Introduction

On May 11, 2016, the Financial Crimes Enforcement Network ("FinCEN") issued a Final Rule under the Bank Secrecy Act ("BSA") that clarifies and enhances customer due diligence ("CDD") requirements for financial institutions and adds a new requirement for covered financial institutions to identify, and verify the identity of, the beneficial owners of certain of their legal entity customers (the "CDD Rule" or "Final Rule"). The Final Rule, which reaffirms the four core elements, or “pillars,” of an anti-money laundering ("AML") program, also adds a fifth pillar: a requirement that covered financial institutions implement and maintain risk-based procedures for conducting ongoing CDD. The issuance of the Final Rule follows FinCEN’s earlier proposals relating to CDD and beneficial ownership requirements as first set out in its Advance Notice of Proposed Rulemaking issued on March 5, 2012 ("ANPRM") and subsequent Notice of Proposed Rulemaking issued on August 4, 2014 ("NPRM"). The CDD Rule becomes effective on July 11, 2016, and covered financial institutions must comply by May 11, 2018 (the "Applicability Date").

A press release accompanying the announcement stated, “The CDD Final Rule advances the BSA by making available to law enforcement valuable information needed to disrupt illicit finance networks. This will in turn increase financial transparency and augment the ability of financial institutions and law enforcement to identify the assets and accounts of criminals and national security threats. This will also facilitate compliance with sanctions programs and other measures that cut off financial flows to these actors.”

In addition to the CDD Rule, the Treasury Department is urging Congress to pass beneficial ownership legislation that would require companies formed within the United States to file beneficial ownership information with the Treasury Department and would impose penalties for failure to comply.²

A Rule Six Years in the Making

In 2010, FinCEN and the federal functional regulators issued joint guidance on enhanced CDD requirements.³ Two years later, FinCEN formally initiated its rulemaking process, publishing in the Federal Register the ANPRM regarding CDD and beneficial ownership requirements. FinCEN received 90 comments on the proposal, many of them expressing concerns about the potential costs and practical challenges associated with a categorical requirement to obtain beneficial ownership information.

To better understand and address these concerns, the Treasury Department held five public hearings from July to December 2012. In these meetings, participants offered specific recommendations about how to balance the benefits of the proposed new requirements against the practical burdens. FinCEN noted that these comments were critical to informing the next phase of the rulemaking process.

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² Press Release, U.S. Department of the Treasury, Treasury Issues Proposed Rules to Enhance Financial Transparency (May 5, 2016), http://www.treasury.gov/press-center/press-releases/Pages/j0451.aspx. As noted in the press release, the Treasury Department also announced proposed regulations to require foreign-owned “disregarded entities,” including foreign-owned single-member limited liability companies, to obtain employer identification numbers with the Internal Revenue Service. These proposed regulations are beyond the scope of this memorandum.

On August 4, 2014, FinCEN published the NPRM, which included a proposed requirement for financial institutions to identify the natural person or persons who are beneficial owners of legal entity customers opening new accounts, subject to certain exemptions, and to verify the identity of those natural persons. FinCEN received 141 comments on the NPRM, many of which asserted that the proposed beneficial ownership requirement would be very burdensome to implement, requiring more than the proposed 12 months. Commenters also argued that the proposed requirement would be far more expensive than estimated and unlikely to achieve the proposal's stated policy goals.

Overview of the Final Rule

FinCEN notes that CDD for covered financial institutions consists, at a minimum, of four core elements:

- Customer identification and verification;
- Beneficial owner identification and verification;
- Understanding the nature and purpose of customer relationships; and
- Ongoing monitoring for reporting suspicious transactions and, on a risk-based basis, maintaining and updating customer information.

According to FinCEN, the first element is already a requirement of an AML program; the second element is a new requirement of the Final Rule; and the third and fourth elements formalize preexisting obligations. Thus, only the second element, the beneficial ownership requirement, is being adopted as a new regulation. The third and fourth elements are addressed via amendments to existing regulations in order to add explicit CDD requirements for understanding the nature and purpose of customer relationships and conducting ongoing monitoring as components of a covered financial institution's AML program requirements. In FinCEN's view, these two elements are necessary in order to comply with the existing requirement to report suspicious activity and therefore simply articulate what should already be current practice.

The Final Rule reflects feedback received during the NPRM comment period. FinCEN stated that it worked with financial institutions to balance the benefits of the new requirements against their costs. The following elements of the CDD Rule are intended to reduce some of the compliance burdens:

- **Two-Year Compliance Period.** Covered financial institutions have until May 11, 2018 to come into compliance.
- **Identity Verification.** Financial institutions must verify the identity of the individual identified as a beneficial owner, but not his or her status as a “beneficial owner.”
- **No Requirement to Use Certification Form.** The required identity information can be obtained by any means, and records of the information can be kept in any manner that satisfies the applicable recordkeeping rules.
- **No Retroactive Application.** The CDD Rule is not retroactive; it does not require financial institutions to “look back” to obtain beneficial ownership information from existing customers, unless those customers open new accounts. Customer information does, however, need to be updated on an event-driven basis in the course of normal monitoring activity.

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4 In other words, a financial institution must verify the existence of the legal entity customer’s purported beneficial owner (identity), but the institution does not need to verify that the purported beneficial owner is in fact the beneficial owner (status). The financial institution may rely on the information the legal entity customer provides regarding the identity of its beneficial owner or owners, as long as the financial institution has no reason to doubt the information's reliability, as discussed below. 81 Fed. Reg. at 29,451 (to be codified at 31 C.F.R. § 1010.230(b)(2)).
Reliance on Another Regulated Financial Institution Permitted. The CDD Rule permits a covered financial institution to rely on another financial institution to collect beneficial ownership information under the same conditions set forth in the applicable customer identification program ("CIP") rules.

More Excluded Entities. The Final Rule expands the categories of entities excluded from the definition of "legal entity customers" and therefore not subject to the new requirement.

No Continuous Updating Requirement. The rule clarifies that financial institutions are not required to update beneficial ownership information on a periodic or ongoing basis, but only on an event-driven basis, when in the course of normal monitoring new information or activity is detected that would be relevant to reassessing the risk.

Flexibility on Verification Procedures. Unlike the NPRM, the Final Rule does not require that the verification procedures for beneficial owners be identical to the institution’s CIP procedures, but rather, that they contain the elements required for verifying the identity of customers that are individuals under the relevant CIP rule. It also permits the use of photocopies for documentary verification purposes.

The Treasury Department’s Broad Strategy to Enhance Financial Transparency

According to FinCEN, the ability of criminals to access financial institutions anonymously through undisclosed beneficial ownership of legal entities has been a long-standing weakness of the financial system. FinCEN asserts that by clarifying and strengthening CDD requirements for U.S. financial institutions, including by requiring the collection of beneficial ownership information, the Final Rule will advance the purposes of the BSA. Specifically, FinCEN argues that the CDD Rule: (1) enhances the availability to law enforcement of beneficial ownership information, which will assist in financial investigations; (2) increases the ability of law enforcement and U.S. financial institutions to identify criminal and national security threats; (3) helps financial institutions identify and mitigate risk; (4) facilitates reporting and investigations in support of tax compliance; (5) promotes consistency in implementing and enforcing CDD; and (6) advances the Treasury Department’s broad strategy to enhance financial transparency for U.S. financial institutions.

FinCEN believes the rule complements the Administration’s continuing work with Congress to facilitate the adoption of legislation that would require the collection of beneficial ownership information at the time legal entities are formed in the United States. It also believes the rule will advance the Treasury Department’s work with international bodies, such as the G-20 and the Financial Action Task Force, that have emphasized the importance of improving CDD practices by, among other things, promoting clear and consistent expectations and practices across financial institutions.

Discussion of Key Provisions of the Final Rule

Identification and Verification of Beneficial Owners

Definitions. Under the CDD Rule, “covered financial institutions” will be required to establish and maintain written procedures that are reasonably designed to identify and verify “beneficial owners” of “legal entity customers,” subject to certain exemptions, and to include such procedures in their AML compliance program. The definition and scope of these terms are discussed below.

- Covered Financial Institutions. Under the CDD Rule, the term “covered financial institution” only applies to those financial institutions subject to a CIP requirement – that is, banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities.

- Beneficial Owners. The definition of “beneficial owner” is two-pronged, focusing on “ownership” and “control” of legal entity customers.
Under the ownership prong, a beneficial owner is any individual who, directly or indirectly, owns 25 percent or more\(^5\) of the equity interests of a legal entity customer.

The control prong requires identification of one individual with significant responsibility to control, manage, or direct a legal entity, including an executive officer, senior manager, or any other individual who regularly performs similar functions.

Under the Final Rule, a financial institution must identify and verify the identity of each individual who satisfies the ownership test (no more than four individuals total), and one individual who satisfies the control test. In cases where an individual is both a 25-percent-or-more owner and meets the definition for control, that same individual could be identified as a beneficial owner under both prongs. If no single individual owns 25 percent or more of the equity interests, then the financial institution would not be required to identify any individuals under the ownership prong. All legal entity customers, however, must identify at least one beneficial owner under the control prong.

The phrase “directly or indirectly” in the ownership prong makes clear that where a legal entity customer is owned by one or more other legal entities, the customer is required to look through those other legal entities to determine each natural person that owns 25 percent or more of the equity interests. Although FinCEN acknowledged commenters’ concerns that identifying beneficial owners under the ownership prong would be difficult with respect to customers with complex legal ownership structures, FinCEN also confirmed that it is generally the responsibility of the legal entity customer to determine whether a natural person meets the equity prong of the test, and that financial institutions may generally rely on their customers’ representations with respect to the identities of beneficial owners.

**Legal Entity Customers.** The CDD Rule defines a “legal entity customer” as a corporation, limited liability company, other entity created by the filing of a public document with a secretary of state or similar office, general partnership, or any similar entity formed under the laws of a foreign jurisdiction, that opens an account.

The Final Rule excludes the following legal entities from the definition of “legal entity customer”:

- Financial institutions regulated by a federal functional regulator and banks regulated by a state bank regulator;
- Domestic government agencies and instrumentalities, and certain legal entities with government authority;
- Publicly held companies traded on the New York, American, or NASDAQ stock exchange and issuers of securities registered under section 12 of the Securities Exchange Act of 1934;
- Securities and Exchange Commission (“SEC”) registered investment companies, investment advisers, exchanges and clearing agencies, and other entities registered with the SEC;
- Registered entities, commodity pool operators, commodity trading advisors, retail foreign exchange dealers, swap dealers, or major swap participants registered with the Commodity Futures Trading Commission;
- Public accounting firms registered with the SEC;
- U.S. bank holding companies and savings and loan holding companies;

\(^5\) FinCEN states: “We reiterate that the 25 percent threshold is the baseline regulatory benchmark, but that covered financial institutions may establish a lower percentage threshold for beneficial ownership . . . based on their own assessment of risk in appropriate circumstances.” 81 Fed. Reg. 29,410.
Pooled investment vehicles that are operated or advised by a financial institution excluded from the definition of legal entity customer;

Insurance companies subject to state regulation;

Certain financial market utilities;

Foreign financial institutions whose home country regulators maintain beneficial ownership information on such institutions; and

Other legal entities only to the extent that they open private banking accounts subject to FinCEN’s private banking account rule.

There are two categories of partially excluded entities. These entities are subject to the control prong but not the ownership prong of the rule:

Pooled investment vehicles operated or advised by a financial institution not excluded from the definition of legal entity customer (such as certain foreign funds); and

Charities, non-profit organizations, and other similar entities that have filed their organizational documents with the appropriate state authority.

The Final Rule takes a position consistent with existing CIP guidance related to certain intermediated relationships. FinCEN has confirmed that, to the extent that existing guidance provides that, for purposes of the CIP rules, a financial institution shall treat an intermediary (and not the intermediary’s customers) as its customer, the financial institution should treat the intermediary as its customer for purposes of the Final Rule as well. This approach is also consistent with the approach FinCEN proposed in the NPRM.

FinCEN has also clarified that – unlike the CIP rules, which exempt from CIP requirements legal entities with existing accounts that open new accounts – the new beneficial ownership requirements do apply to a pre-existing legal entity customer opening a new account.

Requirements with Respect to Beneficial Owners. The Final Rule requires a covered financial institution to establish CDD procedures that enable the institution to:

- Identify the beneficial owners of each legal entity customer at the time a new account is opened, unless an exemption applies; and
- Verify the identity of each beneficial owner according to risk-based procedures to the extent reasonable and practicable, “within a reasonable time” after the account is opened.

Unlike the proposed rule in the NPRM, which would have required a financial institution to identify the beneficial owner using a standard Certification Form at the time the account was opened, the Final Rule permits a covered financial institution to obtain the required information by other means, provided the individual opening the account certifies, to the best of the individual’s knowledge, the accuracy of the information.

The information required to be obtained from the natural person opening the legal entity customer account includes:

- With respect to the natural person opening the account: name and title;
- With respect to the legal entity customer: name and address;
- With respect to the beneficial owners:
  - Name (and title for the controlling individual(s));
  - Date of birth;
  - Address; and
  - Social security number (for U.S. persons), or passport number and country of issuance or other similar identification number (for foreign persons).
While verification procedures must contain the same elements as required under the applicable CIP rule, the CDD Rule does not require the procedures themselves to be identical. In addition, the Final Rule permits a financial institution to accept photocopies or other reproductions of documents listed in the applicable CIP rule. As noted above, financial institutions may generally rely on information supplied by the legal entity customer regarding the identity of its beneficial owner or owners, provided that it has no knowledge of facts that would reasonably call into question the reliability of such information.

A covered financial institution is required to retain records of the beneficial ownership information it collects for five years after the date an account is closed. A covered financial institution that chooses not to use the Certification Form may retain records electronically or incorporate them into existing databases, so long as they meet the substantive requirements of the recordkeeping rule.

FinCEN expects financial institutions to use beneficial ownership information as they do CIP and related customer information. In other words, financial institutions should use the beneficial ownership information they collect to comply not only with the beneficial ownership rule, but with other monitoring and reporting obligations. As an example, FinCEN notes that financial institutions should use beneficial ownership information to help ensure that they do not open or maintain accounts for, or otherwise engage in transactions or dealings with, individuals or entities that are the subject of sanctions administered by the Treasury Department’s Office of Foreign Assets Control. Similarly, financial institutions can use the beneficial ownership information to assist them in complying with Currency Transaction Reporting requirements. Financial institutions must therefore consider not only how they will come into compliance with the beneficial ownership requirement, but also how they will incorporate the new information they collect into existing compliance systems and processes.

Amendments to AML Program Rules – A Fifth “Pillar” of an AML Program

The Final Rule adds a new, so-called “fifth pillar” to the familiar four pillars of an AML program. The four pillars are: (i) development of internal policies, procedures and controls; (ii) designation of a compliance officer; (iii) an ongoing employee training program; and (iv) an independent audit program to test functions. While the “fifth pillar” does not amend the existing pillars, it adds a new requirement that covered financial institutions implement and maintain appropriate risk-based procedures for conducting ongoing CDD that include, but are not limited to: (a) understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and (b) conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

Opinions differ on the significance of this new requirement. Some have called into question FinCEN’s authority to expand BSA/AML program requirements in this way. For its part, FinCEN maintains that the so-called “fifth pillar” essentially formalizes existing expectations for complying with suspicious activity reporting requirements.

**Understanding the Nature and Purpose of the Customer Relationship.** According to FinCEN, understanding the risk posed by a customer should be based on a “customer risk profile.” A customer risk profile refers to information gathered about a customer that is used to develop a baseline against which customer activity is assessed for purposes of suspicious transaction reporting. FinCEN notes that, “to understand the types of transactions in which a particular customer would normally be expected to engage necessarily requires an understanding of the nature and purpose of the customer relationship.”

Depending on the circumstances, other relevant facts for developing a customer risk profile could include basic information about the customer such as annual income, net worth, domicile, and principal occupation or business, as well as, in the case of long-standing customers, the customer’s history of activity. FinCEN observed that in some cases, an understanding of the nature and purpose of the customer relationship can also be developed by inherent or self-evident information about the product or

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6 81 Fed. Reg. at 29,419.
customer type, or basic information about the customer, and that such information may be sufficient to understand the nature and purpose of the relationship.

**Conducting Ongoing Monitoring.** The Final Rule also formalizes the obligation to conduct ongoing monitoring to identify and report suspicious transactions and, on a risk-based basis, to maintain and update information relevant to customers’ profiles, including changes to beneficial ownership. The CDD Rule does not impose a categorical requirement to update customer beneficial ownership information on a continuous and ongoing basis. Rather, the obligation to update customer information is event-driven and triggered only when, through normal monitoring activity, the financial institution detects information relevant to updating the customer profile and reevaluating the risk. This obligation applies on the Applicability Date not only to customers with new accounts, but also to customers with existing accounts, such that covered financial institutions will be required to collect beneficial ownership information from existing customers if they detect, as a result of normal monitoring, that the beneficial owner may have changed, whether or not they have collected this information previously.

**Coming into Compliance**

Although covered financial institutions have until May 11, 2018 to comply with the Final Rule, it will be important for them to start to assess the steps they will need to take, and what additional resources (including financial, personnel, and IT) will be required, in advance of the Applicability Date. Compliance officers should brief senior management and the board of directors on the new requirements, not least of all so that the necessary resources can be factored into the budget. Covered financial institutions will need to not only enhance their processes and systems in order to collect and manage beneficial ownership information, but also consider the extent to which they will have to enhance existing policies and procedures to ensure their compliance with “fifth pillar” requirements of building customer risk profiles and applying risk-based procedures to conduct ongoing monitoring.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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