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Financial Crimes Enforcement Network Pursues New Customer Due Diligence Requirements for Banks' Anti-Money Laundering Programs

Banks are facing the addition of yet another obligation to the already significant requirements of their Anti-Money Laundering (AML) programs – specifically, a requirement to confirm the identity of the “beneficial owner” of any entity that seeks to create a new account. Although the government has asserted that this new requirement, which is expected to be part of a federal regulation finalized in 2015, will impose only limited new burdens on financial institutions, it represents another step in the government’s steady campaign to render banks the “front line” in the fight against money laundering, tax evasion, and terrorist funding.

Banks and other financial institutions must comply with the Bank Secrecy Act (BSA),¹ which requires the implementation and maintenance of adequate AML programs. Customer due diligence – commonly known as Know-Your-Customer, or “KYC” for short – is key to banks’ compliance with the AML program requirements. Failure to maintain sufficiently robust programs can result in civil penalties and, in extreme cases, even in criminal prosecutions.

On August 4, 2014, the Financial Crimes Enforcement Network (FinCEN), the part of the U.S. Department of the Treasury that administers the BSA, proposed new rules clarifying and strengthening the customer due diligence demanded of financial institutions.² Although the majority of the proposed rules are intended to formally codify existing AML program requirements, the proposal also contains a new rule that, if adopted, will significantly increase financial institutions’ already-substantial compliance obligations. Under the proposed rule, banks (and some other

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financial institutions) must identify, verify, and maintain records of the beneficial owners of accountholders that are entities rather than natural persons.

According to FinCEN, requiring identification and verification of entity customers’ underlying beneficial owners serves several purposes. These purposes include (i) generally assisting law enforcement in financial investigations and counterterrorism; (ii) improving

a financial institution’s ability to assess and mitigate risk, and file required Suspicious Activity Reports (SARs); and (iii) advancing commitments made by the U.S. government to share information with foreign governments regarding their own citizens, in order to facilitate reciprocal agreements designed to fight international tax evasion through the exchange of data.³

³*Id.* at 45,153-54.

¹See generally 31 U.S.C. §§ 5311-5332.

²Department of the Treasury, *Customer Due Diligence Requirements for Financial Institutions*, 79 Fed. Reg. 45,151 (Aug. 4, 2014).

Customer Due Diligence

Banks already perform customer due diligence through their Customer Identification Programs (CIPs) and other KYC procedures. FinCEN views customer due diligence as a critical component of combatting money laundering and terrorist financing.⁴ According to FinCEN, customer due diligence has four key elements: (1) identifying and verifying customers' identities; (2) identifying and verifying beneficial owners of legal entity customers; (3) understanding the nature and purpose of customer relationships; and (4) conducting ongoing monitoring to maintain and update customer identification information and to report suspicious transactions.⁵ Only the second element – identification of entity customers' beneficial owners – would, if adopted, represent a new requirement; banks and other financial institutions already must satisfy the other three elements as part of existing BSA and AML program compliance.⁶

The first element is satisfied by the existing requirement that banks maintain CIPs,⁷ which require banks to gather customer information and then verify, to the extent reasonable and practical, customers' identities.⁸ At a minimum, prior to opening an account, the bank must obtain a customer's name, date of birth, address, and an identification number, such as a social security number, passport number, or alien identification card number.⁹ The bank then must verify the customer's identity.¹⁰ For natural persons, this can be done, for example, by reviewing a driver's license. In the case of a customer that is an entity rather than a natural person, this typically involves reviewing certified formation documents, such as articles of incorporation, or a government-issued business license.¹¹

⁴*Id.*

⁵*Id.*

⁶*Id.*

⁷*Id.*

⁸31 U.S.C. § 5318(1).

⁹31 C.F.R. § 1020.220(a)(2)(i)(A).

¹⁰31 C.F.R. § 1020.22(a)(2)(ii).

¹¹31 C.F.R. § 1020.22(a)(2)(ii)(A)(2).

To comply with the CIP requirement, banks only need to verify the proper legal existence of entity customers; the CIP requirement does not require banks to look through entity customers to identify their beneficial owners, i.e., the natural persons who ultimately own and control them.

Beneficial Ownership Identification and Verification

The proposed rule requiring identification of the beneficial owners of entity customers is distinct from, and would be imposed *in addition to*, the CIP requirement. However, it parallels banks' customer identification and verification duties under the CIP requirement. As currently proposed, the rule would apply only to financial institutions that already are subject to the CIP requirement.¹² These institutions, including banks, would be required to identify the natural persons who are "beneficial owners" of "legal entity customers," subject to certain exemptions.¹³ Once identified, these customers' identities must be verified using existing CIP practices.¹⁴

"Legal Entity Customer"

The proposed definition of "legal entity customer" is broad. It encompasses U.S. and foreign corporations, limited liability companies, partnerships, and similar business entities that open new accounts at the bank.¹⁵ Despite this broad definition, some for-profit and non-profit entities are excluded. Entities that are excluded from the definition of "customer" under current CIP regulations¹⁶ are not "legal entity customers" under the proposed rule.¹⁷ Nor are most trusts,¹⁸ federally qualified charities and non-profit entities with tax-

¹²Department of the Treasury, *Customer Due Diligence Requirements for Financial Institutions*, 79 Fed. Reg. 45,151, 45,155 (Aug. 4, 2014).

¹³*Id.* at 45,156.

¹⁴*Id.* at 45,162.

¹⁵*Id.* at 45,159.

¹⁶See 31 C.F.R. § 1020.100(c).

¹⁷Department of the Treasury, *Customer Due Diligence Requirements for Financial Institutions*, 79 Fed. Reg. 45,151, 45,159 (Aug. 4, 2014).

¹⁸Some statutory (i.e., business trusts) are covered. *Id.* at 45,160.

exempt status, or financial intermediaries such as securities and commodity clearing firms and correspondent banks.

Importantly, this definition and the proposed rule requiring identification and verification of beneficial owners applies only to new customers and to those existing customers who open new accounts once the proposed rule becomes effective.²⁰ Banks are *not* required to retrospectively obtain beneficial ownership information on all existing legal entity customers.²¹ To provide banks more time to implement these new requirements, FinCEN has proposed that the rule's effective date be one year from the date that the final version of the rule is issued.²²

"Beneficial Owner"

The August 2014 proposed rule uses two independent tests for determining who qualifies as a "beneficial owner" – an ownership test and a control test. A person only needs to satisfy either one of these tests to qualify as a beneficial owner.²³ However, banks must use both tests and identify beneficial owners under both (unless no one person owns at least 25 percent of the legal entity, in which case no beneficial owner is identified under the ownership test; however, in such a case, a beneficial owner still must be identified under the control test).

Under the ownership test, a person is a beneficial owner if he or she owns, directly or indirectly, 25 percent or more of the equity interests in the legal entity customer.²⁴ "Equity interest" is interpreted broadly. FinCEN intends for it to encompass any ownership interest in a business entity, such as stock, partnership shares, and membership interests.²⁵ Logically, there can be at most four beneficial owners under the

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¹⁹*Id.* at 45,159. See *id.* for a complete list of business entities excluded from the definition.

²⁰*Id.* at 45,160.

²¹*Id.*

²²*Id.* at 45,169.

²³*Id.* at 45,157.

²⁴*Id.*

²⁵*Id.* at 45,158.

ownership test. The bank must identify *each* natural person who owns 25 percent or more of the equity interests.²⁶ If no one person owns 25 percent or more of the legal entity, then the bank is not required to identify any beneficial owners under this test.

When a bank's legal entity customer is, for instance, a subsidiary, *i.e.*, owned in turn by another corporate "parent" entity, the bank must trace through any and all intermediary entity owners in order to identify the natural persons who own the top parent level of the corporate organization(s) that owns the legal entity customer.²⁷ In short, although such tracing may prove difficult and time-consuming, banks must identify beneficial owners "regardless of how many corporate parents or holding companies removed the natural person is from the legal entity customer."²⁸ However, FinCEN simultaneously has stated that it "does not expect financial institutions – *or customers* – to undergo complex and exhaustive analysis to determine with legal certainty whether an individual is a beneficial owner under the definition."²⁹ Given this potentially contradictory guidance, it is unclear how this requirement would work in practice for the individuals who open accounts on behalf of legal entity customers and must certify the accuracy of the beneficial owner identification. That is, in order to provide, and certify the accuracy of, beneficial ownership information, legal entity customers sometimes will be required to undertake "complex and exhaustive analysis," which FinCEN has stated it does not expect them to perform. The guidance apparently poses no parallel problem for banks, which will be entitled to rely on ownership information provided by legal entity customers' representatives.

Under the separate control test for beneficial ownership, an individual who has "significant responsibility to control, manage, or direct a legal entity customer" is a beneficial owner.³⁰ Executive officers and senior managers, or those who perform similar functions, exercise sufficient control to constitute beneficial owners.³¹ Although multiple people at a given legal entity customer likely satisfy the control test, a bank need identify only one individual who satisfies the control test.³² FinCEN also is still considering whether pooled investment vehicles, which would include hedge funds, should be excluded from a bank's requirement to identify beneficial owners, or, alternatively, to apply only the "control" test to pooled investments.³³

Obtaining and Verifying Beneficial Owner Information

To comply with the proposed rule, banks must adopt and employ a standard certification form, provided by FinCEN.³⁴ A bank must obtain from the individual opening an account on an entity customer's behalf a completed standard certification form at the time that a new account is opened.³⁵ This form requires the account opener to identify the legal entity's beneficial owners and provide identifying information for each of them. The required information includes the same information that must be provided for customers pursuant to the CIP requirement: each beneficial owner's name, address, date of birth, and social security or passport number (or similar information for foreign persons).³⁶ The account opener also must certify that the information contained in the form is true and accurate to the best of his or her

knowledge.³⁷

FinCEN has stated that the certification form is designed to help law enforcement demonstrate "unlawful intent in the event the individual completing the form knowingly provides false information."³⁸ However, the form also should play an important role in allowing banks to rely on the representations of customers, as FinCEN has stated that they may. Banks must verify the *identities* of the natural persons disclosed by legal entity customers as beneficial owners in accordance with their existing CIP procedures.³⁹ This includes, for example, reviewing a driver's license or similar identifying document. However, they are *not* required to verify that the identified individuals are in fact beneficial owners – that is, they are not required to research share certificates and the like to ascertain the individuals' claimed status as beneficial owners.⁴⁰ Importantly, FinCEN has stated that banks should be able to rely on customer representations that the identified individuals are in fact beneficial owners. Moreover, requiring certification of the identified beneficial owners' status likely will help deter inaccurate or deceitful identification of beneficial owners. Banks also would be permitted, under certain circumstances, to rely on standard certification forms obtained by other financial institutions for shared customers.⁴¹

Conclusion

The proposed beneficial ownership identification and verification rule certainly will increase banks' customer due diligence burden. Obtaining necessary information from account openers likely presents new challenges, as those opening accounts may be required to provide detailed ownership

²⁶*Id.* t 45,157.

²⁷*Id.*

²⁸*Id.* at 45, 158.

²⁹*Id.* at 45,160-61.

³⁰A copy of the standard certification form was attached to the proposed rulemaking as Appendix A. See *id.* at 45,172. It is a one page form entitled "Certification of Beneficial Owner(s)."

³¹*Id.* at 45,162.

³²*Id.* at 45,171.

³⁷*Id.* at 45,162.

³⁸*Id.*

³⁹*Id.*

⁴⁰*Id.* at 45,158.

⁴¹*Id.* at 45,163.

²⁶*Id.*

²⁷*Id.*

²⁸*Id.*

²⁹*Id.* (emphasis added).

FinCEN has stated that it has attempted to ease the proposed rule's burden. First, banks have a year from the date that the proposed rule is finalized to come into compliance. Second, compliance will be easier because legal entity customer identification information can be verified through existing CIP procedures. Third, banks need not verify individuals' status as beneficial owners.

information about parent corporations about which they may lack familiarity or ready access. This problem likely will be compounded for foreign entity customers, particularly those based in nations with robust privacy and secrecy laws. The fact that the government often focuses on transactions involving foreign customers when scrutinizing whether a bank has complied with its AML requirements ensures that the heightened practical problems of identifying foreign entity owners also will involve heightened legal risks.

FinCEN has stated that it has attempted to ease the proposed rule's burden. First, banks have a year from the date that the proposed rule is finalized to come into

compliance. Second, compliance will be easier because legal entity customer identification information can be verified through existing CIP procedures. Third, banks need not verify individuals' status as beneficial owners. Nonetheless, given existing customer due diligence and BSA/AML compliance protocols, banks always must remain vigilant for suspicious circumstances that arise during the account opening process. The lack of a new requirement to verify the status of individuals as beneficial owners does not mean that traditional KYC requirements have been lessened.

Although the precise provisions of the rule may change before its final adoption, the final rule most likely will

resemble closely the current proposal described here. The rule already has been the subject of public comment, which closed on October 3, 2014, and has been modified in response since it first was contemplated publicly by FinCEN as far back as March 2012.⁴² Thus, banks should prepare to begin identifying legal entity customers' beneficial owners. More generally, banks should expect to continue to play an increasingly large role in the government's efforts to combat money laundering, tax evasion, and terrorist financing, particularly as financial information sharing agreements between nations proliferate.

⁴²Department of the Treasury, *Customer Due Diligence Requirements for Financial Institutions*, 77 Fed. Reg. 13,046 (March 5, 2012).

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