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FinCEN Issues Frequently Asked Questions Regarding Customer Due Diligence Requirements

Frequently Asked Questions Clarify Aspects of Beneficial Ownership Threshold, Identity Collection and Verification, and Ongoing Customer Due Diligence Obligations

EXECUTIVE SUMMARY

The Customer Due Diligence Rules (“CDD Rules”), which will become applicable on May 11, 2018, require federally regulated banks, federally insured credit unions, mutual funds, brokers or dealers in securities, among others (the “Covered Financial Institutions”) to collect and verify the identity of beneficial owners of legal entity customers. The Financial Crimes Enforcement Network (“FinCEN”) issued Frequently Asked Questions (“FAQs”) on April 3, 2018 to assist Covered Financial Institutions in understanding the scope and application of the CDD Rules. Several of the more noteworthy aspects of the FAQs are discussed below. The FAQs provide Covered Financial Institutions a modicum of relief and clarity, particularly in permitting, in limited circumstances, reliance on previously collected information to satisfy beneficial ownership obligations and explaining when it may be appropriate for beneficial ownership information to be collected at thresholds lower than 25 percent and how to calculate indirect ownership interests. However, the FAQs also raise several questions that Covered Financial Institutions will almost certainly grapple with, even as May 11 is just around the corner. And, until the federal banking agencies provide needed guidance, Covered Financial Institutions will continue to struggle with understanding the standards against which their compliance with the CDD Rules will be assessed.

BACKGROUND

The CDD Rules require Covered Financial Institutions to collect and verify the identity of two types of beneficial owners of legal entity customers at the time of opening an account. First, under the “ownership prong,” Covered Financial Institutions must obtain and verify the identity of any individual who directly or indirectly owns 25 percent or more of the equity interests of a legal entity customer. Second, under the “control prong,” they must collect and verify the identity of one individual with significant responsibility to control, manage, or direct a legal entity customer (such as an executive officer or senior manager).

In addition, the CDD Rules revise the anti-money laundering (“AML”) program requirements for Covered Financial Institutions to include four elements: (i) customer identification and verification; (ii) beneficial ownership identification and verification; (iii) understanding the nature and purpose of customer relationships to develop a customer risk profile and (iv) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information.

The FAQs provide guidance to Covered Financial Institutions on aspects of these requirements, which become applicable on May 11, 2018. The rules were initially proposed and discussed in an Advance Notice of Proposed Rulemaking dated March 5, 2012, and a Notice of Proposed Rulemaking dated August 4, 2014. The Final Rules were published on May 11, 2016, followed in short order by an initial set of Frequently Asked Questions dated July 19, 2016.

A. COLLECTION AND VERIFICATION OF IDENTIFYING INFORMATION

The CDD Rules require Covered Financial Institutions to collect and verify beneficial ownership information at the time of opening a new account by a legal entity customer. Put another way, under the CDD Rules, a Covered Financial Institution must identify the beneficial owners of an existing legal entity customer *each time* that same customer opens another account. Similarly, a Covered Financial Institution must identify and verify the beneficial owners of a new legal entity customer *even if* the beneficial owners of the legal entity opening those accounts are already existing customers of the institution. Further, because “account” is defined broadly for purposes of the CDD Rules, *each time* an existing legal entity customer renews a financial product, such as a loan or certificate of deposit, a Covered Financial Institution is required to identify and verify the beneficial owners.

Both before the CDD Rules were finalized and subsequently, industry members expressed concerns about the burdens associated with the account-based beneficial ownership identification and verification requirements in particular circumstances. For example, under the CDD Rules, when a large corporate customer for which beneficial ownership information has already been collected and verified opens a large number of accounts at substantially the same time—a not uncommon occurrence at large financial institutions—the institution is required *for each such account* to separately identify and verify beneficial ownership information.

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Instead of this account-based approach, industry members argued in favor of a customer-based approach under which, once a Covered Financial Institution has collected and verified a legal entity customer's beneficial ownership information, the opening of a new account by that same customer would not trigger a new collection and verification. Instead, industry members argued, a Covered Financial Institution should be able to determine whether new collection and verification is necessary based on whether it has a reasonable belief that it has identified the beneficial owners according to CDD Rules standards.

Although FinCEN did not adopt this customer-based approach, the FAQs arguably reflect a significant step in that direction. Specifically, the FAQs identify three circumstances in which a Covered Financial Institution may, instead of undertaking a new collection and verification of beneficial ownership information, rely on previously collected information that the customer "certifies or confirms."

- 1. When a Legal Entity Customer Opens Multiple Accounts (FAQ 10).** If a legal entity customer opening an additional account has in the past submitted beneficial ownership information pursuant to the CDD Rules, the Covered Financial Institution may rely on the previously delivered information (and need not secure new, separately certified beneficial ownership information) as long as the customer representative certifies or confirms (verbally or in writing) that the previously delivered information is up to date and accurate at the time each additional account is opened and the financial institution has no knowledge of facts that would reasonably call into question the reliability of such information. The Covered Financial Institution would need to keep a record of the certification or confirmation, including any verbal confirmation.
- 2. When an Existing Customer is a Beneficial Owner of a New Legal Entity Customer Account (FAQ 7).** If the beneficial owner of a legal entity customer is also an existing customer of the Covered Financial Institution and is subject to its Customer Identification Program ("CIP"), the Covered Financial Institution may rely on information in its possession to fulfill the CDD Rules' identification *and* verification requirements, provided the information is up-to-date, accurate, and the legal entity customer's representative certifies or confirms (verbally or in writing) the accuracy of the pre-existing CIP information. The Covered Financial Institution's records of beneficial ownership for the new account could cross-reference the relevant CIP records.
- 3. When an Existing Customer Renews a Financial Product or Service (FAQ 12).** Once a Covered Financial Institution has secured certified beneficial ownership information for a legal entity customer of a product or service, the institution may rely on that previously delivered information at the time of subsequent renewals of the same product or service by that same customer, provided the customer certifies or confirms that the beneficial ownership information that was previously provided is accurate and up-to-date and the financial institution has no knowledge of facts that would reasonably call into question the reliability of such information. Notably, in the context of a loan renewal or certificate of deposit, if the customer agrees at the time it certifies beneficial ownership information that it will notify the institution of any changes in such information, FinCEN will permit the agreement to be considered the requisite certification or confirmation and it should be documented and maintained as such.

In the FAQs, FinCEN does not dictate the form a customer certification or confirmation should take or the manner in which it should be secured, although it should be recorded and maintained. Although this will permit institutions discretion to tailor their approach to their unique circumstances and the risks presented

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by particular customers, it may also prompt questions, including whether it would be appropriate to incorporate the certification or confirmation into standard new account documentation.

B. BENEFICIAL OWNERSHIP THRESHOLD

The 25 percent beneficial ownership threshold is another aspect of the CDD Rules that has been the source of industry concern and commentary. In the preamble to the final CDD Rules, FinCEN stated: “the 25 percent threshold is the baseline regulatory benchmark, but [] covered financial institutions may establish a lower percentage threshold for beneficial ownership (*i.e.*, one that regards owners of less than 25 percent of equity interests as beneficial owners) based on their own assessment of risk in appropriate circumstances. As a general matter, FinCEN does not expect covered financial institutions’ compliance with this regulatory requirement to be assessed against a lower threshold.” Subsequently, it was publicly reported that the 25 percent beneficial ownership threshold may be viewed only as a starting point by the federal banking agencies, which will examine financial institutions for compliance with the CDD Rules, and that these agencies intend to enforce lower thresholds when customers present higher risks. The seeming contradiction between the CDD Rules’ 25 percent threshold and the possible enforcement of lower thresholds generated confusion and requests for clarification from industry members.

In the FAQs, FinCEN appears to have tried to provide clarity in two respects:

- 1. The threshold for complying with the CDD Rules’ beneficial ownership standard is 25 percent (FAQ 1).** According to the FAQs, the CDD Rules establish a 25 percent beneficial ownership standard, and a Covered Financial Institution therefore will meet its obligations under the CDD Rules’ ownership prong by collecting information on individuals, if any, who hold, directly or indirectly, 25 percent or more of the equity interest in a legal entity customer. A Covered Financial Institution may choose to collect at a threshold below 25 percent (or to collect information on more than one individual with managerial control under the control prong), but doing so goes beyond the CDD Rules’ ownership prong (or control prong) requirements.
- 2. Collecting at a lower threshold (or taking other steps to mitigate risks) may be appropriate to ensure compliance with other AML program-related obligations (FAQ 2).** A Covered Financial Institution’s AML program must include appropriate risk-based procedures for conducting customer due diligence. Customer due diligence enables financial institutions to understand the risks associated with their customers, to monitor accounts more effectively, and to evaluate activity to determine whether it is suspicious for purposes of complying with suspicious activity reporting obligations. Accordingly, transparency in beneficial ownership—*i.e.*, the 25 percent threshold—is only one aspect of a Covered Financial Institution’s customer due diligence obligations. Given that, there may be circumstances in which, based on an institution’s own assessment of its risk related to a customer, collecting and verifying beneficial ownership at a threshold below 25 percent may be warranted. Conversely, FinCEN recognizes in the FAQs that there may also be circumstances in which an institution may reasonably conclude that collecting beneficial ownership information at a threshold below 25 percent would not help mitigate the specific risk posed by the customer or otherwise provide information useful in analyzing such risk. Rather, a Covered Financial Institution may determine that heightened risk could be mitigated by other reasonable means, such as enhanced monitoring or collecting other information, including expected account activity, in connection with the particular legal entity customer.

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It is important that Covered Financial Institutions establish and maintain written procedures that are reasonably designed to identify and verify the identity of beneficial owners of legal entity customers and to include such procedures in their AML compliance program.

C. CALCULATION OF INDIRECT OWNERSHIP INTEREST

In the final CDD Rules, FinCEN provided several simple examples of how beneficial ownership should be identified in particular corporate structures, but explicitly declined, in response to comments, to provide additional guidance and examples of how legal entity customers should calculate ownership interests when natural persons have indirect equity interests. In the FAQs, FinCEN revisits its prior position, providing an example of how FinCEN expects the 25 percent ownership threshold to apply when ownership by natural persons is held indirectly through multiple corporate structures. According to the FAQs (FAQ 3), natural persons in the ownership chain should be identified any time they indirectly own in the aggregate 25 percent or more of the equity interests of the legal entity customer. The 25 percent threshold is an aggregate calculation performed without regard to whether the natural person owns 25 percent or more of one or more of the legal entities in the ownership chain.

The FAQs leave unclear the threshold, if any, at which an entity's equity interest in a legal entity triggers the need to identify beneficial owners. The FAQs suggest the threshold may be 25 percent—*i.e.*, that beneficial owners need not be identified for any entity that owns less than 25 percent of the legal entity customer—but do not explicitly state as much and the aggregation principle in the FAQs leaves doubt in that regard.

D. ACCOUNTS FOR INTERNAL RECORDKEEPING OR OPERATIONAL PURPOSES

The CDD Rules' beneficial ownership requirements apply every time a legal entity customer opens a "new account." In the securities and futures industries in particular, Covered Financial Institutions, after having opened a new account for a legal entity customer and identified and verified beneficial ownership, often open additional accounts or subaccounts for that customer. In response to questions as to whether these additional accounts qualify as "new accounts," FinCEN explains that, in limited circumstances, they do not. Pointing to the definition of "new account" as an "account opened ... by a legal entity customer," the FAQs distinguish between such accounts and accounts opened by a Covered Financial Institution. Specifically, under the FAQs, an account or subaccount created by a Covered Financial Institution for its own administrative or operational purposes (and not at the customer's request) and where the financial institution has already collected beneficial ownership information on the legal entity customer is not opened by a customer and does not qualify as an "account" or "new account" for purposes of the CDD Rules. In contrast, accounts or subaccounts created to accommodate a trading strategy being carried out by a *separate* legal entity, such as a subsidiary, or through which the customer of a financial institution's existing legal entity customer carries out trading activity directly through the financial institution without intermediation from the existing legal entity customer *would* qualify as accounts.

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E. ENTITIES LISTED ON FOREIGN EXCHANGES

Another aspect of the CDD Rules that has been the source of industry concern and commentary is the rules' failure to exclude entities listed on foreign exchanges from the definition of "legal entity customer." The absence of such an exclusion means that a Covered Financial Institution generally must collect and verify the identity of the beneficial owners of such entities. In the FAQs (FAQ 24), FinCEN reiterates its position that entities listed on a foreign exchange are not excluded, explaining that entities whose shares are listed on foreign exchanges may not be subject to the same public disclosure requirements as companies publicly traded in the United States (which are excluded). Furthermore, FinCEN declines to permit Covered Financial Institutions to take a risk-based approach in collecting beneficial ownership information from legal entity customers that are listed on foreign exchanges, instead simply noting that an institution may rely on such an entity's public disclosure unless there is reason to believe it is inaccurate or stale.

F. CURRENCY TRANSACTION REPORTING

Several questions have arisen concerning the interplay between Covered Financial Institutions' obligations under the CDD Rules to identify beneficial owners and their obligations to aggregate transactions and identify beneficiaries for purposes of filing Currency Transaction Reports ("CTRs"). The FAQs provide clarification in two respects.

- 1. Aggregation of commonly-owned legal entity customers generally is not required (FAQ 32).** When legal entity customers share a common owner, Covered Financial Institutions should presume that the different businesses are operating separately and independently from each other and from the common owner, absent indications to the contrary (*e.g.*, the businesses are staffed by the same employees and are located at the same address, or repeated use of one business's account to pay the expenses of the other business or of the common owner). Accordingly, absent such indications, financial institutions should not aggregate transactions involving those businesses with each other or with the common owner for purposes of filing a CTR.
- 2. Beneficial owners generally do not need to be listed as beneficiaries in CTRs (FAQ 33).** A Covered Financial Institution is not required to list beneficial owners of an account as a matter of course when completing CTRs. Rather, a beneficial owner must be listed in a CTR *only if* the financial institution has knowledge that the transaction requiring the filing is made on behalf of the beneficial owner and results in either cash in or cash out totaling more than \$10,000 during any one business day.

CONCLUSION

The FAQs provide Covered Financial Institutions a modicum of relief and clarity as to several aspects of the CDD Rules. In particular, Covered Financial Institutions will almost certainly welcome the ability they now have under the FAQs, in limited circumstances, to rely on previously collected information to satisfy beneficial ownership obligations. Covered Financial Institutions will probably also appreciate the added clarity the FAQs provide concerning CDD Rule ownership prong compliance and the circumstances in which it may be appropriate to collect beneficial ownership at lower thresholds, as well as the explanation

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of how to calculate indirect ownership in certain circumstances. However, the FAQs also raise several questions that Covered Financial Institutions will continue to grapple with, several of which we have highlighted above, even as May 11 fast approaches. Critically, until the federal banking agencies provide needed guidance, Covered Financial Institutions will continue to struggle with understanding the standards against which their compliance with the CDD Rules will be assessed.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

Thomas C. Baxter Jr.	+1-212-558-4324	baxtert@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjee@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Charles C. Gray	+1-212-558-4410	grayc@sullcrom.com
Shari D. Leventhal	+1-212-558-4354	leventhals@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Stephen M. Salley	+1-212-558-4998	salleys@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com

SULLIVAN & CROMWELL LLP

Washington, DC

Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com

Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
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Paris

William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
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Melbourne

Robert Chu	+61-3-9635-1506	chur@sullcrom.com
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Tokyo

Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
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