ("covered financial institutions"), the same "covered financial institutions" required to implement special due diligence programs for private banking accounts and correspondent accounts for foreign financial institutions under existing FinCEN rules.[3] The scope of covered financial institutions is also generally consistent with the scope of financial institutions currently subject to BSA customer identification program ("CIP") requirements.

Customer Due Diligence

The Final CDD Rule articulates four key elements that in FinCEN's view set the minimum required standards for customer due diligence:

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

The first element (explicitly) and the third and fourth elements (implicitly) are already required by existing AML program and suspicious activity reporting rules.[4] The Final CDD Rule adds the second element – beneficial ownership diligence – as a requirement for covered financial institutions and also amends the AML program requirement for all covered financial institutions to include the third and fourth elements as explicitly required components of their BSA AML programs.[5]

Beneficial Owner Identification and Verification

"Beneficial Owner" Definition

At the time a new account is opened, the Final CDD Rule requires that covered financial institutions

[2] See Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,397 (May 11, 2016).

[3] See 31 C.F.R. § 1010.605(e)(1).

[4] See 31 C.F.R. Ch. X.

[5] The third and fourth elements of customer due diligence are part of a new "fifth pillar" for BSA AML programs, which requires appropriate risk-based procedures for conducting ongoing customer due diligence. In addition to adding the new "fifth pillar," the Final CDD Rule amends the rules implementing the AML program requirement for all covered financial institutions to expressly codify the existing "four pillars" of BSA AML programs: internal controls, independent testing, BSA compliance officer and training.

identify and verify the identity of a legal entity customer's "beneficial owners," – i.e., the natural persons that own and control the legal entity customer – as defined under two separate prongs: an ownership prong and a control prong. FinCEN noted again that the Final CDD Rule requires the identification of natural persons, not legal entities.

The ownership prong defines as a beneficial owner "[e]ach individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25% or more of the equity interests of a legal entity customer." Indicating that the 25% threshold appropriately balances the costs and benefits of collecting information on substantial owners, FinCEN declined to lower the ownership threshold to 10% in the Final CDD Rule as requested by certain commenters. However, FinCEN noted that a risk-based approach may lead covered financial institutions to use a threshold below 25% in some circumstances.

The control prong is satisfied by identifying "[a] single individual with significant responsibility to control, manage or direct a legal entity customer, including (i) [a]n 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) [a]ny other individual who regularly performs similar functions." An individual may be identified as a beneficial owner for both purposes.

Method of Identification and Verification of Beneficial Ownership Information

The Final CDD Rule provides a standard "certification form" to be used for the collection and certification of beneficial owner information; however, the Final CDD Rule permits financial institutions to use an alternative means so long as the substantive requirements for collection of beneficial ownership information are met, including that the individual opening the account certifies the accuracy of the information to the best of the individual's knowledge.

Under the Final CDD Rule, covered financial institutions must verify the identity of a beneficial owner identified by the legal entity using risk-based procedures that address the same elements as are required to be addressed in their CIP programs (e.g., regarding documentary and non-documentary verification, and procedures for when identity cannot be verified); however, the Final CDD Rule also allows covered financial institutions to engage in risk-based reliance on photocopies of documents required for verification purposes under the institution's CIP procedures (even though original documents are generally required in the CIP context).

Covered financial institutions are not, however, required to verify whether the individuals identified are in fact beneficial owners (or the only beneficial owners). This allows covered financial institutions to rely on information supplied by the legal entity customer provided the covered financial institution "has no knowledge of facts that would reasonably call into question the reliability of such information." FinCEN notes that if a covered financial institution knows, suspects or has reason to suspect that ownership has been structured to avoid the beneficial ownership reporting threshold, it may have an obligation to file a suspicious activity report; such an obligation may also arise should the covered financial institution know, suspect or have reason to suspect that beneficial ownership information has been misreported.

"Legal Entity Customer" Definition and Exclusions

A "legal entity customer" is defined as "a 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 under the laws of a foreign jurisdiction that opens an account." Trusts (other than statutory trusts), which are not formed by filing with the state, are not captured by this definition, nor are sole proprietorships or unincorporated associations, but the Final CDD Rule notes that this is not meant to

supersede existing CIP obligations and practices with respect to trusts.[6]

Importantly, certain legal entities are explicitly excluded from the defined term, including:

(i) "Financial institutions" regulated by a Federal functional regulator or banks regulated by a state bank regulator;[7]

(ii) Domestic government agencies and instrumentalities and certain legal entities that exercise governmental authority;

(iii) Publicly held companies traded on certain U.S. stock exchanges, certain subsidiaries of such entities and entities that have a class of securities registered under Section 12 or that are required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act");

(iv) investment companies registered with the U.S. Securities and Exchange Commission ("SEC");

(v) SEC-registered investment advisers;

(vi) An exchange or clearing agency registered under the Exchange Act;

(vii) Any other entity registered with the SEC under the Exchange Act;

(viii) Certain entities (including commodity pool operators, commodity trading advisors, retail foreign exchange dealers, swap dealers, or major swap participants) registered with the Commodity Futures Trading Commission;

(ix) A public accounting firm registered under the Sarbanes-Oxley Act;

(x) A bank holding company or savings and loan holding company (each as defined under relevant statute);

(xi) A pooled investment vehicle that is operated or advised by a financial institution excluded from the definition of legal entity customer;

(xii) A state-regulated insurance company;

(xiii) A financial market utility designated as systematically important pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010;

(xiv) A foreign financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution;

(xv) A non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; and,

(xvi) Any legal entity only to the extent that it opens a private banking account subject to FinCEN's rule establishing special due diligence for private banking accounts (which subjects such customer to independent due diligence of beneficial owners).

If one of these excluded entities owns 25% or more of a legal entity customer, covered financial institutions are not required under the ownership prong to look through the excluded entity to identify and verify the identities of underlying natural persons.

Additionally, certain entities, including nonprofits and pooled investment vehicles not otherwise excluded from the definition of legal entity customer, are subject only to the control prong (and not the ownership prong) of the beneficial ownership requirement.

The application of the Final CDD Rule is further circumscribed by exemptions from its requirements

[6] Existing guidance generally does not require financial institutions to look through a trust to its beneficiaries for AML diligence purposes, but indicates that financial institutions generally identify and verify the identity of the trustees of trusts that are direct customers. See, e.g., Customer Identification Programs for Broker-Dealers, 68 Fed. Reg. 25,113 (May 9, 2003). The Final CDD Rule also indicates that, where a trust (other than a statutory trust) owns 25 percent or more of the equity interests of a legal entity customer, covered financial institutions should treat the trustee of the trust as the beneficial owner for purposes of the ownership prong.

[7] Under FinCEN's rules, this would include most banks and other depository institutions, the U.S. agencies and branches of foreign banks, brokers or dealers in securities, mutual funds, futures commission merchants and introducing brokers in commodities.

when legal entity customers open accounts for certain specific activities (e.g., obtaining point-of-sale retail credit products).

Treatment of Pooled Investment Vehicles

A pooled investment vehicle[8] is either excluded from the beneficial ownership requirement or subject only to the control prong of the requirement depending on the status of its operator or adviser. A pooled investment vehicle is excluded if it is operated or advised by a "financial institution" (as defined in FinCEN's regulations implementing the BSA)[9] that falls within one of the explicit exclusions to the definition of legal entity customer under the Final CDD Rule.[10] This exclusion is based on the rationale that beneficial ownership information is available regarding such excluded operators or advisers.

By contrast, a pooled investment vehicle whose adviser or operator is not excluded from the definition of legal entity customer is subject to the control prong (but not the ownership prong) of the beneficial ownership diligence requirement. The preamble to the Final CDD Rule notes that this category includes non-U.S. managed mutual funds, hedge funds and private equity funds. FinCEN reasoned that the collection of equity ownership information would be difficult and of limited utility for such entities.

Treatment of Intermediated Relationships and Formal Reliance on Another Covered Financial Institution

FinCEN has also indicated, that to the extent that existing guidance allows a covered financial institution to treat an intermediary (and not the intermediary's customers) as its customer for CIP purposes, the covered financial institution should treat the intermediary as its legal entity customer for purposes of the beneficial ownership requirement. For example, a broker-dealer that appropriately maintains an omnibus account for an intermediary may treat the intermediary, and not the underlying clients, as its legal entity customer for purposes of the beneficial ownership requirement.[11]

Additionally, when the Final CDD Rule applies to a covered financial institution's relationship with a legal entity customer, formal reliance on another covered financial institution to perform the beneficial ownership diligence (shifting responsibility for the performance of such obligations) is possible under the same conditions that apply to reliance for CIP purposes.[12]

[8] "Pooled investment vehicle" is not defined in the Final CDD Rule, but SEC regulations under the Investment Advisers Act define it as "any investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7))." 17 C.F.R. § 275.206(4)-8.

[9] The full exclusion does not appear to apply to pooled investment vehicles operated or advised by a foreign financial institution from outside of the United States, given that the definition of "financial institution" under FinCEN's regulations is generally limited to an institution's U.S. agents, agencies, branches and offices and that the preamble indicates non-U.S. managed funds would not be excluded from diligence requirements. However, such funds would only be subject to diligence under the control prong, and information about the foreign financial institution that operates or advises the fund should be readily available.

[10] Investment advisers required to register with the SEC are not currently "financial institutions" as defined in the BSA, although FinCEN has proposed a rule that would include such advisers in that definition and subject them to an AML program requirement. See Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015) (proposed rule).

[11] See Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003). See also, e.g., Guidance from the Staffs of the Department of the Treasury and the SEC, Questions and Answers Regarding the Mutual Fund Customer Identification Rule (Aug. 11, 2003); Frequently Asked Question regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers, FIN-2006-G004 (Feb. 14, 2006); Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries, FIN-2006-G009 (May 10, 2006).

[12] See, e.g., 31 C.F.R. § 1020.220(a)(6).

Compliance Deadline

The compliance deadline for implementation of the Final CDD Rule is two years from the date of the rule's issuance (May 11, 2018). The beneficial ownership diligence requirement will apply to new accounts opened after the compliance deadline and not retroactively to existing accounts. However, the Final CDD Rule notes that financial institutions should obtain beneficial ownership information from existing customers when updating customer information on a risk basis (e.g., when, in the course of their normal monitoring, the financial institution detects information relevant to assessing or reevaluating the risk of such customer, including, for example, information that the beneficial owner of the customer may have changed), as well as when opening new accounts for existing customers.

II. Parallel Legislative and Regulatory Initiatives

In parallel with the release of the Final CDD Rule, the Obama Administration announced other, complementary measures designed to increase transparency of beneficial ownership and to enhance AML and anticorruption enforcement.

First, the Treasury Department announced its intent to submit proposed legislation to Congress that would require legal entities to know and report adequate and accurate beneficial ownership information at the time of an entity's creation, so that the information can be made available to law enforcement.[13] The legislation would authorize the Treasury Department to require that legal entities formed or qualified to do business within the United States file this information with the Treasury Department and provide for penalties for failure to comply. The legislation would also provide for technical amendments to FinCEN's current Geographic Targeting Order ("GTO") authority to clarify FinCEN's ability to collect information under GTOs, such as the GTOs issued in January that require U.S. title insurance companies to record and report the beneficial ownership information of legal entities making "all-cash" purchases of high-value residential real estate in the Borough of Manhattan in New York City, New York, and Miami-Dade County, Florida.

Second, the Internal Revenue Service ("IRS") released proposed regulations to require certain foreign-owned U.S. entities that are "disregarded entities" currently exempt from IRS reporting obligations to begin reporting ownership information to the IRS in order to provide the IRS with information needed to satisfy obligations under tax treaties and similar international agreements and to strengthen the enforcement of U.S. tax laws.[14]

Finally, the U.S. Department of Justice announced its intent to propose various legislative amendments to strengthen the enforcement regime with respect to money laundering and transnational corruption.[15] Amendments will be proposed to (i) expand foreign money laundering predicate offenses to include any violation of foreign law that would be a money laundering predicate offense if committed in the United States, (ii) allow administrative subpoenas for money laundering investigations, (iii) enhance law enforcement's authority to obtain foreign bank or business records by serving branches located in the United States, (iv) create a mechanism to use and protect classified information in civil asset recovery cases, (v) increase the time period in which the United States can restrain property based on a request from a foreign country from 30 to 90 days, (vi) extend the

[13] See U.S. Department of Treasury 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. The text of the proposed beneficial ownership legislation is accessible from the release.

[14] See Treatment of Certain Domestic Entities Disregarded as Separate From Their Owners as Corporations for Purposes of Section 6038A, 81 Fed. Reg. 28,784 (May 10, 2016) (proposed rule).

[15] See U.S. Department of Justice Release, Justice Department Proposes Legislation to Advance Anti-Corruption Efforts (May 5, 2016), available at https://www.justice.gov/opa/pr/justice-department-proposes-legislation-advance-anti-corruption-efforts. The text of the legislative proposals is accessible from the release.

procedures to authenticate foreign records of regularly conducted activity in criminal cases to civil asset recovery cases, and (vii) amend substantive corruption offenses in certain ways, including to expressly criminalize the corrupt offer or acceptance of payments to "reward" official action in programs receiving federal funds as well as those intended to "influence" official action.

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