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Implementation of Treasury’s New Customer Due Diligence Rule: A Step Toward Beneficial Ownership Transparency?

Introduction

Since May 11, 2018, U.S. financial institutions are required to comply with a U.S. Department of the Treasury rule aimed at cracking down on illicit capital flows through accounts held by anonymous corporate vehicles—often called “shell companies.” The Treasury rule, known as the customer due diligence (CDD) rule, amends existing CDD requirements for certain financial institutions, a key element of know-your-customer obligations. Although the new CDD rule was finalized two years ago (May 11, 2016), the Financial Crimes Enforcement Network (FinCEN), a Treasury bureau, delayed implementation until 2018.

The CDD rule’s implementation is the culmination of a multi-year effort by the federal government to address money laundering and tax evasion risks posed by shell companies whose beneficial ownership is not transparent. Although the rule represents a step toward addressing criticism of current beneficial ownership transparency practices in the United States, some policymakers continue to debate whether legislative action may be required to mitigate fully the potential for criminals, terrorists, and corrupt foreign politicians to hide behind shell companies and conceal the proceeds of illegal activity or shelter funds illegally from home country taxation. Several bills in the 115th Congress have sought to address beneficial ownership transparency in sectors not covered by the CDD rule.

Beneficial Ownership and Shell Companies. The term “beneficial owner” broadly refers to the natural person(s) who own or control a legal entity, such as a corporation or limited liability company. When such entities are set up without physical operations or assets, they are often referred to as “shell companies.” Shell companies can be used to conceal beneficial ownership and facilitate anonymous financial transactions. Since corporate vehicles are registered at the state level, laws and requirements for corporate formation also vary by state.

Background

U.S. policymakers concern regarding potential risks posed by shell companies whose beneficial ownership is not transparent has grown in recent years. Such concern has been punctuated by a series of leaks to the media regarding the use of shell companies, as well as sustained multilateral attention to the issue, including criticism of current U.S. practices.

The Leaks

In April 2016 (one month prior to the promulgation of the new CDD rule), a consortium of international investigative

journalists revealed a massive leak of 11.5 million records from the Panamanian law firm Mossack Fonseca, which collectively became known as the “Panama Papers.” The firm specialized in the creation of offshore shell companies and corporate structures behind which the beneficial ownership of such entities could be obscured. In mining the leaked data, investigative journalists revealed how numerous politicians and public officials, including current and former world leaders, benefitted from offshore holdings; journalists also found documents linking the firm to a range of drug traffickers, potential tax evaders, and other criminals.

Citing the Panama Papers as having “brought the issues of illicit financial activity and tax evasion into the spotlight,” the Obama Administration announced in May 2016 steps to “strengthen financial transparency, and combat money laundering, corruption, and tax evasion”—including issuance of the CDD final rule and several legislative proposals. A number of leaks to the media, similar to the Panama Papers, have sustained international attention to the issue of beneficial ownership and corporate financial transparency in recent years, including the Offshore Leaks of 2013, Lux Leaks of 2014, Swiss Leaks of 2015, Paradise Papers of 2017, and West Africa Leaks of 2018.

Multilateral Attention

The international community has also taken steps to acknowledge and address the issue of beneficial ownership transparency through the Group of Eight, Group of 20, Organisation for Economic Co-operation and Development (including through its Global Forum on Transparency and Exchange of Information for Tax Purposes), the World Bank (particularly with respect to its procurement practices), and the Extractive Industries Transparency Initiative (in November 2017, the United States withdrew from EITI). At the 2016 London Anti-Corruption Summit, the United States and more than 40 other countries committed to anti-corruption and transparency measures, including measures related to beneficial ownership.

Some countries, including the United Kingdom, have created a public register of beneficial ownership information—and more countries have committed or are planning to do so. In April 2018, the European Parliament voted to adopt the European Commission’s proposed Fifth Anti-Money Laundering (AML) Directive, which among other measures, would require European Union member states to maintain public national-level registers of beneficial ownership information.

Financial Action Task Force Criticism

For years, the United States has been under international pressure to tighten its AML regime with respect to its beneficial ownership disclosure requirements. Since 2003, the Financial Action Task Force (FATF), an international AML standards-setting body, has recommended global CDD standards for verifying the identity of customers, including the beneficial owners of legal entities and arrangements.

In its most recent review of the U.S. government's AML regime, published in 2016, FATF noted that the "lack of timely access to adequate, accurate, and current beneficial ownership (BO) information remains one of the most fundamental gaps in the U.S. context." According to FATF, this gap exacerbates U.S. vulnerability to money laundering; it also prevents U.S. law enforcement from efficiently obtaining such information during the course of investigations and limits law enforcement's ability to respond to foreign mutual legal assistance requests for beneficial ownership information.

What Does Treasury's Rule Do?

FinCEN, pursuant to its regulatory authority under the Bank Secrecy Act (BSA), has long had in place regulations requiring various types of financial institutions to establish AML programs. Such regulations require a financial institution to set internal policies, procedures, and processes for customer identification (CID) and CDD, along with other requirements. The regulations cover financial institutions that are currently required to develop AML programs, including, for example, banks, securities brokers or dealers, mutual funds, futures commission merchants, and commodities brokers. Prior to the current CDD rule, U.S. financial institutions were not required to document the identities of the individuals who owned and controlled the financial institutions' legal entity customers.

Beneficial Ownership Disclosure

Central to the CDD rule is a requirement for financial institutions to establish and maintain procedures to identify and verify beneficial owners of a legal entity opening a new account. As with CID programs for natural persons, covered financial institutions must now collect from the legal entity customer the name, date of birth, address, and Social Security number or other government identification number (passport number or other similar information in the case of foreign persons) for individuals who own 25% or more of the legal entity; financial institutions are required to obtain the same information for one individual with significant responsibility to control or manage the legal entity at the time a new account is opened.

Risk-Based Customer Monitoring

The CDD rule also requires financial institutions to develop customer risk profiles and to update customer information on a risk basis for the purposes of ongoing monitoring and suspicious transaction reporting. These requirements make explicit what has been an implicit component of BSA and AML compliance programs. Under current regulations governing the filing of suspicious activity reports (SARs), for example, banks must submit SARs to FinCEN when transactions appear to have no business or apparent lawful

purpose or when customers engage in unusual and unexplainable financial activity. Without establishing a profile of a customer's usual business and financial transactions and monitoring and updating such a profile, the bank would be largely unable to spot transactions that may warrant suspicious activity reporting.

FinCEN's AML Regulatory Authorities.

FinCEN's regulations are found in 31 C.F.R. Chapter X, which is generally arranged according to type of institution. For example, standards for AML programs for banks are found in 31 C.F.R. 1020.210 and for brokers and dealers in 31 C.F.R. 1023.210. Due diligence requirements for correspondent accounts for foreign institutions and private banking accounts are prescribed in 31 C.F.R. 1010.610 and 31 C.F.R. 1010.620, respectively.

Sectors Not Covered by Treasury's Rule

Even following the CDD rule's implementation, critics argue that gaps remain in U.S. financial transparency requirements. Critics note that the 25% ownership threshold means that if five or more people share ownership, a legal entity may not name or identify any of them (only one management official). Also, the rule applies to new, but not existing, accounts. Others, such as FATF, have criticized the United States for lacking beneficial ownership requirements for corporate formation agents and real estate transactions. Neither sector is directly affected by the FinCEN rule, but legislation to address both areas has been introduced in Congress.

Beneficial Ownership Disclosure at Company Formation

As previously noted, corporate vehicles are created at the state level. Certain bills in the 115th Congress would address requirements for beneficial ownership identification when states permit corporate entities to be formed, such as S. 1454, S. 1717, and H.R. 3089. Another approach would seek to create a federal office to charter corporations (S. 3348).

Beneficial Ownership Disclosure for Real Estate Purchases

Shell companies can also mask beneficial ownership of real estate purchases and sales. Treasury is authorized under 31 U.S.C. 5326 to issue geographic targeting orders (GTOs) imposing recordkeeping and reporting requirements on domestic financial institutions and nonfinancial businesses in certain geographic areas to facilitate law enforcement detection of criminal activity. Treasury has issued GTOs requiring disclosure of beneficial owners of legal entities involved in "all cash" purchases of luxury real estate in select major metropolitan areas including New York City and Miami, apparently discouraging this as a method of money laundering. H.R. 2426 would require similar information for certain federal agency leases.

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