

Investment Management Alert

New FinCEN Due Diligence Requirements for Legal Entity Customers

On May 11, 2016, the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) released new anti-money laundering (AML) rules and regulations (the "rules") that apply to mutual funds, broker-dealers, banks and futures commission merchants and commodities introducing brokers.

While the rules don't explicitly apply to registered investment advisers, advisers that manage mutual funds may be tasked with helping to ensure their mutual fund shareholders are compliant with the rules. The rules principally focus on the identification and verification of the beneficial owners and controllers of legal entities. Up to now, AML regulations have not specifically required identification of these individuals by investment companies and fund intermediaries. The new rules also outline the requirement for risk-based procedures for conducting ongoing AML due diligence and development of a customer risk profile.

FinCEN anticipates that the rules will reduce the ability for individuals to use legal entities to hide assets in the financial system. The rules aim to enhance AML recordkeeping, provide information that will assist law enforcement in financial investigations and counterterrorism measures and prevent evasion of targeted financial sanctions. The rules are also intended to improve the ability of financial firms to assess risk, facilitate legal entity transparency and tax compliance, and align U.S. AML compliance with global norms.

A description of the changes is provided in the summary charts below:

INVESTMENT COMPANIES

Previous AML Due Diligence Requirements	New AML Due Diligence Requirements
<ul style="list-style-type: none"> • Develop and implement an AML compliance program approved by board of directors • Establish policies, procedures and internal controls • Provide for independent compliance testing • Designate an individual or individuals responsible for the AML program and provide ongoing training to appropriate individuals • Implement and maintain a customer identification program • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts 	<ul style="list-style-type: none"> • Develop and implement an AML compliance program approved by board of directors • Establish policies, procedures and internal controls • Provide for independent compliance testing • Designate an individual or individuals responsible for the AML program and provide ongoing training to appropriate individuals • Implement and maintain a customer identification program • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts • Identify and verify the beneficial owners of legal entity customers at the time a new account is opened (see the description below) • Implement appropriate risk-based procedures for ongoing due diligence to (i) understand the nature and purpose of relationships for developing a customer risk profile; and (ii) conduct ongoing monitoring to identify and report suspicious transactions and update customer information (see the description below)

BROKER-DEALERS, FUTURES COMMISSION MERCHANTS AND COMMODITIES INTRODUCING BROKERS

Previous AML Due Diligence Requirements	New AML Due Diligence Requirements
<ul style="list-style-type: none"> • Implement and maintain an AML compliance program designed to enable, detect and report known or suspected money laundering and that complies with the rules, regulations, or requirements of the self-regulatory organization governing such programs • The rules, regulations, or requirements of the self-regulatory organization have been approved, if required, by the appropriate Federal functional regulator • Implement and maintain a customer identification program • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts 	<ul style="list-style-type: none"> • Develop and implement an AML compliance program approved by senior management • Establish policies, procedures and internal controls to achieve compliance with the Bank Secrecy Act and regulations thereunder • Provide for independent compliance testing • Designate an individual or individuals responsible for the AML program and provide ongoing training to appropriate individuals • Implement and maintain a customer identification program • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts • Identify and verify the beneficial owners of legal entity customers at the time a new account is opened (see the description below) • Implement appropriate risk-based procedures for ongoing due diligence to (i) understand the nature and purpose of relationships for developing a customer risk profile; and (ii) conduct ongoing monitoring to identify and report suspicious transactions and update customer information (see the description below)

BANKS

Previous AML Due Diligence Requirements	New AML Due Diligence Requirements
<ul style="list-style-type: none"> • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts • Implement and maintain a customer identification program • Provide for independent compliance testing • Designate an individual or individuals responsible for coordinating and day-to-day AML program compliance • Provide training to appropriate individuals 	<ul style="list-style-type: none"> • Develop procedures to support AML compliance related to foreign financial institutions and private banking accounts • Implement and maintain a customer identification program • Provide for independent compliance testing • Designate an individual or individuals responsible for coordinating and day-to-day AML program compliance • Provide training to appropriate individuals • Identify and verify the beneficial owners of legal entity customers at the time a new account is opened (see the description below) • Implement appropriate risk-based procedures for ongoing due diligence to (i) understand the nature and purpose of relationships for developing a customer risk profile; and (ii) conduct ongoing monitoring to identify and report suspicious transactions and update customer information (see the description below)

Identification and Verification of Beneficial Owners of Legal Entity Customers

The rules require “covered financial institutions”—banks, broker-dealers, mutual funds, and futures commission merchants and commodities introducing brokers—to identify and verify the beneficial owners of all legal entity customers on the date a new account is opened.¹ The rules provide two methods a covered financial institution may use to obtain adequate identifying information from a legal entity: (i) a standardized certification form (see Appendix A to this Alert) to be completed by the individual opening an account on behalf of the legal entity; or (ii) the information requested in the standardized certification form, but obtained by other means. In order to rely on the second method, a covered financial institution must obtain a certification as to the accuracy of such information from the individual providing it.

The beneficial owner of a legal entity customer is any of the following²:

- An individual who directly or indirectly owns 25 percent or more of a legal entity customer;
- A person with significant responsibility to control, manage or direct the legal entity customer, including a chief executive officer, chief financial officer, chief operating officer, general partner, president, vice president or treasurer, or any other individual who regularly performs similar functions (the “control test”); and
- The trustee of a trust that owns directly or indirectly 25 percent or more of the equity of a legal entity customer.

FinCEN noted in the rule release that to require covered financial institutions to identify beneficial owners of pooled investment vehicles and nonprofit entities by ownership percentage would likely create unreasonable operational challenges. The rules apply only to the control test to determine beneficial ownership for these entities:

- Pooled investment vehicles that are operated or advised by a financial institution that is included within the definition of legal entity customer. The rules exclude investment advisers that are registered with the SEC from the definition of a legal entity customer. As a result, the control test will apply to pooled investment vehicles, such as non-U.S. managed mutual funds and private funds, including hedge funds and private equity funds managed by investment advisers that are not registered with the SEC;
- Any entity that is established as a nonprofit corporation or charity and has filed organizational documents with the appropriate state authority, as necessary.

Once a covered financial institution has been able to ascertain the identity of a legal entity customer’s beneficial owners, it must then verify the identity of the individuals through its existing customer identification program (CIP). Throughout this process, the institution may rely on information provided by the legal entity, so long as it does not have knowledge that would reasonably call the information into question.

The covered financial institution should have recordkeeping procedures related to the identification and verification of legal entity owners. Records related to identification should be kept for a minimum of five years from the time a customer account is closed, and records related to the verification of identity should be kept for a minimum of five years from the time a record is made.

Reliance on Other Financial Institutions and Intermediated Account Relationships

Importantly, a covered financial institution may rely on another financial institution to perform its AML due diligence in relation to identification and verification of legal entity beneficial owners. Reliance on an AML service provider is subject to the following prerequisites:

- The reliance must be reasonable under the circumstances;

¹ Covered financial institutions are not required to retroactively collect and verify beneficial ownership information for existing customer accounts. Institutions should, however, use future triggering events to identify beneficial owners and develop customer risk profiles for pre-existing accounts.

² The following entities are excluded from the definition of legal entity customer and their beneficial owners are not required to be identified: (i) financial institution regulated by a Federal functional regulator or a state bank regulator; (ii) government agency or political subdivision of any state; (iii) securities issuer registered under the 1934 Act; (iv) investment company; (v) SEC registered investment adviser; (vi) 1934 Act exchange or clearing agency or any other entity registered under the 1934 Act; (vii) CPO, CTA, swap dealer or major swap participant or registered entity with the CFTC (as defined in Section 1a of the Commodity Exchange Act); (viii) public accounting firm registered under Section 102 of the Sarbanes-Oxley Act; (ix) bank holding company or savings and loan holding company; (x) a state regulated insurance company; (xi) financial market utility designed by FSOC; (xii) foreign financial institution established where the regulator of the institution maintains beneficial ownership regarding the institution; (xiii) a non-US governmental department, agency or political subdivision that engages only in governmental activities rather than commercial activities; (xiv) a pooled investment vehicle operated or advised by any of the above institutions; (xv) any legal entity only to the extent it opens a private banking account subject to section 31 CFR 1010.620.

- The covered financial institution and service provider must have a contractual agreement requiring the service provider to certify it has implemented and will perform the covered financial institution's AML compliance program; and
- The service provider is subject to FinCEN AML regulations and is regulated by a federal regulator.

The rules also allow a covered financial institution with intermediated relationships to treat the intermediary, rather than the intermediary's underlying clients, as its customer. The covered financial institution must not have a CIP obligation under existing guidance with respect to the intermediary's underlying clients. This provision is especially relevant to investment advisers that manage omnibus variable insurance contracts.

Risk-Based AML Due Diligence and Development of Customer Risk Profiles

FinCEN has included in the rules a requirement for covered financial institutions to implement appropriate risk-based procedures to conduct ongoing AML due diligence. Ongoing due diligence programs are tasked with two specific requirements: (i) understand the nature and reason for a customer relationship for the purpose of developing a customer risk profile; and (ii) monitor transactions and each customer risk profile to identify and report suspicious transactions and update customer information.

The rules leave it up to covered financial institutions to create their own framework and method of developing customer risk profiles. Risk profiles, however, should include information that allows an institution to create a baseline of account activity. Institutions should consider customer asset amounts and types along with personal information in developing customer risk profile. Armed with this information, an institution should be equipped to identify suspicious transactions, including those that may not be the sort the customer would normally be expected to engage in.

Customer risk profiles are not required to be monitored and updated on a continuous or periodic basis, but updates should, instead, be event-driven. A covered financial institution must update a customer's risk profile if it detects information about the customer that is relevant to assessing the customer's transactions for AML purposes (e.g., a significant change in account activity or change in a legal entity's beneficial ownership).

Compliance Dates

The rules will be effective July 11, 2016 and covered financial institutions must comply with the rules by May 11, 2018.

Suggested Actions for Covered Financial Institutions

- **Review and Assess AML Programs:** The rules are designed to fill gaps FinCEN identified related to legal entity ownership and ongoing account monitoring for AML. Covered financial institutions should consider performing a review and gap analysis on their current AML program and procedures in order to ensure they will be fully compliant after implementing the new rules into their AML program.
- **Review Third-Party Agreements; Obtain Certifications:** Institutions that rely on third parties to perform AML due diligence should assess the arrangements and ensure third-party AML programs are up-to-date. Mutual funds with service or selling agreements and platform agreements, and exchange-traded funds with authorized participant agreements should review the agreements for compliance. Institutions should also have procedures to obtain certifications from third-party AML service providers on at least an annual basis. The covered financial institution should document its efforts to obtain certifications.
- **Mutual Fund Director Oversight:** The AML Officer should apprise the mutual fund directors of the new rules and how they may affect the fund, including identified high-risk investors, AML compliance program violations and material developments related to the fund's risk-based due diligence and ongoing monitoring of investor accounts. Directors should also consider requesting an annual AML program summary report including the status of third-party AML service providers and certifications relied on by the fund.

For more information on the application of the rules or AML compliance in general, please contact one of the authors listed below or the Drinker Biddle Investment Management Group lawyer with whom you regularly work.



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APPENDIX A TO § 1010.230

Certification Regarding Beneficial Owners Of Legal Entity Customers

I. GENERAL INSTRUCTIONS

What is this form?

To help the government fight financial crime, Federal regulation requires certain financial institutions to obtain, verify, and record information about the beneficial owners of legal entity customers. Legal entities can be abused to disguise involvement in terrorist financing, money laundering, tax evasion, corruption, fraud, and other financial crimes. Requiring the disclosure of key individuals who own or control a legal entity (i.e., the beneficial owners) helps law enforcement investigate and prosecute these crimes.

Who has to complete this form?

This form must be completed by the person opening a new account on behalf of a legal entity with any of the following U.S. financial institutions: (i) a bank or credit union; (ii) a broker or dealer in securities; (iii) a mutual fund; (iv) a futures commission merchant; or (v) an introducing broker in commodities.

For the purposes of this form, a legal entity includes a corporation, limited liability company, or other entity that is created by a filing of a public document with a Secretary of State or similar office, a general partnership, and any similar business entity formed in the United States or a foreign country. Legal entity does not include sole proprietorships, unincorporated associations, or natural persons opening accounts on their own behalf.

What information do I have to provide?

This form requires you to provide the name, address, date of birth and Social Security number (or passport number or other similar information, in the case of foreign persons) for the following individuals (i.e., the beneficial owners):

- (i) Each individual, if any, who owns, directly or indirectly, 25 percent or more of the equity interests of the legal entity customer (e.g., each natural person that owns 25 percent or more of the shares of a corporation); and
- (ii) An individual with significant responsibility for managing the legal entity customer (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer).

The number of individuals that satisfy this definition of “beneficial owner” may vary. Under section (i), depending on the factual circumstances, up to four individuals (but as few as zero) may need to be identified. Regardless of the number of individuals identified under section (i), you must provide the identifying information of one individual under section (ii). It is possible that in some circumstances the same individual might be identified under both sections (e.g., the President of Acme, Inc. who also holds a 30 percent equity interest). Thus, a completed form will contain the identifying information of at least one individual (under section (ii)), and up to five individuals (i.e., one individual under section (ii) and four 25 percent equity holders under section (i)). The financial institution may also ask to see a copy of a driver’s license or other identifying document for each beneficial owner listed on this form.

II. CERTIFICATION OF BENEFICIAL OWNER(S)

Persons opening an account on behalf of a legal entity must provide the following information:

a. Name and Title of Natural Person Opening Account:

b. Name and Address of Legal Entity for Which the Account is Being Opened:

c. The following information for 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 the legal entity listed above:

Name	Date of Birth	Address (Residential or Business Street Address)	For U.S. Persons: Social Security Number	For Foreign Persons: Passport Number and Country of Issuance, or other similar identification number ¹

(If no individual meets this definition, please write "Not Applicable.")

¹ In lieu of a passport number, foreign persons may also provide an alien identification card number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

d. The following information for one individual with significant responsibility for managing the legal entity listed above, such as:

- An executive officer or senior manager (e.g., Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, Treasurer); or
- Any other individual who regularly performs similar functions.
(If appropriate, an individual listed under section (c) above may also be listed in this section (d)).

Name	Date of Birth	Address (Residential or Business Street Address)	For U.S. Persons: Social Security Number	For Foreign Persons: Passport Number and Country of Issuance, or other similar identification number ¹

¹ In lieu of a passport number, foreign persons may also provide an alien identification card number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

I, _____ (*name of natural person opening account*), hereby certify, to the best of my knowledge, that the information provided above is complete and correct.

Signature: _____ Date: _____

Legal Entity Identifier _____ (Optional)