FinCEN Proposes Tighter Customer Due Diligence Requirements for Financial Institutions

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For financial institutions, customer due diligence may become tougher and costlier in 2015 if the Financial Crimes Enforcement Network's (FinCEN) latest proposed rule is finalized in its current form. On July 30, 2014, FinCEN issued a Notice of Proposed Rulemaking (NPRM) intended to expand customer due diligence (CDD) requirements for banks, securities brokers or dealers, mutual funds, and futures commission merchants and introducing brokers in commodities. Of particular importance, the NPRM proposes amendments to FinCEN's anti-money laundering (AML) program rules that would require these financial institutions to know and verify the identity of the ultimate beneficial owners of their entity customers. The ultimate beneficial owners would include the natural persons who own, directly or indirectly, 25 percent or more of the entity and the natural persons who have significant responsibility to control, manage or direct the entity. The NPRM represents just one element of the U.S. government's broader strategy to enhance financial transparency.

The NPRM also will bring the United States more in line with existing international standards. Since 2005, the European Union has required financial institutions to identify and verify beneficial owners. Other international financial centers such as Switzerland, Singapore and Hong Kong also require the same. Since 2003, the Financial Action Task Force, an intergovernmental body that sets AML standards, has recommended that financial institutions identify and verify the identity of the beneficial owners of customers, including taking reasonable measures to understand the ownership and control structure.

Financial institutions should consider the following takeaways:

Institutions Should Not Delay Preparations. Since the beneficial ownership proposal has been the subject of an Advanced Notice of Proposed Rulemaking, public hearings and significant regulatory guidance, FinCEN and the financial regulators do not view this rule as a surprise. We anticipate that FinCEN will move quickly to finalize the NPRM in order to meet commitments in the Action Plan for Transparency of Company Ownership and Control made following the June 2013 G-8 summit. Although the final rule may change in response to industry suggestions to limit the scope of certain definitions or expand on certain exemptions, we nonetheless expect examiners will begin to focus on this issue immediately in AML target examinations. Institutions should anticipate questions from examiners prior to finalization and plan accordingly.

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As Drafted, the NPRM Impacts Small and Large Institutions Alike. The NPRM estimates that the proposed rule covers approximately 21,500 institutions in the United States, over half of which are considered to be small institutions. Commenters representing these institutions have expressed concern over the associated compliance costs. Nonetheless, small institutions historically have not been immune to regulatory requirements in this area and have been the subject of civil and criminal enforcement actions. Furthermore, regulators — and prosecutors for that matter — have specifically expressed concern that as larger institutions reduce compliance risk, smaller institutions will assume these activities.

The NPRM Permits "Reasonable" Reliance on Representations of Customers. While the NPRM as drafted requires financial institutions to identify and verify beneficial owners, it explicitly does not require financial institutions to verify that the natural persons identified are, in fact, the beneficial owners. FinCEN acknowledged that some customers may have complex legal ownership structures making it difficult to identify indirect beneficial owners. FinCEN expects financial institutions to be able to rely "generally" on the representations of customers, and commenters have even suggested a safe harbor for financial institutions that identify beneficial owners using FinCEN's proposed form. We anticipate, however, that any reliance must be reasonable. As numerous enforcement actions illustrate, regulators are unlikely to be sympathetic to institutions that turn a blind eye to apparent red flags.

Heightened Expectations in Economic Sanctions Compliance Are Likely. Identifying beneficial owners is important in a financial institution's economic sanctions compliance program. Sanctions apply where the ultimate benefit of a transaction is received in a sanctioned country, including by beneficial owners located in that country. Additionally, on August 13, 2014, the Office of Foreign Assets Control changed its longstanding guidance and stated that it would begin aggregating beneficial interests of sanctions targets; now, if two or more sanctions targets together own 50 percent or more of an entity, the sanctions will apply equally to that entity. We expect that a formal beneficial ownership rule and more generally the heightened focus on beneficial ownership in the United States and abroad will make mitigation arguments more difficult.

Voluntary Compliers Should Consider Re-Evaluating Their Programs. The NPRM only applies to covered financial institutions. However, companies that voluntarily subject themselves to AML program requirements may consider adopting the finalized beneficial ownership requirements or at least enhancing their CDD procedures, particularly if other financial intuitions rely on their CDD. For example, broker-dealers who rely on investment advisers pursuant to the Securities and Exchange Commission no-action letter may expect the investment adviser to identify and verify ultimate beneficial owners to the same extent as if it were subject to the rule.

Institutions Must Manage Differences in Applicable Legal Regimes. In February 2013, the European Commission proposed a fourth EU money laundering directive, which would require all companies, legal entities and trustees to hold adequate and up-to-date information on their beneficial owners and to make this information available to persons performing AML due diligence and to law enforcement agencies. Last March, the European Parliament released a separate proposal, which included a requirement for a central registrar of beneficial owners. In December 2014, the European Council and Parliament reached a deal that would require ultimate beneficial owners to be listed in central registers available to the government, "obliged entities" such as banks, and persons who demonstrate a "legitimate interest." The fourth directive must still be finalized, but the message is clear: While the rules concerning beneficial ownership vary across jurisdictions, they are tightening globally.