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New customer due diligence rules in financial crimes enforcement

Drug cartels and other criminal organizations regularly use shell companies, front companies and other legal entities to conceal the proceeds of their illegal activities. Criminals use legal entities to conceal at least $40 billion of illicit activity every year, according to "The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It," The International Bank for Reconstruction and Development/The World Bank (2011).

The anonymity provided by legal entities can be used to conceal criminals' identities and make tracking their activities difficult. Regulators outside of the U.S. have already taken steps to require the disclosure of the individuals who control legal entities, and the U.S. recently moved another step closer toward this requirement.

On July 30, the Financial Crimes Enforcement Network, or FinCEN, a bureau of the U.S. Treasury Department, issued a notice of proposed rulemaking (FIN 1506-AB25) to strengthen customer due diligence requirements for financial institutions regulated under the Bank Secrecy Act. 79 Fed. Reg. 45,151 (Aug. 4, 2014). The period for written comments on the NPRM ended on Oct. 3, and an examination of comments selected for publication reflects some of the challenges financial institutions will face as they "look through" legal entities to identify the natural persons who own or control them.

The institutions affected by the final rule will include banks, broker-dealers, futures commission merchants, introducing brokers in commodities and mutual funds. FinCEN's goal is to codify what are commonly referred to as the four pillars of customer due diligence:

- Identify and verify the identity of customers.
- Identify and verify the identity of beneficial owners of legal entity customers (i.e., the natural persons who own or control legal entities).
- Understand the nature and purpose of customer relationships.
- Conduct ongoing monitoring to maintain and update customer information and to identify and report suspicious activities.

The second pillar is the most challenging in that it requires financial institutions to identify beneficial owners. There are two prongs to the identification process. The first is ownership: The financial institution must identify each individual, if any, who, directly or indirectly, through contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests in a legal entity customer.

The second prong is control: The institution must identify an individual with significant responsibility to control, manage or direct a legal entity customer. This individual may be an executive officer or senior manager.

These two prongs are independent tests, but the first prong will be the most challenging.

These tests apply to any "legal entity customer," which is broadly defined to include most U.S. and foreign corporations, limited liability companies, partnerships or similar business entities that open a new account. It should be noted that FinCEN proposes that certain legal entities with existing accounts at certain financial institutions will be exempt from the rule, but as discussed later, new accounts, even if opened by an existing customer, will be subject to the beneficial ownership tests.

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In this regard, particular challenges may be presented by nonexempt pooled investment vehicles, such as hedge funds, whose ownership structure may continuously fluctuate, rendering the beneficial ownership information only accurate for a brief time.

One of the chief concerns expressed in the comments to the proposed rulemaking is that the burden and costs associated with the categorical collection of beneficial ownership information will outweigh any benefit that law enforcement will derive from such information. FinCEN estimates that 8 million accounts are opened annually for legal entities covered by the proposed rule. According to FinCEN, this would result in an estimated cost of $54 million across the roughly 21,550 financial institutions covered by proposed rule, including depository institutions (13,375) and broker-dealers (5,100).

The cost, however, is likely much higher. Financial institutions must devote additional time and resources to integrate enhanced systems with existing systems and software, such as software for OFAC screening, case management and employee-training modules.

Although the proposed rulemaking includes an appendix with a standard certification form to identify the beneficial owners of legal entity customers, each financial institution has different customers and varying customer onboarding processes and workflows. Using a prescriptive form moves away from the time-tested "risk-based" approach that allows financial institutions to allocate compliance resources to high-risk customers but does not create a safe harbor for those who use the standard certification form. Financial institutions may be faulted if a regulator believes that red flags in certain cases warranted further investigation.

In the proposed rulemaking, FinCEN advises that it does not expect financial institutions to verify the status of a beneficial owner identified on a certification form (i.e., whether the individual identified on the form is, in fact, the beneficial owner).

Although financial institutions are not expected to undertake an exhaustive analysis to determine beneficial ownership, the proposed rule requires financial institutions to leverage existing customer identification policies to verify the identity of each beneficial owner and respond to circumstances in which they cannot form a reasonable basis that they know the true identity of a beneficial owner. This may pose a challenge when the identity of the individual cannot easily be verified or where the legal entity is domiciled in a jurisdiction with secrecy laws.

Although FinCEN proposes an effective date of one year from the date of the issuance of the final rule to allow for implementation, information technology budgets are commonly set in the third quarter of the current year.

Accordingly, if the rule for instance is finalized early next year, implementing IT enhancements necessary to comply with the rule on its effective date may prove problematic, resulting in the deferment of technology upgrades to other systems. Because it appears inevitable though that financial institutions will be required to look through legal entity customers, it is not too early to start planning for implementation of the final rule.

NEXT CHAPTER

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