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FinCEN Finalizes Customer Due Diligence Requirements for Financial Institutions

On May 11, 2018, the US Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") implemented its Final Rule on Customer Due Diligence Requirements for Financial Institutions¹ ("Rule") to amend the scope of customer due diligence ("CDD") obligations required by the Bank Secrecy Act ("BSA").

As we discussed in a prior client alert, this Rule aims to accomplish two objectives by increasing the CDD obligations of covered financial institutions ("CFIs"), including banks, mutual funds, securities broker-dealers, and futures commission merchants. First, it requires CFIs to collect and verify information about the natural persons ("beneficial owners") who own or control the CFIs' "legal entity customers" (e.g., corporations, limited liability companies, general partnerships). Second, it establishes a fifth pillar of anti-money laundering ("AML") programs by requiring CFIs to develop customer risk profiles and conduct ongoing monitoring to identify suspicious activity and update relevant customer information.

In this note, we discuss steps to assist CFIs in complying with the Rule, explain a limited 90-day extension to the new beneficial ownership obligations for certain financial products and services that automatically rollover or renew, and anticipate potential enforcement trends.

BENEFICIAL OWNERS: COLLECTING AND VERIFYING INFORMATION

The Rule requires CFIs to establish and maintain written procedures to identify natural persons who own or control each legal entity customer, including:

- *Ownership*: Each individual – if any – who, directly or indirectly, owns 25% or more of the equity interests of a legal entity customer. However, the FAQs note "There may be circumstances where a financial institution may determine that collection and verification of beneficial ownership information at a lower threshold [than 25%] may be warranted, based on



the financial institution’s own assessment of its risk relating to its customer.”

- **Control:** A single individual with significant responsibility to control, manage, or direct a legal entity customer, including but not limited to an executive officer or senior manager (e.g., Chief Executive Officer, General Partner, Treasurer), or any other individual who regularly performs similar functions. FinCEN explains in its FAQs that it expects the controlling natural person to be “a high-level official . . . responsible for how the organization is run, and who will have access to a range of information concerning the day-to-day operations”.

A legal entity customer must have at least one controlling natural person, and it can have zero to four ownership natural persons depending on its structure. Nominee owners cannot serve as beneficial owners.

The procedures for collecting this information can be co-extensive with a CFI’s customer identification program (“CIP”) requirements, although the Rule does provide for limited deviations. To facilitate this information collection, FinCEN provides a sample form at Appendix A to the Rule. Beneficial owner CDD procedures should cover the following:

- **Scope of Information:** For each ownership or controlling beneficial owner, the legal entity customer must provide his or her name, date of birth, address, and social security number or other government identification number (e.g., passport number). If the intermediate owner of the legal entity customer is another legal entity, the customer must provide its ultimate owner’s natural person beneficial owner(s). CFIs must take a risk-based approach in determining the extent to which it must verify the information, although the burden to provide accurate information falls on the legal entity customer. Generally, a CFI can rely on its existing records (if the beneficial owner already is subject to its CIP) or the records of other CFIs.
- **Timing:** CFIs must collect this information whenever a legal entity customer opens a new account after May 11, 2018. (A CFI does not need to conduct this CDD when the CFI opens the account for internal recordkeeping or operational purposes.) However, the Rule also requires CFIs to update beneficial ownership information for existing legal entity customers when the CFI “becomes aware of information about the customer during the course of normal monitoring relevant to assessing or reassessing the risk posed by the customer, and such information indicates a possible change of beneficial ownership.” Absent a specific risk-based concern, the Rule does not require CFIs to solicit or update beneficial ownership information as a matter of course.
- **Exceptions:** Subject to certain limitations, CFIs are not required to identify or verify the beneficial owners of a legal entity customer for the following four categories of accounts: point-of-sale accounts to provide credit products for retail goods or services up to \$50,000; postage purchase finance accounts; insurance premium finance accounts; and equipment purchase or lease finance accounts.

CUSTOMER RISK PROFILE: A NEW FIFTH PILLAR OF AN EFFECTIVE AML PROGRAM

Previously, the BSA defined an effective AML program as comprising four pillars: a system of internal controls for ongoing compliance; an independent audit function; a designated compliance officer; and an ongoing training program. The Rule adds a fifth pillar by requiring CFIs to conduct ongoing, risk-based CDD as follows:

- **Customer Risk Profile:** This involves understanding the nature and purpose of customer relationships to develop a customer risk profile. As the FAQs explain, “an understanding based on category of customer means that for certain lower-risk customers, a financial institution’s understanding of the nature and purpose of a customer relationship can be developed by inherent or self-evident information,” whereas additional information may need to be gathered for higher-risk customers. Accordingly, a CFI’s AML program should take into consideration the different documentation that may be required to demonstrate this understanding, depending on the type of customer, account, service, or product. Once a CFI has this understanding, it should use information gathered



about a customer “to develop a baseline against which customer activity, such as the customer’s expected use of wires or typical number of deposits in a month, can be assessed for possible suspicious activity reporting.”

- *Monitoring and Updating:* This requires conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information (including beneficial owner information as necessary). A CFI’s existing processes may be sufficient to meet this obligation, as the preamble to the Rule notes that “current industry practice to comply with existing expectations for SAR reporting should already satisfy this proposed requirement.” To the extent that a CFI’s existing processes do not provide a sufficient foundation for such ongoing monitoring and updating, it should implement more rigorous risk-based procedures for conducting ongoing CDD, analyzing the results of such diligence, and reporting any concerns. However, with respect to beneficial ownership information, the FAQs note that “periodic reviews are not by themselves a trigger to obtain or update beneficial ownership information . . . Absent [a] risk-related trigger or event, collecting or updating of beneficial ownership information is at the discretion of the covered financial institution.”

90-DAY EXTENSION FOR BENEFICIAL OWNERSHIP REQUIREMENTS FOR CERTAIN FINANCIAL PRODUCTS

On May 16, 2018, FinCEN published an administrative ruling (“Ruling”) on Beneficial Ownership Requirements for Legal Entity Customers of Certain Financial Products and Services with Automatic Rollovers or Renewals. This narrow Ruling exempts CFIs from implementing the new beneficial ownership requirements to “certain financial products and services that automatically rollover or renew (i.e., certificate of deposit (CD) or loan accounts)” established prior to May 11, 2018. The Ruling is retroactive to May 11, 2018 and expires August 9, 2018, although FinCEN may grant additional relief.

As defined by CIP rules and related interagency guidance, a CFI technically establishes a new formal banking relationship and new account each time a loan or CD renews or rolls over. This legal technicality would require a CFI to undertake the beneficial ownership CDD process anew, even for existing customers. However, some CFIs have created automatic processes to continue the same banking relationship with the customer, which may impact their ability to comply with the Rule. Therefore, FinCEN has granted this narrow Ruling to allow such CFIs to continue their automatic rollover or renewal processes while it examines the issue further. However, we note that only automatically rolled-over products established prior to May 11, 2018 benefit from the Ruling – all newly-established rolled-over products must comply with the Rule.

WHAT’S NEXT?

FinCEN undertook a robust notice and comment process before announcing the Rule, provided CFIs with a two-year period to update their CDD procedures to comply with the new obligations, and issued nearly fifty FAQs to provide additional guidance. Absent discrete issues that unexpectedly arise, such as those that prompted the 90-day rollover and renewal Ruling, FinCEN will expect CFIs to be in compliance with the Rule. FinCEN and its interagency partners are prepared to enforce the Rule and other AML authorities.

For example, five days after the Rule became effective, the US Securities and Exchange Commission (“SEC”) instituted a settled enforcement action against broker-dealers Chardan Capital Markets LLC and Industrial and Commercial Bank of China Financial Services LLC (“ICBCFS”) for “failing to report suspicious sales of billions of penny stock shares.” As broker-dealers, which are CFIs, Chardan and ICBCFS are required to file Suspicious Activity Reports (“SARs”) for transactions that raise red flags. Chardan agreed to a \$1 million penalty, ICBCFS agreed to a \$860,000 penalty, and Chardan’s AML officer Jerard Basmagy agreed to a \$15,000 penalty plus a three year industry bar.

This enforcement action was brought under the SEC’s AML and recordkeeping authorities, but it provides a clear example of how CFIs will be expected to conduct robust CDD, build sufficient customer risk profiles to gain an understanding of the nature and purpose of customers’ businesses, and actively monitor and report suspicious activities.



CONCLUSION

The Rule's increased information-gathering, verification, and updating requirements represent FinCEN's expectation that CFIs will undertake thorough due diligence of each customer to prevent and ferret out suspicious activity. As evidenced by the recent SEC action, FinCEN and its partner agencies are prepared to actively enforce US anti-money laundering authorities, so it is paramount that CFIs implement and maintain robust compliance programs.

King & Spalding will continue to monitor FinCEN and AML developments. Please contact us if you have any questions or would like additional information.

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¹ FinCEN first published the Rule on May 11, 2016, but delayed implementation for two years to provide covered financial institutions ("CFIs") with sufficient time to update their CDD processes. FinCEN also published Frequently Asked Questions ("FAQs") in [July 2016](#) and [April 2018](#) to provide additional guidance to CFIs.