How FinCEN Shell Co. Rules Differ From Past BSA Standards

By **Jules Carter, Carolyn Meade and Barbara Meeks** (March 11, 2022)

Jules Carter

Carolyn Meade

Barbara Meeks

The history of financial crimes enforcement under the Bank Secrecy Act can be fairly divided into three distinct chapters, each representing a political reaction to a social or economic problem characterized by abuse of the financial system.

The law was originally born out of concern that policies intended to protect bank customers' information were being exploited to facilitate organized crime.

In 2001, prompted by the 9/11 attacks, focus shifted to combating money flows to terrorist organizations.[1]

Now, as we enter a new chapter, the BSA has been overhauled once again with the goal of preventing abuse via the use of anonymous shell companies.

The Corporate Transparency Act sets a new goal for the U.S. Department of the Treasury's Financial Crimes Enforcement Network: preventing bad actors from using U.S. corporate laws to conceal illicit financial activity.[2]

The challenge is not FinCEN's alone; U.S. financial institutions, companies and investors are integral to the war on corruption, but they first have to make sense of the overlapping rules and regulations in this area.

One emerging concern for companies doing business in the U.S. is how reporting requirements under the CTA and the implementing regulations **proposed** by FinCEN in December 2021[3] compare to their existing obligations under the customer due diligence, or CDD, rule,[4] which requires financial institutions to collect beneficial ownership from legal entity customers.

This article discusses some of those distinctions.

Reporting Companies

The most significant difference between the CDD rule and the proposed rule is that the former only requires legal entities to identify their beneficial owners to covered financial institutions.[5] It is the financial institution that is responsible for verifying those identities, maintaining relevant records and reporting to authorities.

However, reporting only occurs upon detection of suspicious activity or pursuant to an information request from FinCEN, commonly referred to as Section 314(a) requests.[6]

In contrast, the proposed rule requires all legal entities organized or registered to do business in the U.S. to self-report beneficial ownership information directly to FinCEN.[7]

Under both rules, certain entities are exempt from reporting requirements.

The common thread among the exemptions is that some element of the exempt entities' operation already makes it impracticable for such entities to maintain total secrecy with respect to their ownership structure and leadership.

In most cases, an entity is exempt because it is regulated in a way that requires information disclosure to members of the public or directly to authorities — e.g., an entity traded on a U.S. stock exchange; a charity or nonprofit entity; or a state or federal agency.[8]

That said, the exemptions are not entirely consistent between the proposed rule and the CDD rule.

Under the CDD rule, a foreign financial institution established in a jurisdiction that requires reporting of beneficial ownership information to its regulator will not also be required to report that information when opening an account with a U.S. financial institution.[9]

The proposed rule, however, includes no such exemption.[10]

Likewise, although they must provide beneficial ownership information to covered financial institutions under the CDD rule, the proposed rule exempts the following entities:

- Money transmitting businesses registered with FinCEN under Title 31 of the U.S. Code, Section 5330, and Title 31 of the Code of Federal Regulations, Section 1022.380;

- Venture capital fund advisers;

- Telecommunication, electric power, natural gas, water and sewer public utilities; and

- Inactive entities.[11]

Both the American Bankers Association and the Bank Policy Institute have, in their **comments** to the proposed rule, recommended that the CDD rule and the rules implementing the CTA exempt the same entities to reduce burdens on, and confusion among, banks and customers trying to comply with both rules.

Required Reports and Timing for Filing

Under the proposed rule, a domestic reporting company formed after the rule's effective date must file a report within 14 calendar days of its formation.[12] A foreign reporting company formed after the effective date must file a report within 14 calendar days of its registration to do business within the U.S.[13]

By contrast, the CDD rule applies only when an entity opens a new account at a covered financial institution.[14]

Neither the proposed rule nor the CDD rule impose a categorical requirement mandating updates to beneficial ownership information on a continuous, periodic basis.[15] Instead, update requirements are event-driven.

Under the proposed rule, a reporting company is obligated to file an updated report within 30 calendar days after a change that affects the beneficial ownership information previously submitted to FinCEN.[16]

The CDD rule similarly requires financial institutions to file updated reports when, in the course of their normal monitoring activities, they discover information indicating a change in a customer's previously provided beneficial ownership information.

Note, however, that there are significant practical limitations on a financial institution's ability to detect and update beneficial ownership information following a change.

If a legal entity customer does not promptly and voluntarily disclose this information, it can cause a significant delay in reporting.

Individuals Identified

The proposed rule is likely to increase the number of individuals a reporting company must identify in order to comply with law.

The CDD rule contains a two-pronged definition of "beneficial owner," including (1) "[e]ach individual, if any, who, directly or indirectly ... owns 25% or more of the equity interests of a legal entity customer"; and (2) "[a] single individual with significant responsibility to control, manage, or direct" such legal entity customer.[17]

The ownership prong of the proposed rule is substantially similar, but the proposed rule also includes among beneficial owners any individual "[e]xercising substantial control over the reporting company."[18]

This definition is expansive enough to encompass any person who:

- Serves as a senior officer of a reporting company, e.g., CEO, president, chief financial officer, treasurer, chief operating officer, secretary, general counsel, etc.;

- Exercises "authority over the appointment or removal of any senior officer or [a] dominant majority of the board of directors ... of a reporting company"; or

- Directs, determines or substantially influences important matters of a reporting company.[19]

The proposed rule's control prong is therefore significantly broader than the single individual required to be reported under the control prong of the CDD rule.

Conclusion

FinCEN has engaged significant resources in building the infrastructure and procedures necessary to meet reporting and record-keeping requirements under the CTA, mirroring the efforts undertaken by financial institutions in 2016 when they set about overhauling their customer due diligence processes and controls in response to FinCEN's rulemaking.

While companies await publication of the final rules under the CTA, as well as further guidance on the applicability of the rules to trusts, they will still need to comply with the CDD rule through their financial institutions.

The final CTA rule will also bring sweeping new disclosure obligations.

The greatest impacts will likely be felt in sectors that rely heavily on structured finance strategies involving special purpose entities and tiered holding companies.

Companies should begin the process of assessing potential impacts under the final CTA rules and centralizing entity information now, so they will be prepared to meet the requirements of CTA regulation when FinCEN releases the final rules this year.

In the financial services industry, firms will continue to face substantial costs and expenses to analyze and comply with the evolving rules.

Unless regulators provide some relief from the CDD rule, costly compliance structures will need to be maintained.

Furthermore, additional resources will need to be **expended** to leverage the information that will be made available to financial institutions as their customers comply with FinCEN's new rules.

Financial institution customers will likely produce duplicative information in order to comply with the final rules under the CTA and enable their financial institutions to continue to comply with the CDD rule.

Such duplication will consume valuable resources, but will also enable companies to avoid time-consuming false alerts produced by outdated or inconsistent information.

Jules W. Carter is an associate, and Carolyn P. Meade and Barbara S. Meeks are members, at Moore & Van Allen PLLC.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] P.L. 107-56 (Oct. 26, 2001).

[2] Him Das, Acting Director, Financial Crimes Enforcement Network, Prepared Remarks of FinCEN Acting Director Him Das, Delivered Virtually at the American Bankers Association/American Bar Association Financial Crimes Enforcement Conference (January 13, 2022) https://www.fincen.gov/news/speeches/prepared-remarks-fincen-acting-director-him-das-delivered-virtually-american-bankers.

[3] 31 C.F.R. Part 1010, Federal Register Vol. 83, No. 233 (Wednesday, December 8, 2021) pp. 69920-69973.

[4] 31 C.F.R. §1020.230.

[5] 31 CFR 1010.230(a). A "covered financial institution" is an insured bank, federally charted credit union, savings association and other defined institutions such as a broker or dealer in securities registered or required to be registered with the Securities and Exchange Act of 1934 (except those registering only for purposes of futures transaction on a registered exchange). 31 CFR 1010.605(e)(1).

[6] See 31 U.S.C. § 5318(b) which limits the Secretary of Treasury's examination of financial institution records or production requests to financial institutions to investigations into legal violations.

[7] Proposed 31 CFR 1010.380(b); 31 U.S.C. 5336(a)(11)(A)(i)-(ii).

[8] 31 CFR 1010.230(e)(2)(iii); Proposed 31 CFR 1010.380(c)(2)(i).

[9] 31 CFR 1010.230(e)(1); 31 CFR § 1010.520.

[10] 31 U.S.C. 5336(a)(11)(A)(i)-(ii).

[11] Proposed 31 CFR 1010.380(c)(2)(vi), (xi), (xvi) and (xxiii), respectively.

[12] Proposed 31 CFR 1010.380(a)(1)(i).

[13] Id.

[14] 31 CFR 1010.380(b). An "account" is a formal banking relationship established to provide or engage in services, dealings, or other financial transactions including a deposit account, a transaction or asset account, a credit account, or other extension of credit; or a relationship established to provide a safety deposit box or other safekeeping services, or cash management, custodian, and trust services. This does not include check-cashing, wire transfer, sale of a check or money order, etc.

[15] 81 F.R. 29398-29458, at 29399.

[16] Proposed 31 CFR 1010.380(a)(2). Causes for updating BOI reports include change of beneficial owner or applicant name, expiration of the provided identification number document, or change in the identifying information for the reporting company, such as address or name/DBA. 86 F.R. 69962.

[17] 31 CFR §1010.230(d).

[18] 31 U.S.C. 5336(a)(3)(A).

[19] Proposed 31 CFR 1010.380(d)(1); proposed 31 CFR 1010.380(f)(8). However, "[t]he ordinary execution of day-to-day managerial decisions with respect to one part of a reporting company's assets or employees typically should not, in isolation, cause the decision-maker to be considered in substantial control of a reporting company, unless that person satisfies another element of the 'substantial control' criteria." 86 F.R. at 69934.