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## REGULATORY MONITOR

### US Treasury Update

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#### New FinCEN AML and Customer Due Diligence Regulations Await Mutual Funds

##### Overview

In May 2016, the US Treasury's Financial Crimes Enforcement Network (FinCEN) published final rules (Rules)<sup>1</sup> that will strengthen customer due diligence requirements for covered financial institutions, including mutual funds (but not registered investment advisers or registered transfer agents).<sup>2</sup> The Rules will require mutual funds to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exemptions.

The Rules also will amend anti-money laundering (AML) program requirements to require covered financial institutions, including mutual funds, to adopt risk-based procedures for conducting ongoing customer due diligence. These procedures must be designed such that mutual funds can (i) understand customer relationships for the purpose of developing a customer risk profile, and (ii) conduct ongoing monitoring to identify and report suspicious transactions and update customer information. According to FinCEN, these amendments do not impose new obligations on mutual funds, but merely codify existing implicit regulatory requirements.

Mutual funds are required to comply with the Rules by May 11, 2018.

##### Existing Regulations

FinCEN's current regulations relating to customer identification require every mutual fund to maintain written customer identification procedures as part of the fund's AML compliance program (CIP Rule).<sup>3</sup> The CIP Rule, however, only requires mutual funds to obtain information for its customers. Because customer is defined as "a person that opens a new account," the mutual fund is required to obtain information only for the named accountholder. Mutual funds currently are not required to look through legal entity customers to identify beneficial owners.

In addition, at present, FinCEN's regulations require mutual funds to develop and implement AML compliance programs reasonably designed to prevent the funds from being used for money laundering. These compliance programs must include AML policies and procedures, the designation of an AML compliance officer, an employee training program, and an independent audit function. FinCEN's regulations also obligate mutual funds to file suspicious activity reports when financial institutions have reason to suspect that a transaction involves funds derived from illegal activities or lacks a legitimate business purpose.<sup>4</sup>

##### The New Rules

The Rules will require mutual funds to establish and maintain written procedures that are reasonably

designed to identify and verify beneficial owners of legal entity customers at the time a new account is opened and to include such procedures in their AML compliance programs.

## Key Definitions

**A *beneficial owner*** is a natural person who ultimately owns or controls a legal entity. An individual is a beneficial owner of a legal entity customer if that individual satisfies either an ownership test or a control test. Under the ownership test, a beneficial owner is each individual 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. 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 (for example, 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 ownership test and the control test apply separately. Depending on the factual circumstances, a mutual fund is required to identify up to four individuals under the ownership test, but only a single individual under the control test. Mutual funds are not required to obtain ownership information (but are required to obtain control person information) for certain types of pooled investment vehicles and nonprofit corporations.

**A *legal entity customer*** is “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.”<sup>5</sup> 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.

Mutual funds will not be required to obtain beneficial ownership information for legal entities that purchase fund shares through a broker-dealer or bank financial intermediary.<sup>6</sup>

A ***new account*** is an account opened at a covered financial institution by a legal entity customer. New accounts exclude accounts opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974.<sup>7</sup> Thus, the beneficial ownership identification requirements do not apply with respect to ERISA plan accounts.

## Identifying Beneficial Owners

The beneficial ownership identification requirement applies only to legal entity customers that open a new account after the May 11, 2018 compliance date. The Rules do not impose an obligation on mutual funds to identify the beneficial owner(s) of accounts opened before that date, although some mutual funds already collect this information.

A mutual fund may identify the beneficial owner(s) of a non-excluded legal entity customer by obtaining (i) a completed FinCEN-provided certification form<sup>8</sup> from the individual opening the new account on behalf of the legal entity customer, or (ii) the information required by the FinCEN-provided certification form from the individual in another form, provided the individual certifies, to the best of the individual’s knowledge, the accuracy of the information provided.

Mutual funds will be able to rely on the representations of a legal entity customer when it identifies its beneficial owners, unless the front-line personnel receiving the information have reason to question its accuracy. Similarly, mutual funds are not required to identify control persons who have effective control over a legal entity customer (for example, control arising from other than an official position with the legal entity customer).

Following the approach set forth in earlier FinCEN regulations, the Rules expressly allow a financial institution to rely on another financial

institution in order to comply with the beneficial ownership information requirements, provided certain conditions are met.<sup>9</sup>

### Verifying Beneficial Owners

The Rules require mutual funds to verify beneficial owners' identities "to the extent reasonable and practicable." Mutual funds must implement procedures to verify the identity of individual and legal entity customers pursuant to the CIP Rule.<sup>10</sup>

### Amended AML Compliance Program Regulations

The Rules add two requirements to mutual funds' AML compliance programs.<sup>11</sup> In addition to the existing requirements, mutual funds must implement appropriate risk-based procedures for conducting ongoing customer due diligence to:

- Understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
- Identify and report suspicious transactions and, on a risk basis, maintain and update customer information (including customer information regarding the beneficial owners of legal entity customers).<sup>12</sup> A mutual fund's obligation to update customer information is event-driven and applies only when a fund detects information during the course of its normal monitoring relevant to assessing a customer's risk profile. At that point, the fund must update the customer information, including beneficial ownership information.<sup>13</sup>

According to FinCEN, these requirements simply codify existing obligations implicitly imposed by existing regulations on mutual funds to know and understand their customers in order to detect and report suspicious transactions.<sup>14</sup>

### Discussion and Implications

The Rules highlight the importance that FinCEN attaches to disrupting money laundering

through financial institutions of all types. Within the next year, Securities and Exchange Commission examiners are likely to expand inspections to determine how mutual funds are preparing for the new beneficial ownership requirements and AML program requirements.

FinCEN has given financial institutions until May 2018 to comply with the new Rules. In order to comply, fund complexes will be required to supplement their written AML program procedures to reflect the new requirements and may choose to modify their account-opening forms and procedures to capture the beneficial ownership information required by FinCEN. Developing the required procedures by the compliance date may prove challenging for some mutual funds in light of concurrent efforts to meet other significant new compliance requirements in 2018, including the adoption of Form N-PORT after July 1, 2018 and the implementation of Rule 22e-4 liquidity risk management programs by December 1, 2018.

Separately, as described above, the Rules obligate mutual funds to implement risk-based procedures for conducting ongoing customer due diligence. The customer-updating requirement is event-driven (rather than continuous or periodic) and applies only when mutual funds detect information relevant to assessing the risk of a customer relationship during the course of their normal monitoring. If compliance with this requirement is evaluated in hindsight, as likely will be the case, a mutual fund may be left to explain after the fact why a certain event did not cause the fund to update its customer information, including beneficial ownership information.

On a positive note, the beneficial ownership information requirements in the Rules will assist mutual funds in complying with economic sanctions. The Office of Foreign Assets Control (OFAC) within the US Department of Treasury administers economic sanctions prohibiting US companies, including mutual funds, from accepting investments from persons ordinarily resident in embargoed countries (for example, Cuba and Iran), as well

as individuals targeted by list-based sanctions. The list-based sanctions apply to persons included on OFAC's Specially Designated Nationals and Blocked Persons list, along with entities that are majority owned, directly or indirectly, by such persons. By obtaining beneficial ownership information, mutual funds will be better positioned to ensure they do not unknowingly accept funds from a legal entity customer that is owned by sanctioned persons.

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#### NOTES

<sup>1</sup> 81 Fed. Reg. 29398 (May 11, 2016).

<sup>2</sup> The term covered financial institution also includes banks, broker-dealers in securities and futures commission merchants, and introducing brokers in commodities. *See* 31 C.F.R. §1010.230(f). While registered investment advisers are not covered financial institutions, in August 2015, FinCEN proposed (but has not yet finalized) AML regulations that would make registered investment advisers subject to certain requirements related to money laundering under the Bank Secrecy Act. *FinCEN, Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 Fed. Reg. 52680 (Sept. 1, 2015).

<sup>3</sup> 31 C.F.R. § 1024.220. Other types of registered investment companies, including closed-end

companies and unit investment trusts, are not subject to the CIP Rule.

<sup>4</sup> *See* 31 C.F.R. § 1024.320(a).

<sup>5</sup> 31 C.F.R. § 1010.230(e).

<sup>6</sup> *See* 81 Fed. Reg. 29415 at n.73 *citing* Guidance from the Staffs of the Department of the Treasury and the US Securities and Exchange Commission, "Questions and Answers Regarding the Mutual Fund Customer Identification Rule," Aug. 11, 2003, available at <https://www.sec.gov/divisions/investment/guidancelqamutualfund.htm>. Note that registered investment advisers are not covered financial institutions.

<sup>7</sup> *See* 31 C.F.R. § 1024.100.

<sup>8</sup> *See* 81 Fed. Reg. at 29454–57 (model form).

<sup>9</sup> A covered financial institution may rely on another financial institution (including an affiliate) to comply with the beneficial ownership requirements provided that (i) the reliance is reasonable under the circumstances; (ii) the other financial institution is subject to AML program rules and is regulated by a federal regulator; and (iii) the other financial institution enters into a contract requiring it to certify annually to the covered financial institution that it has implemented its anti-money laundering program and that it will perform the specified requirements of the covered financial institution's procedures to comply with the beneficial ownership requirements. 31 C.F.R. § 1010.230.

<sup>10</sup> 31 C.F.R. § 1024.220(a)(2).

<sup>11</sup> *See* 31 C.F.R. § 1024.210.

<sup>12</sup> *See* 31 C.F.R. § 1024.210(b)(4).

<sup>13</sup> *See* 81 Fed. Reg. at 29424.

<sup>14</sup> *See id.* at 29423–24.

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