

**MEMO# 28307**

August 11, 2014

## **FinCEN Proposes Customer Due Diligence Rules**

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TO: AML COMPLIANCE WORKING GROUP No. 3-14  
BROKER/DEALER ADVISORY COMMITTEE No. 41-14  
SEC RULES COMMITTEE No. 32-14  
TRANSFER AGENT ADVISORY COMMITTEE No. 51-14 RE: FINCEN PROPOSES CUSTOMER DUE DILIGENCE RULES

On July 30, 2014, the Financial Crimes Enforcement Network (FinCEN) issued proposed rules to strengthen and clarify customer due diligence (“CDD”) requirements under the Bank Secrecy Act (“BSA”) for banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities (“Proposal”). [\[1\]](#) The Proposal follows significant dialogue and public consultation on CDD and beneficial ownership information that has been ongoing since 2010 as described below. The Proposal does reflect many of the comments of the Institute and others.

The proposed rules set forth explicit CDD requirements and include a requirement to identify beneficial owners of “legal entity customers,” with certain exemptions (e.g., those entities that are exempt from customer identification program (“CIP”) requirements). The proposed beneficial ownership requirement would apply only with respect to legal entity customers that open new accounts on or after the effective date of a final rule. The effective date of any final CDD rule and other rule amendments is proposed to be one year from issuance of a final rule.

Comments are due October 3, 2014. The Institute intends to submit a comment letter. We will be sending additional information regarding a member call.

### **Background**

Over the past several years, there have been significant discussions regarding CDD and beneficial owners in the United States and globally, through organizations like the Financial Action Task Force (“FATF”) of which the United States is a member. The Institute and industry have followed, and actively participated in, these discussions.

Federal Financial Regulator Guidance (2010). In March 2010, FinCEN, the Securities and

Exchange Commission (“SEC”), and certain other federal financial regulators issued guidance regarding customer due diligence and beneficial ownership information, Guidance on Obtaining and Retaining Beneficial Ownership Information (the “Guidance”). [2] The stated purpose was to clarify and consolidate existing regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships under the anti-money laundering (“AML”) rules issued pursuant to the Bank Secrecy Act (“BSA”). [3] The Institute, the Securities Industry and Financial Markets Association, and the Futures Industry Association (the “Associations”) submitted a letter expressing substantial concerns with the Guidance. [4] The Associations stated that the concept of CDD described in the Guidance was not addressed in the BSA rules applicable to the securities and futures industries, and that the CDD expectations had not been previously communicated to the industry. The Associations also observed that certain aspects of the Guidance appeared to conflict with CDD expectations embodied in FATF standards and CDD guidance previously provided to the banking industry. [5] In this Proposal, FinCEN states that the “future status” of the Guidance will be addressed at the issuance of a final rule. [6]

Advance Notice of Proposed CDD Rulemaking and Public Hearings (2012). Following the guidance in February 2012, FinCEN issued an advance notice of proposed rulemaking (“ANPRM”) to solicit comment on a wide range of questions pertaining to CDD, including a requirement for financial institutions to identify beneficial ownership of accountholders. [7] The Institute submitted a comment letter raising numerous and significant concerns. [8] Following the ANPRM, FinCEN hosted several hearings and roundtables around the country seeking public input and discussion on the ANPRM. Members and/or the Institute participated in all five of these hearings.

FATF Revised Recommendations (2012). During 2010 and 2011, FATF developed and consulted on various revisions to its Recommendations, culminating in the publication of revised Recommendation in February 2012. [9] The Recommendations are international standards for countries to implement through measures adapted to their particular circumstances. Important changes and clarifications were included in the revisions relating to CDD and beneficial ownership information.

## **Proposed New Rule and AML Program Rule Amendments**

In the Proposal, FinCEN states CDD consists, at a minimum, of the following four elements:

1. Identifying and verifying the identity of customers (is satisfied by existing identification CIP requirements);
2. Identifying and verifying the identity of beneficial owners of certain legal entity customers;
3. Understanding the nature and purpose of customer relationships; and
4. Conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

The proposed rules address elements 2, 3 and 4. The second element is proposed as a new rule -31 CFR 1010.230 - and the third and fourth elements are proposed to be explicitly added to applicable AML program rules, e.g. for mutual funds - 31 CFR 1024.210. There are also record retention requirements that follow the record keeping standards under the CIP rules (proposed 31 CFR 1010.230(f)). Reliance on other financial institutions is also permitted as it is under applicable CIP rules (proposed 31 CFR 1010.230(g)).

Importantly, the requirements contained in this Proposal are intended to be consistent with, and not supersede, any regulations, guidance or authority of any federal financial regulator

relating to customer identification.

## **Element 2 - Identifying and Verifying Beneficial Owners of Certain Customers**

FinCEN is proposing a new requirement for certain financial institutions ("FIs"), including mutual funds, to identify natural persons who are beneficial owners of legal entity customers, subject to certain exemptions. The definition of "beneficial owner" requires that the identified person be a natural person. To satisfy this requirement, the FI must, at the time a new account is opened, obtain a standard certification directly from the individual opening the account for the legal entity customer.

FIs must identify beneficial owners consistent with CIP practices but are not required to verify that a natural person is in fact a beneficial owner. FinCEN states this means the FI will verify the identity of beneficial owners but will not verify their status as a beneficial owner. FinCEN asserts that this requirement is the only new requirement imposed in the rulemaking.

**Exemption and Exclusion from Beneficial Owner Requirement.** The Proposal exempts from the beneficial ownership requirement those types of entities that are exempt from customer identification requirements under the CIP rules, including but not limited to federally regulated financial institutions, certain publicly traded companies and domestic government entities and agencies. The exemptions are incorporated by excluding them from the definition of "legal entity customer" which corresponds to how the entities are excluded from CIP, i.e., by excluding them from the definition of customer. The exemption includes all exclusions based on guidance issued by FinCEN and the other federal financial regulators with regard to the applicability of the CIP rules, e.g., guidance clarifying who is the "customer" in a particular relationship.

FinCEN also proposes certain specific entities for exemption from the beneficial ownership requirement, including public accounting firms registered under the Sarbanes-Oxley Act, investment companies registered under the Investment Company Act of 1940, investment advisers registered under the Investment Advisers Act of 1940, and entities registered under the Securities and Exchange Act of 1934.

**Intermediated Account Relationships.** For purposes of the beneficial owner requirement, if an intermediary is the customer and the FI has no CIP obligation with respect to the intermediary's underlying clients under existing guidance, the FI can treat the intermediary, and not the intermediary's clients, as its legal entity customer. Existing FinCEN guidance for CIP is to be used for determining the FI's beneficial ownership obligation in these circumstances.

FinCEN is considering whether nonexempt pooled vehicles advised or operated by FIs that are proposed to be exempt also should be exempt from the beneficial owner requirement or if its application should be modified in this circumstance, such as only requiring identification of beneficial owners under the control prong of the definition of beneficial owner (described below).

**Identification and Verification (proposed 31 CFR 1010.230(b)).** To identify a beneficial owner, the FI must obtain a signed certification (form included in the Proposal) from the individual opening the account for a legal entity. Information required for the form includes the identity of the beneficial owners of the entity - name, date of birth, address and social security number for US persons or, for foreign persons, a passport number and country of

issuance (or similar identification number). This verification is intended to follow the same verification procedures applicable to an individual opening an account under existing CIP and under the same documentary and non-documentary methods.

FinCEN did not propose a requirement to update beneficial ownership information but stated CDD information, including beneficial ownership information, should be kept as current as possible on a risk-basis. FinCEN also stated that in general a FI may rely on another FI to conduct CIP on shared customers subject to certain conditions.

Beneficial Owner Definition (proposed 31 CFR 1010.230(c)). The proposed definition includes an ownership and a control prong. The FI must identify each individual under the ownership prong – each individual owning, directly or indirectly, 25% or more of equity interests – and one individual under the control prong. If there is no individual under the ownership prong, then the FI can identify a beneficial owner under the control prong only. The term “equity interest” is intended to be interpreted broadly, i.e., an ownership interest in the entity.

Specifically, FinCEN proposes the following definition of a beneficial owner of a legal entity customer:

1. Each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25% or more of the equity interests of a legal entity customer;
2. A single individual with significant responsibility to control, manage, or direct a legal entity customer, including:
  - i. An executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or
  - ii. Any other individual who regularly performs similar functions.

With respect to how this requirement affects rules under Section 312 of the USA PATRIOT Act, the Proposal provides that it would apply to all legal entity customers, including legal entities that open a foreign private banking account.

The proposed requirements would not apply to the beneficial owner of funds or assets in a payable-through account of the type described in § 1010.610(b)(1)(iii) (correspondent accounts for foreign financial institutions), since the owner of such funds or assets does not have an account relationship with the covered financial institution.

In those circumstances, compliance with the information requirements included in § 1010.610 would be adequate.

Legal Entity Customer Definition (proposed 31 CFR 1010.230(d)). The definition of “legal entity customer” under the Proposal is a corporation, limited liability company, partnership or similar business entity (whether formed under US or foreign law) that opens a new account, i.e., a legal entity customer’s account opened after the effective date of a final rule.

This definition does not include trusts other than those created through a filing with a state, e.g., a statutory business trust. While trusts are not included, FinCEN understands that FIs currently take a risk-based approach to collecting information with respect to trusts and expects FIs to continue those practices while FinCEN considers possible future guidance or rules.

## **Elements 3 and 4- Understanding the Nature and Purpose of Customer Relationships for Monitoring/Reporting Suspicious Activity**

FinCEN is proposing amendments to the AML program rules to explicitly address elements 3 and 4 and to codify the baseline standard of due diligence for an AML program. Element 3 requires FIs to understand the nature and purpose of customer relationships in order to develop a customer risk profile which FinCEN states is necessary to comply with required suspicious activity reporting under the BSA. Ongoing monitoring, element 4, is necessary for maintaining and updating customer information and identifying and reporting suspicious activity.

FinCEN also states that the incorporation of these elements into the AML program rules makes clear that a FI's procedures with respect to these requirements are subject to examination and enforcement by appropriate regulators.

**Understanding the Relationship.** FinCEN states that it does not necessarily intend to modify existing practices with respect to industry approaches to understanding their customers and does not expect FIs to ask each customer for a statement as to the nature and purpose of the relationship. FinCEN instead believes it is clarifying expectations for FIs. FinCEN states that it recognizes some inherent information about a customer relationship such as the type of customer, type of account or product offered may be sufficient to understand the nature and purpose of an account.

**Ongoing Monitoring.** FinCEN believes that compliance with suspicious activity reporting requirements implicitly requires FIs to conduct ongoing monitoring and that including explicit requirements in the AML program rules is needed to make clear minimum standards for CDD. FinCEN states that the fourth element does not impose a categorical requirement to update or refresh customer information. Rather in the course of monitoring, if the FI becomes aware of information relevant to assessing risk, the FI is expected to update the customer's information. FinCEN therefore views the requirement as one to update a profile as a result of monitoring and not a requirement to update information at prescribed periods.

Susan Olson  
Senior Counsel - International Affairs

### **endnotes**

[1] The Proposal is available at  
<http://www.gpo.gov/fdsys/pkg/FR-2014-08-04/pdf/2014-18036.pdf>

[2] Policy Statement on Obtaining and Retaining Beneficial Ownership Information for Anti-Money Laundering Purposes, SEC Release No. 34-61651 (Mar. 5, 2010).

[3] 31 U.S.C. §§ 5311 et seq.

[4] Joint Association (ICI, SIFMA and FIA) Letter on the Guidance (June 9, 2010), available at <http://www.ici.org/pdf/24354.pdf>.

[5] For example, the Guidance states that “[w]here the customer is a legal entity that is not

publicly traded in the United States, such as an unincorporated association, a private investment company (PIC), trust or foundation,” a financial institution should obtain “information about the structure or ownership of the entity so as to allow the institution to determine whether the account poses heightened risk” (emphasis added). Compare with Recommendation 5 of the Financial Action Task Force on Money Laundering, available at <http://www.fatf-gafi.org> (envisaging that financial institutions obtain beneficial ownership and other measures as part of CDD, “but may determine the extent of such measures on a risk sensitive basis depending on the type of customer, business relationship or transaction”).

[6] Proposal at note 26.

[7] The ANPRM is available at [http://www.fincen.gov/statutes\\_regs/frn/pdf/1506-AB15\\_CDD%20ANPRM.pdf](http://www.fincen.gov/statutes_regs/frn/pdf/1506-AB15_CDD%20ANPRM.pdf).

[8] The Institute’s comment letter on the ANPRM, dated May 4, 2012, is available at <http://www.ici.org/pdf/26148.pdf>.

[9] See ICI Memo [25947](#), FATF Publishes Revised Recommendations, February 29, 2012; ICI Memo [25504](#), ICI Letter on FATF Consultation on Review of the Standards (Second Public Consultation), September 20, 2011; ICI Memo [24890](#), Comment Letter on Consultation Paper of the Financial Action Task Force, January 19, 2011; ICI Memo [25371](#), FATF Consultation – Second Phase of the Review of the Recommendations, August 1, 2011.

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