

June 9, 2016

FinCEN Issues Customer Due Diligence Rules and Amends AML Program Rules

On May 11, 2016, the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN") published a final rules release (the "[Release](#)") containing new rules to strengthen customer due diligence ("CDD") requirements for "financial institutions," which term includes mutual funds (but not registered investment advisers).¹ The new CDD requirements will require mutual funds to identify and verify the identity of beneficial owners of fund shares that are owned by legal entities, subject to certain exclusions and exemptions.

The Release also amends the anti-money laundering ("AML") compliance program rules applicable to all financial institutions, including mutual funds. As amended, mutual funds' AML compliance programs will be required to adopt risk-based procedures for conducting ongoing customer due diligence. These procedures must include procedures for (i) understanding customer relationships for the purpose of developing a customer risk profile, and (ii) conducting ongoing monitoring to identify and report suspicious transactions based on updated customer information. According to FinCEN, incorporating these two elements expressly into the existing AML compliance program rules merely codifies current practice based on existing regulatory expectations.

The changes made by the Release are summarized below. The compliance date for all of the Release's changes is May 11, 2018.

Existing Requirements

At present, the customer identification program rule (the "CIP Rule")² requires every mutual fund to maintain written customer identification procedures as part of the fund's AML compliance program.³ The CIP Rule applies only to "customers." Because "customer" is defined as "a person that opens a new account," only the named accountholder is currently deemed a customer subject to the CIP Rule. If a customer is a legal entity, there is no existing requirement for a mutual fund to look through the legal entity to identify the individuals who own or control the legal entity (also known as the "beneficial owners").

Existing AML regulations⁴ require mutual funds to develop and implement a written AML compliance program reasonably designed to prevent a mutual fund from being used for money laundering or financing of terrorist activities and to monitor compliance with FinCEN's AML regulations. Among other things, FinCEN's AML regulations require mutual funds to file a suspicious activity report ("SAR") for any suspicious transaction relevant to a possible violation of law or regulation, to the extent specified by the FinCEN regulations.⁵

¹ The term "financial institution" also includes banks, broker-dealers in securities, and futures commission merchants and introducing brokers in commodities. *See* 31 U.S.C. § 5312(a)(2). While registered investment advisers are not financial institutions, as discussed [here](#), in August 2015, FinCEN proposed AML regulations applicable to registered investment advisers.

² 31 C.F.R. § 1024.220.

³ Other types of registered investment companies, including closed-end companies and unit investment trusts, are not subject to CIP requirements.

⁴ 31 C.F.R. § 1024.210.

⁵ *See* 31 C.F.R. § 1024.320(a).

New CDD Requirements

The new CDD requirements will require mutual funds to establish and maintain written procedures that are reasonably designed to identify and verify [1] “beneficial owners” of [2] “legal entity customers” at the time a [3] “new account” is opened, and to include such procedures in their AML compliance programs.

Definitions

1. *Legal entity customer* means “a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account.” Various entities are excluded from the definition of legal entity customer, including banks, broker-dealers, registered investment advisers, registered investment companies, state-regulated insurance companies, and entities with equity securities listed on an exchange.
2. *Beneficial owners* are natural persons. An individual is a beneficial owner of a legal entity customer if that individual satisfies either an ownership test or a control test.
 - a. Under the ownership test, a beneficial owner is each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer.
 - b. Under the control test, a beneficial owner is an individual with significant responsibility to control, manage, or direct a legal entity customer, such as 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 any individual who regularly performs similar functions.

The two tests apply separately. A mutual fund will be required to identify up to four individuals under the ownership test, but is required to identify only one individual under the control test.

3. The *new account* definition follows the CIP Rule definition of “account,” which, by its terms, *excludes* an account opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974. Thus, ERISA plan accounts are not legal entity customers.

Identifying Beneficial Owners

The new CDD requirements will require mutual funds to identify the beneficial owner(s) of each legal entity customer at the time a new account is opened, unless the customer is otherwise excluded or the account is exempted. A mutual fund may identify the beneficial owner(s) either by obtaining a completed FinCEN-provided certification form from the individual opening the account on behalf of the legal entity customer, or by obtaining the information required by the FinCEN form from the individual by another means, provided the individual certifies, to the best of the individual’s knowledge, the accuracy of the information.

1. The identification requirement applies only to legal entity customers that open a new account after the Release’s compliance date, May 11, 2018. There is no requirement to identify the beneficial owners(s) of accounts opened before that date, although some financial institutions already collect this information.
2. A mutual fund is not required to engage in an analysis to identify “indirect ownership.” Mutual funds will be able to rely on the representations of a customer when it identifies its beneficial owners, unless the “front-line” mutual fund employees have reason to question the accuracy of the information presented. Similarly, a

mutual fund is not required to identify control persons who have effective control (*e.g.*, control arising from other than an official position with the legal entity customer).

3. In the Release, FinCEN confirmed that the approach followed under the existing CIP Rule – a mutual fund may treat an intermediary (*and not the intermediary's customers*) as its customer – also applies with respect to the identifying beneficial owners under the new CDD requirements.

Verifying Beneficial Owners

The new CDD requirements will require mutual funds to verify the *identity* of each beneficial owner identified to the fund “according to risk-based procedures to the extent reasonable and practicable” (there is no obligation on the part of the mutual fund to verify an identified beneficial owner’s *status* as a beneficial owner). The new CDD requirements state that, “[a]t a minimum, these procedures must contain the elements required for verifying the identity of customers that are individuals under [the CIP Rule’s identity verification procedures⁶].”

1. The new CDD requirements provide that, in verifying the identification of a beneficial owner, a mutual fund may rely on the information supplied by the legal entity customer regarding the identity of its beneficial owner(s), provided that it has no knowledge of facts that would reasonably call into question the reliability of such information.
2. Mutual funds will be able to rely on photocopies or other reproductions of the documentary verification permitted under its required procedures (*e.g.*, an unexpired driver’s license or passport).

Amended AML Compliance Program Rules

The Release adds two new requirements to the AML compliance program rules that apply to all mutual funds, including mutual funds. In addition to existing requirements, a mutual fund’s AML compliance program will be required to implement appropriate risk-based procedures for conducting ongoing customer due diligence, including:

1. Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile, and
2. Conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information (including customer information regarding the beneficial owners of legal entity customers, derived from the new CDD requirements).

According to FinCEN, understanding the nature and purpose of customer relationships encapsulates practices already generally undertaken by mutual funds to know and understand their customers. Such understanding is the baseline to detect aberrant or suspicious transactions. Accordingly, FinCEN believes that, in complying with existing SAR requirements, mutual funds should already be complying with this requirement and, therefore, the amended rule merely codifies general practice.

With respect to ongoing monitoring, the amended AML rule states that ongoing monitoring is conducted to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information. FinCEN believes that this requirement, too, codifies existing supervisory and regulatory expectations of an AML compliance program. FinCEN emphasized that the ongoing monitoring requirement is not intended to impose a requirement to update customer information on a continuous or ongoing basis. Instead, the obligation to update is event-driven and applies when mutual funds detect information relevant to assessing the risk of a customer relationship during the

⁶ 31 C.F.R. § 1024.220(a)(2).

course of their normal monitoring. At that point, a fund must update the customer information, including beneficial ownership information.

The two new requirements added to the AML compliance program rules will apply to all legal entity customers, including those existing on the May 11, 2018 compliance date.

Related Development

In connection with the publication of the Release, the U.S. Treasury sent a [letter](#) and [proposed beneficial ownership legislation](#) to Congress. The letter urged swift passage of the legislation, which, if enacted, would authorize the Treasury to issue regulations requiring legal entities to disclose the identities of their beneficial owners to the Treasury.

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The Release highlights the importance that the U.S. Treasury attaches to disrupting money laundering through financial institutions of all types.

- FinCEN extended the compliance date from FinCEN's proposed one year to two years based on the wide range of changes to systems and processes identified by commenters that would be required to implement the new CDD requirements. These requirements are likely to cause funds (and, therefore, investors) to bear substantial compliance costs.
- At some point in the near future, SEC examiners are likely to expand inspections to determine how funds are getting ready for the new CDD requirements.
- While the ability of funds to rely on the information supplied by a legal entity customer regarding the identity of its beneficial owner(s) is an important concession by FinCEN, it remains to be seen where FinCEN will draw the line with respect to a fund's claim that it had no knowledge of facts that reasonably called into question the reliability of information provided to the fund. For example, what happens when only one of two affiliated financial institutions has information in its possession?
- Finally, FinCEN noted that the Office of Foreign Assets Control ("OFAC") requires financial institutions to block accounts of persons appearing on the Specially Designated Nationals and Blocked Persons List ("SDN List"). The SDN List is deemed to include any entity that is 50 percent or more owned, in the aggregate, by one or more blocked persons, regardless of whether the entity is formally listed on the SDN List. Therefore, newly available information about beneficial owners also will impact mutual funds' OFAC compliance.

For further information about how the changes described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.