

FinCEN releases proposed rule on beneficial ownership

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FinCEN's proposed rule addresses requirements for reporting companies to submit their beneficial ownership and company applicant information to the agency, the first of three rules creating a national database of corporate ownership.

On December 7, 2021, the Financial Crimes Enforcement Network (FinCEN) released a much-anticipated Notice of Proposed Rulemaking (the Proposed Rule) requiring certain legal entities to submit to FinCEN a report containing information related to the beneficial owner and company applicant information of the reporting company. The Proposed Rule defines the companies that are subject to the reporting requirements of the Corporate Transparency Act (CTA), the information that covered entities must report (including the meaning of "beneficial owner" for the purposes of the rule), the time frame in which the information must be provided to FinCEN, and the penalties for failing to report required information or for willfully reporting false information.

The Proposed Rule is the first of three rulemakings that would implement the requirements of the CTA, legislation intended to promote financial transparency and thwart the use of corporate structures to launder money. The CTA requires, among other things, FinCEN to implement regulations that: (1) establish reporting requirements for certain legal entities regarding their beneficial ownership; (2) create and maintain a secure central database containing this information, accessible to law enforcement, regulators, and authorized financial institutions with their customer's permission; and (3) rescind and revise portions of FinCEN's existing Customer Due Diligence Rule (CDD Rule).¹ The Proposed Rule implements the first of those requirements. FinCEN has invited comments on any aspect of the Proposed Rule and specifically seeks comments on a series of 40 questions for key stakeholders. The comment period closes on **February 7, 2022**.

Notably, the Proposed Rule diverges from FinCEN's CDD Rule both by adopting a broader definition of "beneficial owner," potentially increasing substantially the number of persons to be reported, and by expanding the types of corporate entities that are exempt from its requirements. The broader ownership definition and misalignment of the scope of entities that the two rules cover suggest that FinCEN's eventual revisions to the CDD Rule may be substantial.

The Corporate Transparency Act and beneficial ownership information

Corporate structures such as shell companies and front companies are some of the most widely used vehicles to conceal the nature and ownership of criminal funds. By disguising criminal proceeds under the name of an anonymous company, or by transacting in the name of an ostensibly legitimate business, bad actors are able to obfuscate the ownership of their ill-gotten gains. This abuse of corporate structures increases the investigatory challenges for law enforcement and increases the burden on financial institutions in conducting their legally required due diligence. FinCEN estimates that there are roughly 30 million corporate entities operating in the United States, and yet "there is currently no systematic way to obtain information on the beneficial owners of entities" in the country. States vary significantly in the level of information that they collect about the beneficial ownership of corporations and, at present, there is no database that consolidates such information at a national level.

The Financial Action Task Force (FATF), an organization that sets international standards for anti-money laundering (AML) and countering the financing of terrorism (CFT), has been critical of the United States for this lack of corporate transparency, identifying the government's failure to collect beneficial ownership information as a fundamental gap in the U.S. AML/CFT regime.² The CTA, which was enacted as part of the Anti-Money Laundering Act of 2020, is intended to address this gap in the U.S. AML/CFT regulatory framework, and to provide law enforcement and financial institutions with the information necessary to better identify and prevent money laundering through corporate structures.

Reporting requirements under the Proposed Rule

The Proposed Rule implements the CTA by adding a new requirement at 31 C.F.R. § 1010.380 that directs covered legal entities (Reporting Companies) to report certain beneficial ownership information (BOI) to FinCEN.

Reporting companies subject to the Proposed Rule

The Proposed Rule applies both to companies established and registered in the United States, or "domestic reporting companies," and to "foreign reporting companies," which are entities established in foreign jurisdictions and registered to do business in the United States. In both cases, the definition includes corporations, limited liability companies, and any entity formed with (or, in the case of foreign entities, registered to do business with) a secretary of state or similar office of any U.S. jurisdiction or Native American tribe.³ The CTA excluded 23 types of entities from the definition of "reporting companies," which the Proposed Rule implemented largely without modification. The most notable exempt entities are: large operating companies;⁴ banks, credit unions, depository institution holding companies; broker-dealers, clearing agencies, investment companies, investment advisers, and other Exchange Act registered entities; and pooled investment vehicles.⁵

The Proposed Rule and CDD Rule do not align in the scope of entities that they cover, due in large part to the Proposed Rule's exemptions. The CDD Rule requires financial institutions to collect ownership information from certain "legal entity customers," with a narrower set of exemptions that include banks and publicly traded companies. The Proposed Rule, in contrast, excludes a wider range of entities from its reporting requirements, such as large operating companies. Accordingly, when FinCEN rescinds and revises the CDD Rule, the agency may make substantial modifications to conform the CDD requirements to the Proposed Rule.

Required reports

The Proposed Rule requires companies to provide an initial report to FinCEN containing identifying information about the company, its beneficial owners, and company applicant (BOI Report or Report).⁶ Further, should the information in a Report change, the Proposed Rule would require the company to submit an updated Report to FinCEN within 30 calendar days after such changes. With respect to the reporting company, the BOI Report must provide the company's name, trade names, address, state of formation, and Taxpayer Identification Number.⁷ For each beneficial owner, the report must provide the individual's full legal name, address, and a unique identifying number taken from a passport, driver's license, or state-issued ID, as well as an image of the document from which the number was obtained.⁸

Beneficial owner

The Proposed Rule defines "beneficial owner" as any individual who either: (1) exercises substantial control over a reporting company, or (2) owns or controls at least 25 percent of the ownership interests of a reporting company.⁹ The Proposed Rule's definition of beneficial ownership is significantly broader than that of the Customer Due Diligence Rule, which defines beneficial ownership as: (1) each individual who owns 25 percent or more of the equity interests of a legal entity customer; and (2) a single individual with significant responsibility to control, manage, or direct a legal entity customer.

Under the CDD Rule, an individual with significant responsibility includes "an executive officer or senior manager" or "[a]ny other individual who regularly performs similar functions." In contrast, under the Proposed Rule, substantial control over a reporting company includes:

- service as a senior officer of the reporting company;
- authority over the appointment or removal of any senior officer or a majority or dominant minority of the board of directors (or similar body);

- direction, determination, or decision of, or substantial influence over, important matters affecting the reporting company;¹⁰ or
- any other form of substantial control over the reporting company.

Unlike the CDD Rule, the Proposed Rule does not limit the substantial control prong of the beneficial owner definition to a single individual. FinCEN believed that adopting the CDD Rule's numerical limitation would be "inconsistent with the CTA's objective of establishing a comprehensive BOI database for all beneficial owners of reporting companies."

In addition to expanding the identified controlling persons of a company, the Proposed Rule's definition of substantial control increases the forms of authority that can render an individual a beneficial owner. FinCEN based its definition of "substantial control" on a variety of different sources, including concepts of agency law and corporate law, functional tests adopted by other federal statutes, FATF Recommendations, standards from beneficial ownership rules in other countries, federal tax law, and the statutory law and administrative practice informing the activity of the Committee on Foreign Investment in the United States.¹¹ FinCEN stated that each indicator of substantial control is intended to support the CTA's "basic goal of requiring a reporting company to identify the individuals who stand behind the reporting company and direct its actions." Although FinCEN acknowledged that this broader definition of beneficial ownership would increase reporting requirements for covered entities, the agency concluded that those burdens would not be unduly onerous—smaller companies are generally less likely to have complex ownership and hierarchies, while larger entities, which may have complex corporate structures, are generally exempt from the reporting requirements of the Proposed Rule.

The Proposed Rule also clarifies that ownership interest includes "both equity in the reporting company and other types of interests, such as capital or profit interests (including partnership interests) or convertible instruments, warrants or rights, or other options or privileges to acquire equity, capital, or other interests in a reporting company." FinCEN proposed adopting this definition of ownership "as a way of ensuring that the underlying reality of ownership, not the form it takes, drives the identification of beneficial owners," and to thwart "the use of complex ownership structures and ownership vehicles other than direct equity ownership to obscure a reporting company's real owners." This definition is broader than the definition of "beneficial owner" under the ownership prong of the CDD Rule, which is based exclusively on "equity interest."

Timing and penalties

The Proposed Rule would impose different deadlines for companies created before and after the effective date of the final rule. Domestic reporting companies incorporated after the effective date of the final rule would be required to file with FinCEN within 14 calendar days of formation with a secretary of state. Foreign reporting companies must also register within 14 calendar days of "the date it first became a foreign reporting company" (i.e., within 14 days of registering in the United States). Companies in existence before the final rule's effective date must file with FinCEN in a "timely manner" and no later than one year after the effective date of the final rule. It remains to be seen how FinCEN will communicate these requirements to the estimated 30 million corporate entities in the United States.

Consistent with the CTA, the Proposed Rule provides for the imposition of civil or criminal penalties on persons who "willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN," or who "willfully fail to report complete or updated beneficial ownership information to FinCEN" as required by the rule.

Issues for public comment

FinCEN requested public comment on all aspects of the Proposed Rule and posed a list of 40 questions for stakeholders. The questions include both general inquiries regarding the rule's clarity and substantive questions on issues such as reporting requirements, the definitions of reporting companies and beneficial owners, and the timing of reports and updates. Notable issues for comment include:

- **Reporting requirements:** FinCEN posed a series of questions on the Proposed Rule's reporting requirements, including whether the information that companies must report is sufficiently clear and whether FinCEN should collect additional information from reporting companies.
- **Beneficial owners:** FinCEN requested comments on whether the Proposed Rule's broad definition of "beneficial owner" would be burdensome for reporting companies and whether the broad definition would be useful for national security and law enforcement purposes. FinCEN has also asked whether the definition and proposed indicators of substantial control are sufficiently clear and whether FinCEN should add other indicators of substantial control.

- **Reporting companies:** FinCEN requested comments on whether the definition of “reporting company” is sufficiently clear and whether the exemptions to the Proposed Rule’s reporting requirements are defined too broadly or too narrowly.
- **Timing of reports:** FinCEN sought feedback on the Proposed Rule’s timeframes for reporting, correcting, and updating BOI reports. FinCEN also asked whether the agency should alter the timeframes “because the burden imposed outweighs the gains in ensuring information is current and accurate.”

The outlook for the Proposed Rule

The Proposed Rule is an important step towards closing a significant gap in the United States’ AML/CFT framework. The limited availability of beneficial ownership information at a national level is a continuing source of frustration for both law enforcement and compliance professionals at financial institutions. The Proposed Rule’s reporting requirements lay the groundwork for a national database of corporate ownership, which may significantly improve both public and private efforts to identify and prevent financial crime. Many additional steps remain, however, before this database becomes a reality. While FinCEN notes that it is “committed to identifying the soonest possible effective date” for the Proposed Rule, it has not suggested even a notional proposed effective date at this stage of the rulemaking process, citing uncertainties over the time required to design and build the systems needed to house the database and the time required for reporting companies to come into compliance with the rule and for secretaries of state and other authorities to provide notice and guidance concerning the new requirements. As noted, FinCEN is also conducting two additional, separate rulemakings under the CTA to create the beneficial ownership registry and revise the CDD Rule, both of which will need to be coordinated with the Proposed Rule. Important questions remain, including the precise mechanisms through which authorized financial institutions will access FinCEN’s BOI database, and how the beneficial ownership rules will affect the due diligence obligations of financial institutions. Until these rulemaking processes progress further, the practical implications of the Proposed Rule are currently unknown. In the interim, financial institutions and reporting companies should continue to monitor FinCEN’s rulemaking activities, and may wish to consider submitting comments to FinCEN, as the agency’s progress towards implementing the CTA will continue.

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

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- ¹ The CDD Rule requires certain financial institutions to identify and verify the identity of their legal entity customers' beneficial owners.
- ² Although FinCEN's 2016 CDD Rule was intended to mitigate the vulnerabilities arising from the limited corporate transparency in the U.S., members of Congress, as well as the Department of the Treasury, and the Department of Justice have long advocated for a more comprehensive approach, which included collecting beneficial ownership information at the time of corporate formation and the creation of a national beneficial ownership registry.
- ³ FinCEN also stated that the definition likely includes limited liability partnerships, business trusts and most limited partnerships, however, depending on local law, may exclude other entities that do not require any governmental filing to be formed or to do business in the United States, such as certain trusts and partnerships.
- ⁴ An entity qualifies as a "large operating company" if it: (1) employs more than 20 employees on a full-time basis in the United States; (2) filed in the previous year Federal income tax returns in the United States demonstrating more than \$5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of other entities owned by the entity and through which the entity operates; and (3) has an operating presence at a physical office within the United States.
- ⁵ The Proposed Rule imposes a special rule for foreign pooled investment vehicles, requiring such entities to submit the BOI related to the individual who exercises substantial control over the entity, or, if more than one individual exercises substantial control, the BOI with respect to the individual who has the greatest authority over "the strategic management of the entity."
- ⁶ Company Applicants are the individuals that file the document to create a reporting company.
- ⁷ If the reporting company does not have a tax identifier number, the report must provide the company's Dun & Bradstreet Data Universal Numbering System Number or a Legal Entity Identifier.
- ⁸ After an individual has provided FinCEN with the personal information required of beneficial owners, an individual may obtain an identification number (or FinCEN Identifier) to be used in subsequent reports. In lieu of providing the requisite personal information in every subsequent report, individuals may use their FinCEN identifier.

- ⁹ This definition mirrors that of the CTA, which established the same two-prong definition based on “substantial control” and “ownership.” The CTA left it to FinCEN, however, to define “substantial control.”
- ¹⁰ The Proposed Rule provides examples of matters that are sufficiently important to a reporting company to establish substantial control. They include, without limitation, decision-making authority as to: (A) The nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company; (B) The reorganization, dissolution, or merger of the reporting company; (C) Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company; (D) The selection or termination of business lines or ventures, or geographic focus, of the reporting company; (E) Compensation schemes and incentive programs for senior officers; (F) The entry into or termination, or the fulfillment or non-fulfillment of significant contracts; and (G) Amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures.”
- ¹¹ Some of the Proposed Rule's examples of substantial control appear to derive directly from the definition of “control” under the CFIUS statutory and regulatory regime.