

## Clifford Chance Regulatory Update: FinCEN issues Final Rule on Identifying Beneficial Owners and Conducting Customer Due Diligence

On May 6, 2016, the Financial Crimes Enforcement Network ("**FinCEN**") issued its long awaited rule ("**Final Rule**") clarifying and strengthening customer due diligence requirements under the Bank Secrecy Act ("**BSA**"). The Final Rule: (1) provides new requirements that covered financial institutions collect information regarding beneficial owners of legal entity customers; and (2) supplements anti-money laundering ("**AML**") compliance program requirements relating to customer risk profiling and monitoring by adding some requirements and making others explicit.

**The Final Rule reflects FinCEN's views that there are four core elements of customer due diligence (CDD), which should be explicit requirements of AML programs for all covered financial institutions. These are: (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.**

Issuing the Final Rule, FinCEN stated that the first of these core requirements (customer identification and verification) is already an AML program requirement. FinCEN also stated that the third and fourth core elements (developing risk profiles and ongoing monitoring) are already implicitly required for covered financial institutions to comply with their suspicious activity reporting requirements – but the Final Rule makes them explicit requirements. Both the new beneficial owner and the clarified customer due diligence requirements are discussed further below.

The Final Rule applies to "**Covered Financial Institutions**," which include: (i) banks; (ii) brokers or dealers in securities; (iii) mutual funds; and (iv) futures commission merchants and introducing brokers in commodities. Covered Financial Institutions have until May 11, 2018 to comply with the Final Rule.

### Beneficial Owners – Information Gathering

Under the Final Rule, Covered Financial Institutions must collect information verifying the existence of **Beneficial Owners** for new accounts. Under the Final Rule, Beneficial Owners include: (1) a natural person who owns more than 25 percent of the equity interests in a legal-entity customer, or (2) a single natural person who exercises control over the legal-entity customer. A Covered Financial Institution may comply either by obtaining the required information on a standard certification form that FinCEN appended to the Final Rule or by other means that comply with the substantive requirements of this obligation.

Of interest, the Final Rule requires financial institutions to verify the identity of the individual identified as a beneficial owner. Financial Institutions may, however, rely on the information supplied by the legal entity customer regarding the identity of its beneficial owners or owners "provided that it has no knowledge of facts that would reasonably call into question the reliability of such information."<sup>1</sup>

FinCEN also acknowledged that the identification and verification procedures for beneficial owners, although similar, are not identical to requirements that a financial institution would have in place under existing customer identification program (CIP) requirements. For instance, FinCEN acknowledged that since a beneficial owner may not be present at account opening, financial institutions may rely on photocopies.

Financial institutions must maintain records of the beneficial ownership information, and may rely on another financial institution for the performance of these requirements, in each case to the same extent as under their CIP rule.

## The 25% Threshold?

In the Final Rule, FinCEN declined to lower the beneficial ownership threshold to 10 percent. However, FinCEN notes that many financial institutions currently have this standard in place. In addition, FinCEN notes that 25% is the "baseline regulatory benchmark," and notes that Covered Financial Institutions may establish lower percentage thresholds based on the risk associated with a particular customers.<sup>2</sup>

## Implications for OFAC Screening

Under the Final Rule, FinCEN highlights its expectation for financial institutions to use the beneficial ownership information it collected as it would CIP information and use the information to comply with other requirements. In the Final Rule, FinCEN uses compliance with OFAC regulations as an example and notes that "institutions should use beneficial ownership information to help ensure that they do not open or maintain an account, or otherwise engage in prohibited transactions or dealings involving individuals or entities subject to FOAC-administered sanctions."<sup>3</sup>

## Implications for Currency Transaction Reporting Requirements

FinCEN also notes that collection of beneficial ownership information may impact aggregation of transaction for Currency Transaction Reporting requirement practices, in order to determine if transactions are by or on behalf of the same person. In this regard, FinCEN notes that a financial institution may decide to aggregate transactions that a legal entity and individual deposit if the financial institution determines that a legal entity customer or customers "are not being operated independently from each other or from their primary owner."<sup>4</sup>

## Exclusions from definition of "Legal Entity":

The Final Rule excludes various entities from the definition of Legal Entity and thus the beneficial ownership requirements. Examples of these entities include:

A financial institution regulated by a Federal functional regulator or a bank regulated by a State bank regulator;

- A department or agency of the United States, of any State, or of any political subdivision of a State;
- Entities that exercise governmental authority on behalf of the United States, States or political subdivision;

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<sup>1</sup> Final Rule, Page 39.

<sup>2</sup> Final Rule, Page 51.

<sup>3</sup> Final Rule, Page 44.

<sup>4</sup> Final Rule, Page 45.

- Any entity (other than a bank) whose common stock or analogous equity interests are listed on the New York, NYSE MKT, or NASDAQ stock exchange;
- An issuer of a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 159d) of that Act'
- An investment company that is registered with the SEC;
- An investment adviser that is registered with the SEC;
- An exchange or clearing entity;
- Any other entity registered with the SEC under the Exchange Act;
- A registered entity, commodity pool operator, commodity trading advisor, retail foreign exchange dealer, swap dealer, or major swap participant;
- A public accounting firm;
- A bank holding company or savings and loan holding company;
- A pooled investment vehicle;
- An insurance company that is regulated by a State;
- A non-US financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information

### A few additional items to highlight:

In the Final Rule, FinCEN:

1. Determined not to apply to requirement retroactively;
2. Declined to specify who would need to sign a certification form, instead allowing financial institutions to rely on their existing documentary requirements;<sup>5</sup>
3. Declined to provide a safe harbor if a financial institution uses the certification form included in the final rule.

FinCEN stated that the purpose of this requirement is to prevent "criminals, kleptocrats, and others" from hiding ill-gotten gains by accessing the financial system anonymously. According to FinCEN, the beneficial ownership requirement will "provide information that will assist law enforcement in financial investigations, help prevent evasion of targeted financial sanctions, improve the ability of financial institutions to assess risk, facilitate tax compliance, and advance U.S. compliance with international standards and commitments."

## Customer Due Diligence – the Fifth Pillar of AML Compliance Programs

The Final Rule also supplements pre-existing AML program requirements, deemed the "four pillars" of an AML program, by adding a fifth pillar aimed at making explicit "necessary and critical steps" for compliance with existing suspicious activity reporting requirements already imposed under the BSA.<sup>6</sup> This "fifth pillar" requires that the covered financial institution adopt appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not limited to: "(i) [u]nderstanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and (ii)

<sup>5</sup> In this regard, FinCEN noted that "to be of greatest use, FinCEN believes that beneficial ownership information must be, at the time of account opening, both (1) current, and (2) certified by an individual authorized by the customer to open accounts at financial institutions to be accurate to the best of his or her knowledge." FinCEN Final Rule, Page 33, emphasis added.

<sup>6</sup> The Four Pillars of AML program requirements are: policies, procedures, and internal controls; independent testing; a designated compliance official; and employee training.

[c]onducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.”<sup>7</sup> FinCEN has indicated that covered financial institutions should already be performing activities associated with this fifth pillar in connection with existing suspicious activity reporting (SARs) requirements.

FinCEN has also provided some guidance for complying with these customer due diligence requirements. With respect to developing the customer risk profile, FinCEN stated that: “a customer risk profile refers to the information gathered about a customer at account opening and used to establish a baseline against which customer activity is assessed for suspicious activity reporting.” FinCEN has stated that this process may rely on “self-evident information” such as the type of customer or type of account, service, or product. The profile may also but “need not, include a system of risk ratings or categories of customers.”

With respect to ongoing monitoring, FinCEN explained that the customer risk profile should be used to identify suspicious transactions, such as those that are “not of the sort the customer would be normally expected to engage in.” In essence, the customer risk profile should be integrated into the financial institution’s automated monitoring system, and may be used after a potentially suspicious transaction has been identified, as one means of determining whether or not the identified activity is suspicious.

FinCEN also explained that the covered financial institution must update customer information – including beneficial owner information – when this “normal monitoring” reveals information that would be relevant to assessing the risk posed by the customer. This information could include, for example, a significant and unexplained change in the customer’s activity, such as executing cross-border wire transfers for no apparent reason or a significant change in the volume of activity without explanation. It could also include information indicating a possible change in the customer’s beneficial ownership, because that information could also be relevant to assessing the risk posed by the customer.

FinCEN explained that the monitoring and updating requirement applies to all legal entity customers, including those that pre-date the May 2018 date on which compliance is required.

FinCEN also explained the monitoring and updating provision does not create “a categorical requirement” that financial institutions must update customer information on a continuous or periodic basis. Instead, FinCEN has indicated that the updating requirement should be event-driven, and occur as a result of normal monitoring.

## Conclusion

FinCEN has said that the Final Rule is intended to ensure clarity and consistency across sectors, as well as to bring US AML standards into line with international standards. However, the Final Rule also leaves uncertainties in its wake. For example, there are seeming inconsistencies between the beneficial owner information collection requirements, which FinCEN stated apply only to new accounts, and the customer due diligence requirements, which apply to pre-existing accounts. To the extent that risk profiling under the Final Rule draws on information relating to beneficial owners, then it suggests that covered financial institutions will have to identify beneficial owners of accounts that pre-date the compliance date of the Final Rule. Furthermore, it remains to be seen to what extent the fifth pillar becomes viewed as an independent requirement rather than an articulation of an implicit, existing requirement.

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<sup>7</sup> Under the BSA, federal banking agencies’ examination and enforcement practices have focused on the following four pillars: policies, procedures, and internal controls; independent testing; a designated compliance official; and employee training

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