

CLIENT MEMORANDUM

Treasury Department's Proposed Anti-Money Laundering Regulations Would Require "Know Your Customer" Due Diligence to Look Through to "Beneficial Owners"

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On August 4, 2014, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") published proposed regulations designed to strengthen the U.S. anti-money laundering ("AML") rules by requiring financial institutions subject to Bank Secrecy Act ("BSA") regulations to "look through" a customer or client to conduct AML "know your customer" ("KYC") due diligence on beneficial owners having a 25 percent or greater ownership interest in, and on an individual in control of, the customer/client.¹ The Treasury Department will accept public comments on the proposed regulations until October 3, 2014, followed by a period of indeterminate length in which it will review those comments. The final version of the regulations is expected to take effect sometime in 2015, and would apply prospectively only to accounts opened after the effective date.

If adopted as proposed, the regulations would directly affect—

¹ The proposed regulations were published in the Federal Register on August 4, 2014 and are available at <http://www.gpo.gov/fdsys/pkg/FR-2014-08-04/pdf/2014-18036.pdf>. KYC procedures are formally referred to in the existing BSA regulations, and in the proposed rules, as a "Customer Identification Program" or "CIP."

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- BSA-regulated financial institutions—including **banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers** in commodities—because they would be required to verify the name, address, date of birth, and social security number (or passport number or similar information from a foreign person) for *both* (1) each individual (if any) having a direct or indirect 25 percent or more ownership interest in the legal entity that is the actual customer or client (the “legal entity customer”) of the financial institution (the “beneficial owner prong”) *and* (2) an individual having significant management responsibility over the legal entity customer, such as an officer, general partner, or managing member (the “control prong”). The information would be obtained through a standard “Certification” form, a draft of which is appended to the proposed regulations.
- Firms doing business with a BSA-regulated financial institution—including **private equity and hedge funds, corporations, limited liability companies, partnerships**, or other business entities—because they would be required to disclose their 25 percent or greater beneficial owners and an individual in control to comply with the financial institution’s KYC obligations. In a departure from existing regulations, the natural person opening an account or otherwise establishing a relationship with a financial institution on behalf of the legal entity customer would be required to certify that the information provided in the form “is true and accurate to the best of his or her knowledge.” The FinCEN release states that such certifications would also assist law enforcement agencies in demonstrating unlawful intent in the event the person completing the form knowingly provides false information.

With respect to “pooled investment vehicles,” such as hedge funds, the proposed regulations raise some significant issues for comment and further consideration, including how exactly the look-through requirement would be applied when those entities open accounts or establish other financial relationships with a BSA-regulated entity. As currently proposed, the new identity verification requirement would apply to any such pooled investment vehicle seeking to open an account with a BSA-regulated financial institution. However, FinCEN has invited public comment on whether and how the final version of the rule should be applied with respect to those entities. The FinCEN release states that the Treasury Department might be willing to exempt BSA-regulated financial institutions from verifying the identities of beneficial owners and persons in control of pooled investment vehicles when such vehicles are operated or advised by entities proposed to be exempt, such as registered investment advisers (see below). Alternatively, if financial institutions are required to obtain this information, FinCEN is considering whether to require that those institutions verify only the identity of a person in control, and not that of beneficial owners.

Other financial institutions that are partially regulated for AML purposes, but not generally subject to KYC requirements—including **insurance companies, casinos, and money services businesses**—would not be subject to the proposed regulations. However, FinCEN indicates that it reserves the right to extend KYC requirements to those entities in the future.

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Exemptions

The proposed rules would exempt BSA-regulated financial institutions from the proposed beneficial owner and control person identity verification requirement with respect to certain entities. The regulation would not apply with respect to, among others: **U.S. publicly traded companies** and their **domestic subsidiaries**; **registered investment companies** (i.e., **mutual funds**); **investment advisers** and **other entities registered with the U.S. Securities and Exchange Commission** (the “SEC”); and **commodity pool operators, commodity trading advisors, retail foreign exchange dealers, swap dealers, or major swap participants**—each as defined in section 1a of the Commodity Exchange Act—registered with the U.S. Commodity Futures Trading Commission (the “CFTC”). Also exempt are **trusts**, other than those created through a filing with a state authority (e.g., statutory business trusts). However, the FinCEN release cautions BSA-regulated financial institutions that the proposed exemption for trusts does not absolve them from conducting the appropriate risk-based AML due diligence on trust customers in accordance with existing federal agency guidance.

Treatment of Intermediaries

The FinCEN release also discusses whether and how the proposed KYC requirement should be applied to accounts held by **intermediaries** on behalf of third parties as, for example, when a broker-dealer establishes omnibus accounts for an investment adviser that, in turn, establishes sub-accounts for its clients. FinCEN proposes to require a financial institution to verify the identities of the beneficial owners of an intermediary *itself* (i.e., the direct customer), but considers the question of identifying beneficial owners of the intermediary’s *clients* a separate issue. Under the existing AML regulations, identities of the underlying clients may or may not be disclosed to the broker-dealer.

FinCEN notes that the securities and derivatives industries have already raised concerns as to whether a BSA-regulated financial institution would be required to identify the intermediary’s own *underlying clients* or *the beneficial owners of those clients*. However, FinCEN expresses its own concerns in the release about the potential money laundering risk posed by the underlying clients of intermediary customers because of the lack of insight a financial institution has into those clients and their activities. For now, FinCEN recognizes that this risk might be better managed through other means—potentially through “appropriate regulation of the intermediaries themselves,” among other options—and preliminarily concludes that, under the proposed regulations, if an intermediary is a customer and a financial institution has no KYC obligation with respect to the intermediary’s underlying clients under existing BSA guidance, the financial institution should regard only the intermediary, not the intermediary’s underlying clients, as its legal entity customer. We note, however, that the existing BSA guidance does not address the multiplicity of intermediaries operating in the financial sector.

Other Customer Due Diligence (“CDD”) Requirements

Finally, the proposed regulations also reinforce and clarify other elements of AML CDD that were generally implied by existing regulations, but never clearly or directly stated. They include: customer identity verification; understanding the nature and purpose of the specific customer relationship; and ongoing monitoring of customer information and

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transactions—to which will be added the proposed requirement of verifying the identity of beneficial owners of legal entity customers.

Next Steps

BSA-regulated financial institutions should carefully review the proposed regulations and prepare to update their AML policies and procedures to comply once the regulations are adopted and take effect. Other affected entities, including hedge funds and other pooled investment vehicles, should also review the proposed regulations to assess their anticipated effects and may wish to consider either commenting directly to FinCEN or working through their trade associations to address specific concerns.

If you have any questions regarding this memorandum, please contact Russell L. Smith (202-303-1116, rsmith@willkie.com), Barbara Block (202-303-1178, bblock@willkie.com), or the Willkie attorney with whom you regularly work.

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