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MEMORANDUM

May 7, 2018

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RE: FinCEN's New Customer Due Diligence Requirements for Financial Institutions in the Context of Certain Sales of Securities

Background

Effective **May 11, 2018**, new rules adopted by the Financial Crimes Enforcement Network (“FinCEN”), within the U.S. Department of the Treasury, will require financial institutions to identify and verify the identity of key individuals (*i.e.*, “beneficial owners”) who own or control legal entity customers of the financial institutions and to obtain a certification from the legal entity customers as to their beneficial owners (the “beneficial ownership requirement”). The new rules are intended to assist law enforcement in investigating and prosecuting terrorist financing, money laundering, and other financial crimes that may be perpetrated through the use of legal entities.

The beneficial ownership requirement applies at the time each new account is opened. For these purposes, an account is defined to include a formal relationship with a broker-dealer established to effect transactions in securities. Accordingly, broker-dealers have considered how the beneficial ownership requirement may apply when providing clients with trading and underwriting services.

Beneficial Ownership Requirements

FinCEN’s beneficial ownership definition includes two parts:

- (a) the control prong, covering *a single individual* with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer, a senior manager or any other individual who regularly performs similar functions; and
- (b) the ownership prong, covering *each individual* (if any) who directly or indirectly owns 25% or more of the equity interests of a legal entity customer.

The new rules require covered financial institutions to collect and verify the beneficial ownership information of up to five individuals: one person under the control prong and each person who meets the definition under the ownership prong. FinCEN has provided a certification form that financial institutions may use to obtain the required beneficial ownership information, but firms are not required to do so and may choose to obtain the required information through their own forms or any other method that complies with the substantive requirements of the rules.

Although FinCEN’s rules require the collection of information about owners of 25% or more of the equity interests of a legal entity customer, some financial institutions may collect information about owners of 10% or more of the equity interests. They may do so as a matter of practice, based on their own assessments of risk, or pursuant to other regulatory requirements. FinCEN has confirmed that financial institutions may use a beneficial ownership threshold lower than 25%.

Covered financial institutions must collect name, date of birth, address, and social security number (or, for non-U.S. persons, other government identification number) for each beneficial owner.



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They must also take action to verify the identity of each beneficial owner, which may include obtaining photocopies or other reproductions of identification documents.

Application to Underwriting Agreements, including Block Trades

In the context of an underwritten sale of securities, it is the intention of many underwriters that a certification of beneficial ownership and copies of identifying documents will be obtained by or on behalf of the lead underwriter with respect to each issuer and/or selling securityholder, as applicable. The lead underwriter will determine, based on its own policies and practices, whether to obtain equity ownership information at the 25% or 10% level. It is expected that the beneficial ownership information from the issuer and/or selling securityholder(s) will be made available to members of the syndicate through (1) counsel to the issuer and/or selling securityholder(s), (2) counsel to the underwriters, (3) a service provider for the distribution of documents, or (4) other means. Each member of the syndicate will apply its own procedures for verification, as applicable. This approach will be used in connection with underwriting agreements, including formal relationships established with respect to “block trades,” executed on or after May 11, 2018.

In the context of underwritten transactions, the participation of financial institutions subject to FinCEN’s beneficial ownership requirement would be facilitated if the documentation provided to the members of the syndicate were to include:

(a) a certification regarding beneficial owners of legal entity customers (both the control prong and the ownership prong) in the form of Attachment A or Attachment B, as specified by the lead underwriter, executed on behalf of each issuer and/or selling securityholder that is a legal entity customer, and

(b) copies of the identifying documentation for (i) each issuer and/or selling securityholder that is a legal entity and (ii) each beneficial owner identified on the certification(s) (the “verification documentation”).

Because covered financial institutions will be required to identify and obtain a certification as to the beneficial owners of legal entity customers prior to or at the time that an underwriting agreement is signed on or after May 11, 2018, variations from the foregoing approach may delay the completion of a contemplated transaction.

In the context of “block trades,” a slight modification to the above approach is essential from a timing and process standpoint. Among other things, the seller in a block trade typically intends to sell quickly, the underwriting agreement often is prepared prior to potential underwriters being contacted, and lead underwriter(s) and other participants may not be identified until a short time prior to the transaction. In these transactions, the participation of covered financial institutions would be facilitated if (separate and apart from any applicable underwriting agreement) the documentation provided by the seller to the underwriter(s) when presenting a bid package for a block trade were lined up to include (a) a certification in the form of Attachment A, executed on behalf of each seller that is a legal entity customer, and (b) copies of the verification documentation for each legal entity and beneficial owner identified on the certification(s). Because covered financial institutions will be required to identify and obtain a certification as to the



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beneficial owners of legal entity customers in connection with each formal block trade relationship established on or after May 11, 2018, variations from the foregoing approach may delay the completion of a block trade.

Additional Information; Exclusions

The text of FinCEN's new beneficial ownership requirements is available at 31 C.F.R. 1010.230.

On July 19, 2016, FinCEN issued guidance summarizing the new requirements and responding to certain frequently asked questions: https://www.fincen.gov/sites/default/files/2016-09/FAQs_for_CDD_Final_Rule_%287_15_16%29.pdf.¹ Among other things, FinCEN's 2016 guidance summarizes the types of entities excluded from the beneficial ownership requirement (both the control prong and the ownership prong), which include:

- a financial institution regulated by a federal functional regulator or a bank regulated by a state bank regulator;
- a department or agency of the United States, of any state, or of any political subdivision of a state;
- an entity established under the laws of the United States, or any state, or of any political subdivision of any state, or under an interstate compact, that exercises governmental authority;
- an entity (other than a bank) whose common stock or analogous equity interests are listed on the New York, American, or NASDAQ stock exchange;
- a subsidiary, other than a bank, of an entity described in the immediately preceding bullet that is organized under the laws of the United States or of any state and at least 51% of whose common stock or analogous equity interests are held by the listed entity;
- an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of that Act;
- an investment company, as defined in section 3 of the Investment Company Act of 1940, registered with the Securities and Exchange Commission (the "SEC");
- an SEC-registered investment adviser, as defined in section 202(a)(11) of the Investment Advisers Act of 1940;
- an exchange, a clearing agency, or any other entity registered with the SEC under the Securities Exchange Act;
- a registered entity, commodity pool operator, commodity trading advisor, retail foreign exchange dealer, swap dealer, or major swap participant, defined in section 1a of the Commodity Exchange Act, registered with the Commodity Futures Trading Commission;
- a public accounting firm registered under section 102 of the Sarbanes-Oxley Act;
- a bank holding company, as defined in section 2 of the Bank Holding Company Act of 1956 (12 USC 1841), or a savings and loan holding company, as defined in section 10(n) of the Home Owners' Loan Act (12 USC 1467a(n));
- a pooled investment vehicle operated or advised by a financial institution excluded from the beneficial ownership requirement;

¹ FinCEN issued additional frequently asked questions on April 3, 2018. *See* https://www.fincen.gov/sites/default/files/2018-04/FinCEN_Guidance_CDD_FAQ_FINAL_508_2.pdf.



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- an insurance company regulated by a state;
- a financial market utility designated by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Wall Street Reform and Customer Protection Act of 2010;
- a foreign financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution;
- a non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; and
- any legal entity only to the extent that it opens a private banking account subject to 31 C.F.R. § 1010.620.

In addition to these exclusions, the following types of entities are subject to the control prong of the beneficial ownership requirement, but not the ownership prong:

- a pooled investment vehicle operated or advised by a financial institution that is not excluded from the beneficial ownership requirement; and
- any legal entity that is established as a nonprofit corporation or similar entity and has filed its organizational documents with the appropriate state authority as necessary.

These exclusions may apply to any issuer and/or selling securityholder, but an exclusion available to one party to a transaction does not exclude other parties. For example, in a secondary equity offering, any selling securityholder that does not otherwise qualify for an exclusion would need to comply with the beneficial ownership requirements, even if the issuer is excluded.

We suggest that any exclusion an issuer and/or selling securityholder may believe to be applicable should be considered by and discussed between counsel to the issuer and/or selling securityholder and counsel to the underwriter(s) and addressed with the underwriter(s) as appropriate.

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As noted by FinCEN, it is the responsibility of a legal entity customer to identify its ultimate beneficial owners, and financial institutions may rely on the information provided (absent reason to question its reliability).
