FinCEN's New AML Rules for Legal Entity Customer Due Diligence: Where Are We Six Months Later?

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On May 11, 2018, new rules of the Financial Crime Enforcement Network of the U.S. Treasury Department ("FinCEN") went into full effect requiring enhanced customer due diligence ("CDD") by covered financial institutions in opening new accounts for *legal entities*. These rules depart dramatically from prior U.S. requirements and can be found here. 31 CFR 1023.320, added by 83 Fed. Reg. 29398 (May 11, 2016) [1] See www.fincen.gov/news/news-releases/fincen-reminds-financial-institutions-cdd-rule-becomes-effective-today

For covered financial institutions, the Rules represent a fundamental shift in their Know Your Customer ("KYC") obligations for new accounts of covered legal entities opened on or after May 11, 2018. The traditional obligation to Know Your Customer (i.e., the account holder entity) is now a deeper obligation to Know the Entity Owner(s) and Control Person of the customer. These changes were made in response to long-standing criticism from international organizations, such as the global Financial Action Task Force ("FATF") (of which the United States is a member), that the United States was too lax in letting legal entities such as LLCs and LLPs be used to gain access to the global financial system with little or no insight into who actually beneficially owned and/or controlled the entity.[2]

Now that we are approaching six (6) months after the May 11, 2018 compliance deadline, it is appropriate to take a look at where these changes stand, and their effect, especially on smaller covered financial intermediaries like small to medium size broker-dealers and their customers. Before we do that, a brief review of who the Rules cover and what they require follows. And, as will be shortly apparent, while these rules are of most concern to financial institutions like broker-dealers, other entities like investment advisers and hedge funds, are also affected.

The Rules

A. What Changed?

Conceptually, the new CDD Rules impose two distinct but related levels of obligations:

1. Customer level: Covered financial institutions must implement procedures to enhance customer due diligence (CDD) to identify each 25% beneficial owner of and a control person for each new legal entity customer account

2. Programmatic: Covered financial institutions must add a so-called "fifth pillar" to their Bank Secrecy Act (BSA) anti-money laundering (AML) programs: using the customer information developed, financial institutions must (after verification) understand the nature of the new customer relationship to develop a risk profile. They must update customer information, enhance existing customer AML risk profile(s), and use the profile to drive customer monitoring and surveillance. Although the CDD Rules primarily apply to "new" accounts opened May 11, 2018 and after, pre-existing legal entity accounts must also be subjected to enhanced CDD if a financial institution has reason to believe the customer's risk profile has changed (such as by an ownership change).

B. The Basics of the CDD Rule

1. Who is a covered financial institution?

Generally a covered financial institution is one subject

1 These new rules were actually effective May 11, 2016 but provided an unusually long two year compliance period, with a deadline for compliance of May 11, 2018. They are the end product of a lengthy rulemaking process that took over four years to complete and included town hall meetings in Washington, DC, Chicago, Los Angeles, Miami and New York. 83 Fed. Reg. at 29402.

2 See FATF, Mutual Evaluation Report: Anti-money laundering and Counter Terrorism Financing: United States at 118 & n. 34 (Dec. 2016) ("FATF MER") (discusses issue and its history in noting adoption of new CDD rules favorably).

to Bank Secrecy Act ("BSA") AML requirements. Examples of covered institutions include: broker-dealers (both introducing and carrying), banks, registered investment companies (mutual funds), federally-regulated trust companies, and commodities futures commission merchants. Also covered are entities like registered crowdfunding and online brokerage portals, (where there is significant potential for friction with the lighter information-acquiring practices embedded in many of their business models.)

Two prominent examples of financial institutions *not covered* by the CDD Rules are: investment advisers (both registered and unregistered) as well as unregistered investment companies (e.g., hedge funds). While they are not covered financial institutions strictly speaking, and relieved from the Rule's requirements for their own investors, the practical impact of that exclusion may be diminishing as discussed further below.

2. Who are covered legal entity customers?

The answer to this question is in two parts: i) who is a "legal entity"? and 2) what legal entities are "covered" by the enhanced CDD Rules?

a. *Who is a legal entity?*

Simply put, a legal entity is any entity other than a natural person. For example, a corporation, a general or a limited partnership, a limited liability company, or a limited liability partnership. A "rule of thumb": if a US entity is created by a state filing, or is a similarly-created foreign entity assume it is a "legal entity" *potentially* subject to the CDD Rules.

b. *What legal entities are covered/not covered by the Rules?*

Though the definition of a "legal entity" is broad, the CDD Rules themselves and related FINCEN guidance exclude from coverage many of the types of legal entities a financial institution will open an account for. At the most basic level, a simple trust or a single owner unincorporated business association (sole proprietorship) (even an individual or association doing business as) is not covered by the Rule since such arrangements generally do not raise the transparency issues the Rules are concerned with. Also excluded are sovereign governments, departments or agencies of the United States, of any State, or of any political subdivision of a State. Interestingly, a non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities is excluded but not a government-owned, sponsored or affiliated commercial entity such as a sovereign wealth fund or a state-owned business such as an oil company.

Accounts opened by or for the following are generally also not covered by the new Rules because equivalent information is otherwise publicly available or the entity is required to report equivalent information to a governmental authority:

- An issuer of securities registered under section 12 of the Securities Exchange Act of 1934 (SEA) or that is required to file reports under 15(d) of that Act;
- Any entity (other than a bank) whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchange (being listed on a foreign exchange is not grounds to be excluded);
- Any entity organized under the laws of the United States or of any State at least 51% of whose common stock or analogous equity interests are held by a listed entity;
- U.S. federally-registered financial institutions (e.g., a Bank Holding Co.);
- U.S financial institutions regulated by a federal or state functional regulator;
- U.S. registered broker-dealers;
- U.S. registered investment companies;
- U.S. registered exchanges;
- U.S registered clearing agencies;
- An insurance company regulated by a State of the United States; and
- A foreign regulated financial institution whose regulator collects and maintains ownership information of the beneficial owners for the financial institution.

Certain other organizations are exempt from providing beneficial ownership information but must provide control person identification (see below):

- Pooled Investment Vehicles: Financial institution must collect control person information on the vehicle only (but not on beneficial owners of assets in the pool).

- Charities: Charities are also excluded not only if tax-exempt under Internal Revenue Code section 501(c) (3) but also if organized as a non-profit under state law. The financial institution must collect control information but not beneficial ownership information.

- A trust that is a 25% beneficial owner of a legal entity: the owner is considered to be the trustee; do not have to get additional beneficial owner information for the trust.

3. What is required to open an account for a legal entity covered by the Rules?

The Rules require that covered financial institutions identify and verify the identity of each "beneficial owner" and one "control person" of each "legal entity customer."

a. "Beneficial Owner"

A "beneficial owner" is each individual who, directly or indirectly, owns 25% or more of the equity interest in or controls more than 25 % of the voting power of a legal entity customer. There can be up to four such beneficial owners per entity. It is also important to note that institutions must follow the ownership chain of legal entities that are owned by other legal entities to find at least one natural person who is a 25% beneficial owner, directly or indirectly. If one of those owner entities is a US public company or an otherwise excluded legal entity, however, the analysis of that beneficial owner chain stops there.

b. "Control Person"

A "control person" is a single individual with significant responsibility to control, manage or direct a legal entity customer. Some roles such persons may fill include CEO, President, COO, CFO, managing partner, general partner, managing member, and managing director. This control person may be, but need not also be, a beneficial owner. The control person will typically sign the account agreements and complete and sign the covered legal entity beneficial owner information form (see below). By signing, the control person certifies the control and beneficial ownership information provided is accurate.

c. FinCEN Form

In the final enhanced CDD rules FinCEN provided a sample form financial institutions can use to capture the required information and obtain the control person's signature and certification. It has also made a fillable electronic version of the form available.

Use of FinCEN's form is not mandatory under the CDD Rules. Unfortunately use of FinCEN's form also does not provide a compliance "safe harbor"--during the rulemaking FinCEN was asked to provide that relief but declined to do so. [3]

In this author's experience even smaller firms use some sort of form to capture control person and beneficial owner information. That form may be the FinCEN form, one derived from it or one incorporating it into another standard document. The key element to have is the control person's certification and signature, enabling reliance on the accuracy of the information provided.

3 81 Fed. Reg. at 29406-07.

d. Identification and Verification: "Enhanced Due Diligence"

The identification and verification procedures for beneficial owners and control persons are generally the same as those for individual customer identification (e.g., production of an official document like a passport or driver's license for each individual plus identity verification and checking against the information provided). Unlike the usual KYC requirement to see an original identification document, copies of individuals' documents alone may be accepted. This is largely because a financial institution may rely upon the beneficial ownership information provided by the certifying control person signer for the customer, so long as it has no knowledge of facts that would reasonably call into question the reliability of that information. This KYC/CDD process also does not have to be completed before an account is opened but must be completed within a reasonable time thereafter.

4. What about that "Fifth Pillar"?

This programmatic requirement addresses how a financial institution uses the enhanced CDD information it obtains on new covered legal entity accounts. It also creates an exception to the Rules requiring CDD for certain pre-existing accounts. As summarized by FINRA in two Regulatory Notices[4], the enhanced CDD requires procedures and processes for ongoing due diligence to develop and maintain risk profiles for new accounts using the information acquired, and monitoring thereafter not only for suspicious transactions but also to maintain and update such information (the "risk profile"). The updating requirement also requires risk-based review of pre-existing accounts to determine if additional diligence needs to be done to understand the customer adequately in AML-risk terms based on such triggers as a change in ownership or structure. To update pre-existing accounts for covered legal entities will mean obtaining control and beneficial ownership information compliant with the enhanced CDD Rules and putting it to use as above.

C. Interpretive Questions and Practicalities

Interpretive Guidance

On April 3, 2018 FinCEN issued guidance entitled Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions[5] ("FAQs") and after the Rules went into effect has provided limited formal exceptive relief on defined issues. Some of the issues resolved and some that remain follow.

1. "New" Legal Entity Accounts: Known owners, multiple accounts and new accounts for defined purposes (sub-accounts).

The FAQs clarify certain situations in using information already in a financial institution's possession to satisfy the control person or beneficial owner identification requirements of the Rules but also generate some uncertainty around sub-accounts.

a. Known Owner

To verify an individual beneficial owner's identity, a financial institution may rely upon information already in its possession from an existing account so long as the control person who is the account's representative confirms the information is accurate.

b. Same legal entity with multiple accounts

If a legal entity opens multiple accounts it is easy to conjure a situation where each account is a "new" account, causing the financial institution to have to identify control and beneficial ownership repetitively over and over again. So long as the customer's control person verifies the beneficial owners remain the same, FinCEN will not require repetitious forms and due diligence (FAQs 7&9-10).

4 FINRA Regulatory Notices 17-40 (November 2017) and 18-19 (May 2018)

5 FIN-2018-G001 (April 3, 2018)

c. Same legal entity with different sub-accounts.

Legal entities like investment advisors often have broker-dealers they trade with or other financial institution dealings through a master account and separate sub-accounts created to accommodate the financial institution or customer's business, administrative or operational requirements. Under the literal terms of the CDD Rules each sub-account could need to be treated as a "new" legal entity accounts requiring separate enhanced CDD.

FinCEN FAQ 11 recognizes the impracticality of requiring this for some accommodation accounts on the condition that the sub-accounts are established by the financial institution itself and not at the customer's request. According to FAQ 11 this distinction is made to differentiate situations such as where a different affiliated entity of the legal entity customer or even a customer of the legal entity might trade through the sub-account. The more serious example is where a concealed customer, entity or person (especially a foreign one), is allowed to trade though a sub-account without identification and verification or understanding of the purpose of its activity. This is a well-known and serious longstanding AML issue and the subject of numerous settled AML regulatory actions imposing substantial sanctions[6]. The other example, of an affiliate with a different trading strategy, is less compelling since it appears to be simply requiring identification and CDD if a separate legal entity owner is present, even if it is affiliated with the master account owner.

Bearing in mind the inarguable seriousness of the sham sub-account for a hidden customer issue, this author believes drawing the distinction at who wants the sub-account established is too broad and creates needless confusion. It has the practical effect of creating uncertainty around long-accepted customer–driven uses of sub-accounts. Examples of such sub-accounts include: those for different clearing brokers; for trading strategies by the identical investment adviser master account owner; and "allocation accounts" permitting securities transactions placed as a single order by the master account investment adviser and receiving a single price to be allocated to sub-accounts established to receive allocation of parts of the trade to facilitate the adviser's bookkeeping or, indeed, its regulatory compliance. There would seem to be little benefit in unsettling long-standing legitimate industry practices such as these, [7]certainly assuming appropriate verification of the ownership and purpose for the sub-account the customer requests is obtained.

2. Trusts

Premised on the traditional view that a trust is a creature of contract, FINCEN treats the "owner" of a trust as the trustee, and generally does not require beneficial ownership information on the beneficiary (-ies) of a trust. Instead identification of an individual natural person trustee will suffice to satisfy both the control person and beneficial ownership prongs. The trustee is the person upon whom verification is performed not its beneficial owners. In the instance of a trust being trustee of another trust a look though is required to find a natural person or verify there is none. Similarly for a trust with more than one trustee only one trustee must be identified and verified but financial institutions can decide to do enhanced CDD on more trustees or even all of them. FAQ 19. While there is other published FinCEN guidance suggesting situations where a look-through to beneficial owners and further diligence may be needed, this author

6 SEC National Exam Risk Alert, Master/Sub Accounts, at 3-4 (Sept 29, 2011), citing the early foundational cases simultaneously settled by the SEC and FinCEN with Pinnacle Capital Markets LLC, SEC Rel. 34- 62811(Sept 1, 2010); FinCEN Matter No. 2010-4 (Sept 1, 2010). One of many other examples is Oppenheimer& Co. Inc., SEC Rel.74141 (January 27, 2015) ($10 million penalty).

7 See FINRA Regulatory Notice 10-18 Master and Sub-accounts, at 2 (April, 2010) (recognizing "'bona fide IA'" may use these arrangements for various legitimate business reasons, giving as examples sub-accounts for different trading strategies or asset classes).

would not be surprised if we do not hear more on trusts in the future given the obvious potential for abuse in this area.[8]

Practicalities

3. No exemption for smaller financial institutions

During the rulemaking, FinCEN declined to exempt smaller financial institutions from the enhanced CDD Rules despite suggestions from commenters their legal entity customers pose lower systemic risk and that compliance would be disproportionately costly for them, opting instead for a "blanket" rule.[9]

Such seemingly simple duties like obtaining basic control person and beneficial owner information and verifying it, even with a control person certifying, can be burdensome in small firms that often have thin resources to devote. Requirements like following the beneficial ownership chain up or across an interlocking group of legal entity owners add to the practical burdens for smaller institutions.

One solution could be a centralized list or collection point for legal entity information. Recognizing there is no reasonable expectation FinCEN would assume this task, there may be an opportunity for vendors such as those who collect and provide Qualified Institutional Buyer (QIB) certificates and FINRA Rule 2111 Suitability Certifications for a fee to provide a similar service.[10]

4. Foreign Regulated Financial Institution

A foreign regulated financial institution whose primary regulator collects and maintains ownership information on the beneficial owners of the financial institution is generally excluded from the beneficial ownership prong of the enhanced CDD rules. FAQ 26. The realization that regulated foreign financial institutions can be allowed CDD relief because they are regulated in their home countries is commendable. As is that the foreign requirements do not need to be identical to those of the enhanced CDD Rules.

The utility of this exclusion especially to smaller covered entities is, however, limited by several factors. First, other than that the requirements do not need to be identical to those of the U.S., FinCEN has offered no guidance on what foreign requirements suffice except to say a financial institution can contact the foreign regulator if necessary or may rely upon its customer's written representations and certification of comparability in an appropriate case. FAQ 26. FinCEN also declines to produce a list of comparable jurisdictions/regulators/regulations. FAQ 27.

5. FinCEN Exceptive relief

FinCEN has the authority and has indicated a willingness to provide interpretive assistance or even exceptive relief in appropriate situations, balancing the commercial need versus the regulatory risk. The first example of it doing this is a carve-out from guidance in its FAQ 12 requiring CDD for product or service renewals. On September 7, 2018, FinCEN gave permanent exceptive relief from required beneficial owner CDD for rollovers of certain products: certificate of deposits (CDs); renewal, modification, or extension of a loan, commercial lines of credit or credit card accounts (e.g., to set a later payoff date) that do not require underwriting review and approval; and renewal of a safe deposit box rental.[11]

The exception process and the ability to obtain Staff interpretive guidance are certainly available, but how practical this is remains an issue, especially for entities with cost constraints.

6. Investment Advisers

The long regulatory history of why investment advisers and unregistered funds are exempt from BSA AML requirements, including adopting KYC requirements

8 See FINCEN, FIN-2016-G013, FAQs Regarding Customer Due Diligence Requirements for Financial Institutions, at 8 (FAQ 22: Trusts) It is interesting to note that requiring CDD for trust beneficiaries, especially of trusts administered by institutional trust administrators, is a continuing unresolved FATF recommendation. See FATF, MER, at 118.

9 81 Fed. Reg. at 29417.

10 The author has been told that one large financial information company that provides multiple services such as email surveillance, record retention and order management software platforms to clients has begun to provide a private subscriber service paid for by sell-side firms but free to buy-side clients.

11 CIN-2018-R003

for their investor onboarding, is beyond the scope of this article.[12]

Large registered investment advisers, especially those targeting institutional investors, have voluntarily adopted such programs for a long time so that selling agent broker-dealers can rely upon the adviser's AML program if both comply with the requirements of long-standing SEC no-action advice obtained by SIFMA (and its predecessor SIA).

Where does this leave smaller and mid-sized unregistered advisers and exempt funds who do not voluntarily adopt such programs? Perhaps between the proverbial rock and a hard place with the pressure only increasing. For example, in two very recent SEC actions, settlements were obtained because two well-respected broker-dealer/custodians failed to file SARs on activity of investment advisers they terminated relationships with due to suspicious transactions done by those advisers.[13] Some commentators have raised the alarm this is a warning of a backdoor attempt to regulate advisers through their broker-dealers/custodians.

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12 FinCEN first proposed rules to extend BSA coverage to them in 2003 but that rulemaking was abandoned in 2007. FinCEN proposed another rule to cover primarily larger advisers in September 2013. The comment period closed in November 2015, and the rulemaking has not moved forward since then.

13 SEC v. Charles Schwab & Co. Inc., No. 18-cv-3942(N.D. Cal. July 2, 2018) (permanent injunction and penalty of $2.8 million); TD Ameritrade, Inc., SEC Rel. 34-84269 (Sept. 24, 2018) ($500,000 penalty).