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Bruce Zagaris explains what the US Treasury's final rules on customer due diligence mean for US financial institutions

KEY POINTS

WHAT IS THE ISSUE?
The US Treasury Department has issued final rules on customer-due-diligence (CDD) requirements for financial institutions (FIs).

WHAT DOES IT MEAN FOR ME?
Transactions and FIs dealing with the US face increased anti-money laundering requirements, especially CDD requirements.

WHAT CAN I TAKE AWAY?
US FIs will more closely scrutinise their customers against their customers' risk profile and, where necessary, will close relationships with customers, including correspondent bank relationships and product lines, to comply.

On 5 May 2016, the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Department of the Treasury, issued final rules under the *Bank Secrecy Act* (BSA) to clarify and strengthen customer-due-diligence requirements for financial institutions (FIs). The final rules are effective as of 11 July 2016.[1] Covered FIs must comply with the rules by 11 May 2018.

FinCEN explains that, presently, FIs do not have to know the identity of individuals who beneficially own or control the legal entity/clients of FIs. As a result, criminals and others who are trying to hide proceeds of crime are able to access the financial system anonymously. The beneficial-ownership requirement will address this weakness and require FIs to obtain and provide information on such individuals, thereby helping law enforcement in financial investigations, helping to prevent evasion of targeted financial sanctions, improving the ability of FIs to assess risk, facilitating tax compliance, and advancing US compliance with international standards and commitments. Additionally, the final rules support the Treasury's continuing work with the G20 Finance Ministers and Central Bank Governors, the Financial Action Task Force, and the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes. It furthers the US' G8 commitment to entity transparency.

FinCEN has determined that more explicit rules for FIs with respect to customer due diligence (CDD) are required to clarify and strengthen CDD within the BSA regime. The final rules contain the key elements of CDD: (1) identifying and verifying the identity of customers; (2) identifying and verifying the identity of beneficial owners of legal-entity customers (i.e. the natural persons who own or control legal entities); (3) understanding the nature and purpose of customer relations; and (4) conducting ongoing monitoring.

FinCEN initiated the rule-making process in March 2012 by issuing an Advance Notice of Proposed Rulemaking (ANPRM), and on 4 August 2014 issued the Notice of Proposed Rulemaking (NPRM) that described FinCEN's proposal to codify explicit CDD requirements. The Treasury held five hearings from July to December 2012 to solicit comments on the ANPRM. FinCEN ultimately received 90 comments on the ANPRM and 140 comments on the NPRM, raising concerns ranging from the potential costs and practical challenges associated with a categorical requirement to obtain beneficial-ownership information to expressing concerns with respect to FinCEN's understanding of the 'nature and purpose of customer relationships' and ongoing monitoring requirements. The commenters stated that, contrary to FinCEN's stated intention, these requirements would in part be new requirements, rather than an explicit codification of pre-existing obligations. FinCEN responded by pointing out that the final rules codify the CDD requirements that were already contained in its guidance and regulatory audit programmes.

Based on comments that FIs needed more time to comply, especially to acquire hardware and software upgrades, FinCEN extended the deadline to comply from one to two years.

THE FINAL RULES

The new rules require covered FIs to obtain and verify information from any new clients about 'any individual who owns, whether directly or indirectly, 25 per cent or more of the legal entity'. Due to comments from the financial industry, FinCEN abandoned a rule that would have required institutions to identify the owner that had the highest equity stake relative to other shareholders, even when no owner had an equity stake greater than 25 per cent.[2] Under the final rule, the FI must obtain the beneficial owner's name, date of birth, address, and social security number or passport number/country of issuance. The FI must also obtain the same information for at least one individual who controls or manages the legal entity (who might also be a beneficial owner).

Under the control test, FIs must collect and verify information for a single individual who has 'significant responsibility to control, manage, or direct a legal entity customer', such as a chief executive, president, or similar 'executive officer or senior manager'.

The FI must take reasonable steps to verify the accuracy of the information obtained about each beneficial owner.

The final rules include an optional form for use to obtain and verify beneficial-ownership information. The individual opening the account for a legal entity must sign the form.

The FIs must retain records of the information they obtain regarding beneficial ownership. The records must include, at a minimum, the identifying

information obtained (including the certification form, if used); and a description of documents that the FI reviewed to verify the beneficial owner's identity. The FI must retain the identification records for five years after the account is closed and retain the verification records for five years after the record is made.

The final rules exclude from the definition of 'legal entity customer' the following: a bank holding company; a pooled investment vehicle that is operated or advised by a financial institution; an insurance company regulated by a state; a financial market utility; a foreign financial institution established in a jurisdiction where the regulator of such institutions maintains beneficial-ownership information regarding such institutions; a non-US governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; any legal entity only to the extent that it opens a private banking account for non-US persons that are subject to FinCEN's private-banking-account regulations; non-excluded pooled investment vehicles, such as non-US managed mutual funds, hedge funds and private equity funds; charities; intermediated relationships; and non-profit entities.

The final rules also exclude escrow accounts set up by lawyers. Some civil society organisations have criticised this aspect of the final rules, while Bar associations have fought to exempt escrow accounts from being subject to CDD.[3]

The final rules explicitly require a covered FI to understand the nature and purpose of customer relationships in order to develop a customer-risk profile. According to FinCEN, covered FIs should already satisfy this requirement by virtue of complying with the existing requirement to identify and report suspicious activity under the BSA. Hence, FinCEN does not anticipate that this requirement will force covered financial institutions to modify existing AML practices and procedures.

As the final 'pillar' of CDD codified by the final rules, FIs would be required to conduct ongoing monitoring for the purpose of maintaining and updating customer information, and identifying and reporting suspicious activity.

ANALYSIS

Many commenters noted the practical difficulties resulting from the fact that there is no authoritative source for beneficial-ownership information of legal entities, as there is no requirement for US states to collect this information at the time a company is formed.

One apparent loophole is for an organisation to structure investment so that no investor meets the proposed 25 per cent ownership threshold, in which case only a senior manager will need to be listed.

As a result of comments from the financial industry, the final rules apply only prospectively, rather than forcing retroactive applicability with respect to existing accounts.

The final rules provide for optional use of a standardised form for recording beneficial ownership information, thereby providing flexibility for FIs.

Some commenters representing the securities and futures industries asserted that, contrary to assumptions in the NPRM, several of the CDD requirements did not yet in fact exist in those industries and that such requirements would be unduly burdensome and of little utility.

At present, a weakness in the final rules is the reliance on self-certification of beneficial ownership. FinCEN decided against any requirement to verify, except the requirement to verify the customer's identity. In this regard, FinCEN listened to the comments from the financial industry, conceding that requiring FIs to take further steps to verify beneficial-ownership information would be too onerous and burdensome.

The large number of exemptions raises implementation challenges and costs for FIs, who must redesign their hardware, software and training to navigate the maze of exemptions.[4]

The CDD rules are part of a Treasury Department initiative operating alongside beneficial-ownership draft legislation. The rules focus on FIs knowing who their legal-entity customers are, regardless of where those entities are formed, as part of due diligence. The legislation focuses on ensuring that legal entities formed in the US are more transparent to law enforcement, regardless of where they conduct their financial activity. A major challenge for the Obama administration is to find sufficient support to enact the legislation.

Most importantly, the final rules will require FIs to strengthen their AML due-diligence programmes; in turn, FIs will require other fiduciaries with which they deal to submit more information. Additionally, FIs will be more likely to decline new business, close accounts where CDD raises red flags, and close correspondent accounts where FIs cannot ascertain that their correspondent banks know their customers' customers and adhere to proper CDD. The final rules will help FIs furnish information for the Common Reporting Standard, should the US decide to participate.

Despite the final rules, the US does not meet international standards on entity transparency and the gatekeeper standards from 2003. The US declined to promise to undertake exchange of beneficial-ownership information at the global Anti-Corruption Summit on 12 May 2016 in London,[5] and similarly chose not to join the G5 announcement on 14 April 2016 on exchange of beneficial-ownership information.[6]

For STEP, the issue is whether the international AML standards, which include the entity-transparency and gatekeeper rules, can be properly implemented without a level playing field, especially when the world's superpower has been out of compliance for 13 years.

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1 For a text of the final CDD rules, see www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf
2 Jamal El-Hindi, Deputy Director, FinCEN, speech to Institute of International Bankers Annual Anti-money Laundering Seminar, 16 May 2016
3 For example, Mark Hays of Global Witness noted that one lawyer suggested using escrow accounts as a way to avoid money-laundering requirements. For more information, see JP Finet and William Hoke, 'Obama addresses tax avoidance by targeting shell companies', *Worldwide Tax Daily*, 89-2 (9 May 2016)
4 Brian Monroe, 'Along with implementing finalized CDD "beneficial ownership" rule, financial institutions must navigate maze of exemptions', ACFCS News (12 May 2016)
5 Bruce Zagaris, 'Anti-corruption global summit focuses on exchanging beneficial ownership information', 32 *International Enforcement Law Reporter* 188 (May 2016)
6 Bruce Zagaris, 'G5 countries agree to exchange beneficial ownership information and G20 mandates the OECD to develop criteria to identify non-cooperative countries by July', 32 *International Enforcement Law Reporter* 122 (May 2016)

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