

# Client Alert

February 2019

## New Beneficial Ownership Rules in Full Effect: What to Expect and How to Manage the New Procedures

### Executive Summary

The Financial Crimes Enforcement Network (FinCEN) issued a final rule on May 11, 2016, (effective for covered financial institutions on May 11, 2018) regarding customer due diligence requirements for covered financial institutions. As a result, a company entering into new lending, treasury management, hedging or other relationships or opening new bank accounts with covered financial institutions must now generally disclose additional information related to individuals who (i) control the company and (ii) own a certain amount (directly or indirectly) of the company. These requirements are in addition to the “know your customer” (aka KYC) deliverables mandated by the USA PATRIOT Act (the Patriot Act). Practical takeaways about the Beneficial Ownership Rule discussed in this article include:

- **Your Financing and Any Amendments to Your Existing Credit Facility Will Likely Be Affected.** Even if you already have existing bank accounts and are obtaining new financing with an institution with whom you have an established relationship, expect renewed legal entity due diligence, more questions, new forms to complete and additional KYC hurdles.
- **Communicate Upfront.** Start the conversation early with bank lenders to determine how the bank’s compliance department is implementing the Beneficial Ownership Rule and to learn what ownership threshold (i.e., 10 percent, 25 percent) the bank is requiring.
- **Allow Time to Complete Forms.** Allocate additional time and resources to completing the administrative tasks related to the beneficial ownership forms.
- **Carefully Handle Information.** Handle with care the communication of individuals’ Social Security numbers and other personally identifiable information.
- **Impact on Credit Documents.** If your credit agreement does not already address the Beneficial Ownership Rule, expect financial institutions to introduce provisions covering this topic upon refinancing or an amendment. While the Loan Syndication and Trading Association (LSTA) has proposed model provisions implementing the Beneficial Ownership Rule, those provisions have not been universally adopted by many financial institutions in the commercial loan space.<sup>1</sup>

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<sup>1</sup> Although this client alert does not focus on the impact of the Beneficial Ownership Rule on credit documents, the LSTA has published updates to its model credit agreement. See blackline of October 17, 2017 to May 4, 2018 Form Revolving Credit Agreement: [https://www.lsta.org/legal-and-documentation/primary-market?download\\_file=45962074-ec36-11e8-bd85-bc764e0453da](https://www.lsta.org/legal-and-documentation/primary-market?download_file=45962074-ec36-11e8-bd85-bc764e0453da)

## General Overview

The Beneficial Ownership Rule became effective for covered financial institutions on May 11, 2018, and includes amendments to existing Bank Secrecy Act rules to require financial institutions to identify (and verify such identity of) legal entity customers' beneficial owners.<sup>2</sup> Already in effect at the effective time of the Beneficial Ownership Rule, the Patriot Act separately requires that financial institutions collect certain customer information in order to verify the customer's identity.<sup>3</sup> Thus, companies, often frustrated by banks' preexisting KYC inquiries, are now struggling with the more intensive Beneficial Ownership Rule and its interplay with existing KYC disclosure requirements.

## Background on FinCEN: Protecting the Financial System and Fighting Kleptocrats

FinCEN, a bureau of the US Treasury Department, has the mission of protecting the United States financial system from illicit use and promoting national security through the collection and dissemination of financial intelligence. To achieve these goals, FinCEN provides law enforcement authorities with access to financial intelligence used to combat kleptocrats, terrorist financing and criminals hiding money. In particular, FinCEN is looking to smoke out "nominees" or "straw men" and identify the true beneficial owners of legal entities.<sup>4</sup>

Treasury estimates that \$300 billion each year is generated in the United States from financial crimes.<sup>5</sup> Though recognizing the burden of the Beneficial Ownership Rule on financial institutions and the economy overall, FinCEN maintains that even a 0.6 percent reduction in illicit activity would make the onerous expenses worthwhile.<sup>6</sup>

## FinCEN's Beneficial Ownership Rule: The Nitty Gritty

*Who Is In—and Who Is Out?*

**Covered Financial Institutions:** (i) banks or credit unions; (ii) brokers or dealers in securities; (iii) mutual funds; (iv) futures commission merchants; and (v) introducing brokers in commodities.<sup>7</sup>

**These entities, among others, are not covered financial institutions subject to the new rule:** casinos and money services businesses.<sup>8</sup>

**Legal Entity Customers:** corporations, limited liability companies or other entities that are created by the filing of a public document with a Secretary of State or similar office, general partnerships and any similar entities formed under the laws of a foreign jurisdiction that opens an account.<sup>9</sup>

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<sup>2</sup> See FinCEN CDD Rule, 31 CFR §1010.230.

<sup>3</sup> See Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, 107 P.L. 56, as amended.

<sup>4</sup> See FIN-2016-G003 issued on July 19, 2016 by FinCEN entitled *Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions*.

<sup>5</sup> See 80 FR 80308.

<sup>6</sup> See FinCEN CDD Rule, 31 CFR §1010.230.

<sup>7</sup> See 31 C.F.R. § 1010.605(e)(1).

<sup>8</sup> See 31 C.F.R. § 1010.100(t) and C.F.R. § 1010.100(ff).

<sup>9</sup> See 31 C.F.R. § 1010.230(e)(1).

**These entities, among others, are not legal entity customers:** (i) sole proprietorships, unincorporated associations and natural persons opening accounts on their own behalf; (ii) financial institutions regulated by any federal/state regulator; (iii) issuers of securities registered under Section 12 of the Securities Exchange Act of 1934; (iv) investment companies as defined in Section 3 of the Investment Company Act of 1940 that are registered with the Securities and Exchange Commission under the Act; (v) investment advisors as defined in Section 202(a)(11) of the Investment Advisers Act of 1940; (vi) exchange or clearing agencies as defined in Section 3 of the Securities Exchange Act of 1934; (vii) any other entities registered with the SEC under the Securities Exchange Act of 1934; (viii) pooled investment vehicles operated/advised by a financial institution also excluded under the Beneficial Ownership Rule; (ix) insurance companies regulated by any state; and (x) foreign financial institutions established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution.<sup>10</sup>

**What Information Is Required to Satisfy the Beneficial Ownership Rule?**

Set forth below is a summary of the specific due diligence requirements of the Beneficial Ownership Rule for legal entity customers. While FinCEN has provided—and the LSTA has created its own version of—a beneficial ownership form to be used by legal entity customers of covered financial institutions when opening accounts, financial institutions often have their own forms and those forms do not necessarily align with the examples published by FinCEN and the LSTA.

1. **Ownership and Control Disclosures.** The Beneficial Ownership Rule generally requires the disclosure of (i) each individual who owns, directly or indirectly, 25 percent or more of the equity interests of the legal entity customer and (ii) one individual with significant responsibility for managing the legal entity customer.

But note that FinCEN considers 25 percent a baseline regulatory benchmark. Accordingly, some banks maintain a lower threshold (e.g., to 10 percent direct/indirect equity ownership) based on internal risk management, and thus may trigger the disclosure of a larger number of direct/indirect equity holders.<sup>11</sup>

2. **What is Required of Each Disclosed Individual.**

For any of the individuals disclosed, the following information is required:

<u>US PERSON</u>	<u>FOREIGN PERSON</u>
<ul style="list-style-type: none"> <li>1. Name/Title</li> <li>2. Date of Birth</li> <li>3. Address (Residential or Business Street Address)</li> <li>4. Social Security Number</li> </ul>	<ul style="list-style-type: none"> <li>1. Name/Title</li> <li>2. Date of Birth</li> <li>3. Address (Residential or Business Street Address)</li> <li>4. Passport Number and Country of Issuance (or similar identification)</li> </ul>

<sup>10</sup> See 31 C.F.R. § 1010.230(e)(2)(i)-(xvi).

<sup>11</sup> See Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 91 (May 11, 2016) at 29410.

The above information is used to satisfy the requirement that the covered financial institution identify and verify the identity of the true beneficial owners of its customers.<sup>12</sup>

**3. To What Transactions Does the Rule Apply?** The Beneficial Ownership Rule only applies to newly created accounts as of May 11, 2018, for covered financial institutions. Accordingly, covered financial institutions are not legally required to look back for compliance purposes, but are encouraged to do so for high-risk accounts. That said, even if a legal entity customer is an existing client of the covered financial institution, the Beneficial Ownership Rule still applies to any account being opened in the United States at US banks and US branches of foreign banks by such legal entity customer.<sup>13</sup>

Additionally, two noteworthy carve-outs from the Beneficial Ownership Rule apply when minimal changes are being made to an existing credit facility. The carve-outs are for any renewal, modification or extension (i) of a loan that does not require underwriting review and approval and (ii) of a commercial line of credit that does not require underwriting review and approval.<sup>14</sup>

**Overlap with Certain Patriot Act Requirements**

At the time of implementation of the Beneficial Ownership Rule, the Patriot Act already required that banks collect certain information of parties opening bank accounts. Specifically, pursuant to Section 326 of the Patriot Act, banks must obtain the following Customer Identification Program (CIP) information from customers and reasonably verify such information:<sup>15</sup>

<ul style="list-style-type: none"> <li>• Name;</li> </ul>
<ul style="list-style-type: none"> <li>• Date of birth (for an individual);</li> </ul>
<ul style="list-style-type: none"> <li>• Address ((i) for an individual, a residential or business street address and (ii) for a nonindividual, a principal place of business, local office or other physical location); and</li> </ul>
<ul style="list-style-type: none"> <li>• Identification number ((i) for a US person, tax ID or (ii) for a non-US person, one or more of a tax ID, passport number and country of issuance).</li> </ul>

In addressing comments related to the overlap of the Beneficial Ownership Rule with some current Patriot Act KYC requirements, FinCEN noted its view that the new rules do not materially alter current bank obligations for sharing information with law enforcement:

*A few commenters asked FinCEN to provide guidance as to how beneficial ownership information should be incorporated into processes for information sharing pursuant to USA PATRIOT Act Section 314(a); one of these commenters asked FinCEN to declare such information per se outside of the scope of Section 314(a). FinCEN does not expect the information obtained pursuant to the beneficial ownership requirement to add additional requirements with respect to Section 314(a) for financial institutions. The rule implementing Section 314(a), set forth at 31 CFR 1010.520, does not authorize the reporting of beneficial ownership information associated with an*

<sup>12</sup> See Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 91 (May 11, 2016) at 29407.

<sup>13</sup> See 31 C.F.R. § 1010.230(g). For the purposes of this section, new account means each account opened at a covered financial institution by a legal entity customer on or after the applicability date.

<sup>14</sup> See FIN-2018-R004 issued on September 7, 2018 by FinCEN entitled *Exceptive Relief from Beneficial Ownership Requirements for Legal Entity Customers of Rollovers, Renewals, Modifications, and Extensions of Certain Accounts*.

<sup>15</sup> See 31 C.F.R. § 1020.220(a)(1)-(2).

*account or transaction matching a named subject. Under that rule, financial institutions need only search their records for account or transactions matching a named subject, and report to FinCEN whether such a match exists using the identifying information that FinCEN provides.*<sup>16</sup>

Thus, while the Patriot Act's CIP focuses on the customer, the Beneficial Ownership Rule requires a deeper dive into both the direct and indirect owners of a company. Additionally, it should be noted that banks often request related Patriot Act information for officers signing loan documents and, in some cases, may even request information for all officers on incumbencies and other management. The inquiries from banks related to the Patriot Act often vary in scope. Thus, knowing upfront the scope of information that will be requested is helpful.

## Conclusion

The Beneficial Ownership Rule increases the administrative burden on companies and the amount of personally identifiable information being relayed to banks. When added to the diligence requirements of the Patriot Act, the deliverables mandated by the Beneficial Ownership Rule can be daunting and should be started early in any financing process. The more complex the ownership structure of a company, the more information that will be needed to discern individual direct and indirect owners. Thus, business entities impacted by the Beneficial Ownership Rule should be mindful of communicating early and openly with financial institutions regarding such institution's Patriot Act and Beneficial Ownership Rule compliance requirements.

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<sup>16</sup> See Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 91 (May 11, 2016) at 29409.