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The Beneficial Ownership rule

A shift in policy



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The Beneficial Ownership rule: A shift in policy

U.S. banks and other financial institutions are subject to a number of rules governing their business relationships. A vital current regulatory challenge is the information that must be collected and maintained on the beneficial owners of a public entity.

A beneficial owner is an individual that, either directly or indirectly, has a significant ownership interest in a company. Behind this simple concept countless hours, exhaustive debate and much legislative effort has gone into understanding exactly what ownership information needs to be collected, where it should be stored, who should have access to it, and how it should be used.

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Over the course of 2023, it will be incumbent upon banks, financial institutions, and other entities to understand the obligations created by regulators as they implement beneficial ownership rules designed to rein in the use of shell companies to mask illicit transactions. These new rules and regulations will go into effect soon and full compliance will be required with limited time to cure defects.

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued its final version of the beneficial ownership rule on September 29, 2022. The rule implements reporting requirements under section 6403 of the Corporate Transparency Act of 2021 (CTA), the Anti-Money Laundering (AML) Act of 2020, and the National Defense Authorization Act of 2021. The new rule takes effect on January 1, 2024.

Following that reporting-requirements rule, Treasury on December 15 issued its much-anticipated proposal on which entities will have access to the collected beneficial ownership data. These regulations may increase compliance burdens on financial institutions. Comments on the proposed access rule are due by February 13, 2023.

The proposal was made under a provision of the AML Act that mandated the creation of a national registry of information regarding the individuals behind companies that are registered or doing business in the United States. Financial institutions had initially hoped that the new registry might relieve them of their obligation to collect such data while bringing on new clients, or otherwise ease their customer due diligence burden.

“The beneficial ownership information reporting rule finalized earlier this year is a major step forward in unmasking shell companies and protecting the U.S. financial system from abuse by money launderers, drug traffickers, sanctioned oligarchs, and other criminals,” said FinCEN Acting Director Himamauli Das in announcing the proposed access regulations. “In this next step, the proposed rule would provide the highest standards of security and confidentiality while ensuring that the new beneficial ownership database is highly useful to law enforcement agencies.”

While there is more to come regarding the beneficial ownership rule, thus far the situation has not yet provided the relief that financial institutions hoped for. As 2023 progresses and there is further clarification, it is possible that the anticipated relief will come to light and the compliance burden will shift away from the financial institutions.

Overview and background

The CTA, which was enacted as part of the landmark AML Act of 2020, charged FinCEN with implementing the rules for beneficial ownership, developing protocols for access to and the sharing of the information, and with amending the Customer Due Diligence (CDD) rule applicable to financial institutions. The beneficial ownership rule finalized in September 2022 only addresses *ownership* reporting and requires beneficial ownership information to be reported to and housed within a new database referred to as the Beneficial Ownership Secure System (BOSS).

It is anticipated that the BOSS database will be developed by FinCEN, and that it will be non-public, but available to federal agencies in support of their national security, intelligence, and law enforcement activities, as well as state, local, and foreign law enforcement agencies in specified circumstances.

While the final rule goes into effect on January 1, 2024, there is a one-year grace period for covered entities created or registered prior to the effective date. Companies created or registered on or after January 1, 2024, will have 30 days to file their initial reports. Noncompliance with the reporting requirements, including failing to report complete beneficial ownership information or reporting false or fraudulent information, can result in civil penalties of up to \$500 per day or criminal penalties, including up to \$10,000 in fines and imprisonment for up to two years.

In addition to the December 15 proposal on access to the BOSS database, FinCEN also is reportedly working on a rule to incorporate National AML/CFT Priorities, announced in June 2021, into various financial institutions' AML program rules, according to industry sources.

Exemptions

FinCEN specifically exempts 23 types of entities from the “reporting company” definition that would trigger beneficial ownership rule compliance. The exemptions include a wide range of regulated entities already required to report beneficial ownership information to their respective regulators. FinCEN has said that its beneficial ownership rule targets “generally smaller, more lightly regulated entities that may not be subject to any other beneficial ownership information reporting requirements.”

The 23 exempt categories include:

1. All reporting securities issuers that report to the Securities and Exchange Commission (SEC)
2. Governmental authorities
3. Banks
4. Credit unions
5. Depository institution holding companies
6. Money services or transmitting businesses
7. Brokers or dealers in securities registered with the SEC
8. Securities exchanges or clearing agencies
9. Other Exchange Act-registered entities
10. Investment companies or investment advisers registered with the SEC under the Investment Advisers Act of 1940
11. Venture capital fund advisers as described in Section 203(l) of the Advisers Act
12. Insurance companies
13. State-licensed insurance producers
14. Commodity Exchange Act registered entities
15. Accounting firms
16. Public utility companies
17. Financial market utilities as designated by the Federal Reserve Board
18. Pooled investment vehicles advised by certain exempt entities
19. Tax-exempt entities
20. Entities assisting a tax-exempt entity
21. Large operating companies
22. Subsidiaries of certain exempt entities, and
23. Inactive entities

Further, many pooled investment funds, such as hedge funds or private equity funds, are included in the exemption list under some circumstances. Private funds that rely on exemptions from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act are exempt from reporting beneficial ownership information under the pooled investment vehicle exemption, provided the private fund is advised by a federally registered investment adviser, an exempted reporting adviser that relies on the venture capital fund adviser exemption, a bank, credit union, or a broker-dealer. This category represents a very large percentage of all pooled funds.

Private funds that are advised by an exempted reporting adviser that relies on the private fund adviser exemption and state-registered investment advisers *are not* exempted from reporting beneficial ownership information.

FinCEN also includes a limited exemption for foreign pooled investment vehicles where the only beneficial ownership information required to be reported is that of the individual with the greatest authority over the strategic management or substantial control of the fund. However, FinCEN clarified that a foreign fund is required to rely only on the limited foreign pooled investment vehicle exemption to the extent it is a foreign reporting company in the first place.

Although FinCEN was granted the authority to add exempt entities to the list, it has declined to make any additions thus far.

FinCEN estimated in its rulemaking process that the burden of the beneficial ownership information reporting would be approximately 40 minutes.

Financial institution and regulator access to the registry

The Corporate Transparency Act authorizes FinCEN to disclose a reporting company's beneficial ownership information to a financial institution "only to the extent that such disclosure facilitates the financial institution's compliance with CDD requirements under applicable law, and only if the reporting company first consent."

"FinCEN takes these constraints seriously given the sensitive nature of beneficial ownership information and the potential number of financial institution employees who could have access to it," the proposed rule continues. "FinCEN is therefore not planning to permit financial institutions to run broad or open-ended queries in the beneficial ownership IT system or to receive multiple search results."

The proposal adds that FinCEN "anticipates that a financial institution, with a reporting company's consent, would submit to the system identifying information specific to that reporting company, and receive in return an electronic transcript with that entity's beneficial ownership information."

With regard to regulatory agencies' access to the registry, the CTA "permits similarly narrow access for federal functional regulators and other appropriate regulatory agencies exercising supervisory functions," FinCEN's proposal states. "The statute allows these agencies to request from FinCEN beneficial ownership information that the financial institutions they supervise have already obtained from the bureau, but only for assessing a financial institution's compliance with CDD requirements under applicable law."

This suggests that financial institutions will face more regulatory oversight of their compliance with FinCEN's amended CDD rule. Further, the access proposal states that FinCEN "envisions" that financial institution employees "may need to share beneficial ownership information with counterparts, *e.g.*, if they are working together to on-board a new customer."

However, the Treasury bureau plans "to expressly limit financial institutions to redisclosing beneficial ownership information to other officers, employees, contractors, and agents of the financial institution physically present in the United States," the proposal states, adding that "FinCEN believes this limitation is necessary to provide appropriate protection to beneficial ownership information against disclosures to foreign governments outside of the framework established by the CTA."

Financial institutions, therefore, would need to put into place safeguards to ensure beneficial ownership information data is not viewed by employees outside of the United States.

Compliance takeaways

Several key questions should be considered carefully to ensure full compliance with the new rules around beneficial ownership information collection and reporting, both in the U.S. and abroad.

Are banks responsible for policing BOSS registry data?

FinCEN's proposal notes that the CDD rule requires "that certain types of U.S. financial institutions identify and verify the beneficial owners of legal entity customers at the time those financial institutions open a new account for a legal entity customer."

The proposal adds, however, that the CDD rule provides "only a partial solution" to the establishment of beneficial ownership because the information provided to U.S. financial institutions about beneficial owners currently "is generally not comprehensive and not reported to the U.S. government."

The proposed rule continues: "The utility and value of beneficial ownership information reported to FinCEN (for inclusion in the registry), therefore, rests in large part on the bureau's ability to provide authorized recipients predictable and efficient access to reported beneficial ownership information while protecting the confidentiality and integrity of the information."

To some AML compliance experts, this portion of FinCEN's proposal suggests that FinCEN will expect financial institutions to access FinCEN registry data to compare it with information collected from customers during the on-boarding process in order to search for discrepancies, effectively making banks responsible for policing the accuracy of registry data.

"So banks will be put in charge of policing private enterprise?" asked Sarah Beth Felix, a former Bank Secrecy Act (BSA) compliance officer who now runs Palmera Consulting, an AML consulting firm. "If the true intent of the CTA was to provide better info to law enforcement for investigations, then the (FinCEN registry) should be accessible by BSA officers and should not require financial institutions to have time-sucking processes in place to get permission from clients, keep evidence of permission, ping the registry, record it, go back to the client for discrepancies, etc."

How will the U.S. rule be reconciled with other similar rules abroad?

As the U.S. works to finalize the BOSS system and confirm the access to the database, it could look to the European Union's experience, which has seen challenges. The E.U.'s Beneficial Ownership Registers Interconnection System (BORIS) currently pulls in data from four countries and identifies beneficial owners from 194 jurisdictions.

Now, however, European lawmakers are seeking ways to re-open access to national beneficial ownership registers following a judgment by the European Court of Justice (ECJ), which has caused E.U. countries to limit their public access.

Lawmakers working on the upcoming Sixth Anti-Money Laundering Directive (6MLD) are now looking for possible ways to include access to the registers for “those contributing to the fight against money-laundering and terrorist financing,” while still respecting the ECJ decision, according to those members of the European Parliament (MEPs) assigned to the legislative process.

“The judgment by the ECJ on limiting public access to such registers surprised us,” said MEPs Luděk Niedermayer and Paul Tang, co-rapporteurs of 6MLD. “Beneficial ownership registers are an essential tool in the fight against money laundering and terrorist financing. [The] registers play an important part in ensuring compliance with existing rules, such as the obligation of know-your-customer checks and corporate due diligence procedures.”

In its November 2022 decision, the ECJ found the general public access to beneficial ownership information, as laid down in the previous AML directive (5MLD), constituted a “serious and disproportionate violation of the fundamental rights to private life and protection of personal data.”

What of other incidents of restricting access?

Following the ECJ decision, several countries have tightly restricted access to the registers. The MEPs said some countries appeared to have gone beyond what was called for in the judgment, by closing registers even for obliged entities such as banks or for updating information, which the MEPs called “unjustified.”

“Worse, it can harm the ability of member states’ authorities to effectively tackle money laundering and terrorist financing,” they said. “We strongly believe that limiting the access for competent authorities and obliged entities even for a limited period of time would lead to a substantial risk of an uptake of money laundering. It is of key importance that the access to those registers for competent authorities and financial intelligence units is not affected.”

The MEPs said work on 6MLD had already incorporated improvements with regards to access to beneficial ownership registers, but that the ECJ decision would now have to be reflected in the upcoming legislation. A draft report on the 6MLD proposal is due for a vote in the E.U. Parliament’s Committee on Economic and Monetary Affairs and its Committee on Civil Liberties, Justice & Home Affairs in mid-March, the MEPs said.

Conclusion

It is important to get the correct information about the direct and indirect owners of legal entities, and it is also important to properly store and protect that information. New standards have been vetted and the aim is to ensure that this process will generally make it more difficult for illicit actors and money launderers to continue to act in the shadows.

Further, the financial industry faces a need for singular compliance standard, especially around collecting and accessing beneficial ownership information data. The BOSS system, which will become active in January 2024, is only the first step, but it is an important one. Failure to meet the strict new compliance guideline could have banks, financial institutions, and other entities facing financial penalties and other actions.

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