

# Legal Update

## FinCEN Issues Proposed Rules Requiring Certain US and Non-US Legal Entities to Report Beneficial Ownership Information

On December 8, 2021, the US Financial Crimes Enforcement Network (“FinCEN”) published a Notice of Proposed Rulemaking (“NPRM”) to implement registration and disclosure requirements of the Corporate Transparency Act (“CTA”), which was enacted into law as part of the National Defense Authorization Act (“NDAA”) on January 1, 2021.<sup>1</sup>

The registration requirements proposed in the NPRM will apply to specified US corporate and other legal entities, as well as specified legal entities formed outside the United States that are registered to do business in the United States. The registration and disclosure requirements may be particularly relevant to banks and investment fund structures that establish legal entities in connection with financings and corporate acquisitions.

### I. Background

The CTA requires certain legal entities, including limited liability companies (“LLCs”), to register with FinCEN and disclose their ultimate beneficial owners. On April 5, 2021, FinCEN published an ANPRM, which was the initial step in the rulemaking process and was discussed in detail in a [previous Legal Update](#). The NPRM is the next step toward the implementation of the CTA.<sup>2</sup>

The NPRM also is part of a broader Biden administration strategy to combat financial crimes. On December 6, 2021, right before FinCEN published the NPRM, the White House released the first-ever “US Strategy on Countering Corruption”<sup>3</sup> (the “Strategy”), in which it discusses five pillars that will be deployed by the White House to combat corruption.<sup>4</sup> In one of the five pillars, the White House explained that it would issue beneficial ownership transparency regulations to counteract opaque corporate structures. This facet of the Strategy overlaps with FinCEN’s move to implement the CTA.

### II. Notice of Proposed Rulemaking

As detailed by FinCEN in the NPRM, closely held corporate entities, particularly shell companies, have been used to conceal the proceeds of crimes, including corruption and terrorist financing. However, currently law enforcement must rely on costly and time-consuming investigative tools to obtain

beneficial ownership information for closely held corporate entities.<sup>5</sup> The implementation of the CTA's provisions, such as the CTA Registry contemplated in the NPRM, is intended to provide law enforcement, regulators and financial institutions with a single, comprehensive source of beneficial ownership information. With this information, law enforcement in particular will be better positioned to identify "linkages between potential illicit actors and business entities."<sup>6</sup>

Following FinCEN's review of 220 public comments received in response to its ANPRM, the NPRM addresses who will be required to file beneficial owner information with the CTA Registry (and who will be exempt from filing), what will need to be filed and when filers will be required to provide the required information. Below we discuss each of these concepts, along with the potential civil and criminal penalties for failure to comply with these reporting obligations, and the implications of the NPRM for financial institutions.

## **A. WHAT IS A "REPORTING COMPANY"?**

The CTA's filing requirements apply to "reporting companies," which include both domestic and foreign companies.<sup>7</sup> Under the NPRM, a domestic reporting company would include a corporation, LLC or any other entity created by the filing of a document with a secretary of state or similar office, including, in certain circumstances, limited partnerships and business trusts.<sup>8</sup> A foreign reporting company would include a corporation, LLC or other entity formed under the law of a foreign country that is registered to do business in any jurisdiction within the United States.<sup>9</sup>

## **Who Are "Exempt Entities"?**

The CTA sets forth exemptions from the reporting requirements for certain domestic and foreign legal entities.<sup>10</sup> FinCEN plans to adopt verbatim the statutory language of the CTA, under which 23 categories of entities<sup>11</sup> are exempt from the regulation. Generally, the categories of exempt entities cover entities that are heavily regulated and, therefore, have beneficial ownership information that is more readily available to US regulators, such as US banks, US Securities and Exchange Commission ("SEC")-reporting issuers, SEC-registered broker-dealers, SEC-registered investment companies and advisers, FinCEN-registered money transmitting businesses, and insurance companies, among many others. While the proposed rule does not diverge from the language of the CTA, the NPRM proposes clarifications to certain exemption definitions, such as "public utilities," "dormant entities," "large operating companies" and entities covered by what FinCEN calls the "subsidiary exemption." Notwithstanding these clarifications, key questions remain regarding the meaning of certain exemptions, such as how to treat "pooled investment entities."

### ***"Large Operating Companies" Exemption.***

Under the NPRM, an entity will be exempt from the reporting requirements if it is a larger operating company, which is defined as an entity that (1) employs more than 20 employees on a full-time basis in the United States; (2) filed in the previous year federal income tax returns in the United States demonstrating more than \$5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of other entities owned by the entity and through which the entity operates; and (3) has an operating presence at a physical office within the United States.<sup>12</sup> The NPRM clarifies what it means to employ someone on a full-time basis by referencing the US Internal Revenue Service's ("IRS") definition of a "full-time employee." For the tax filing prong, the relevant filing may be a US federal income tax or information return, including a parent company's consolidated return. For the

“operating presence at a physical office” prong, the entity must have a physical office that is owned or leased, is not a residence and is not a shared space.

### ***Subsidiary Exemption.***

With respect to the “subsidiary exemption,” the NPRM seeks to clarify which entities (usually subsidiaries) that are owned or controlled by other exempt entities (which include most, but not all, exempt entities under the CTA) will themselves be exempt from the filing requirement.<sup>13</sup> Notably, FinCEN interprets the statutory text as requiring an entity to be owned entirely by one or more specified exempt entities in order to qualify for this exemption, which may preclude entities subject to director qualifying share requirements from qualifying.

Given that the “large operating companies” exemption and the “subsidiary exemption” have the potential to cover a wider range of entities than some of the other exemptions, those submitting comments to FinCEN may advocate for broader definitions of these statutory categories.

### ***“Pooled Investment Vehicles” Exemption.***

As discussed in our [previous Legal Update](#), the CTA and the current Customer Due Diligence (“CDD”) Rule<sup>14</sup> treat the “pooled investment vehicles” exemption in different ways. The exemption in the CTA for pooled investment vehicles is narrower than the exemption in the existing CDD Rule and covers only certain vehicles that are SEC-registered investment companies or 3(c)(1) or 3(c)(7) companies. This could prove problematic for unregistered investment companies that rely on another exclusion (e.g., 3(c)(5) companies). However, the NPRM does not provide additional guidance regarding the pooled investment vehicles exemption and adopts the CTA’s definition verbatim.<sup>15</sup> Thus, questions regarding the definition of pooled investment vehicles will likely remain as those who seek to qualify under an exemption to the reporting requirements will have to not only satisfy the CDD Rule’s definition but also qualify under the CTA’s requirements. We anticipate that FinCEN’s forthcoming proposal amending the CDD Rule will harmonize the requirements for this exemption.<sup>16</sup>

## **B. WHOSE INFORMATION MUST BE REPORTED?**

The CTA requires the reporting company to submit to FinCEN information relating to each of its “beneficial owner(s)” and “company applicant(s).”

### **1. Beneficial Owner.**

The CTA defines a “beneficial owner” as “an individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise—(i) exercises substantial control over the entity; or (ii) owns or controls not less than 25 percent of the ownership interests of the entity.”<sup>17</sup> As described below, FinCEN has proposed regulations that expand on the meaning of these terms.

### ***Substantial Control.***

In order to clarify what it means to exercise “substantial control” over an entity, FinCEN identifies three indicia of substantial control in the NPRM: (1) service as a senior officer of a reporting company; (2) authority over the appointment or removal of any senior officer or dominant majority of the board of directors (or similar body) of a reporting company; and (3) direction, determination or decision of, or substantial influence over, important matters of a reporting company.<sup>18</sup>

The definition of “senior officer” includes any “individual holding the position or exercising the authority of a president, secretary, treasurer, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function.” Further, senior officers may not rely on the exemption for employees of a reporting company.

This interpretation greatly expands the universe of persons who must be reported to include many executives who may have no financial interest in the performance or assets of the reporting company. It also may be particularly burdensome for foreign companies subject to comprehensive privacy laws (e.g., EU General Data Protection Regulation or GDPR), which could be required to disclose the foreign residential addresses of executives.

### ***Ownership or Control of Ownership Interests.***

The NPRM also clarifies what it means to “[own] or control not less than 25 percent of the ownership interests of the entity”<sup>19</sup> by defining ownership interests (which may be held through trusts or similar arrangements), providing guidance on how to determine a 25 percent ownership interest (which is done by aggregating all of the individual’s ownership interests in comparison to the undiluted ownership interests of the company) and explaining how an individual can “own or control” interests (which can be done directly or indirectly). Notably, “ownership interests” include all instruments that represent a capital interest in the reporting company or a right or interest in the value of the reporting company or its profits. This would include equity kickers and potentially could include other instruments with equity-like attributes, such as preferred shares.<sup>20</sup>

## **2. Company Applicant.**

In addition to beneficial owners, a reporting company is required to submit information regarding the “company applicant.” For domestic reporting companies, the proposed rule defines a company applicant as an individual who files the document that forms the entity.<sup>21</sup> For foreign reporting companies, a company applicant is the individual who files the document that first registers the entity to do business in the United States.<sup>22</sup>

In both cases, anyone who directs or controls the person who files the relevant document would also be a company applicant. Further, the NPRM explicitly states that a deceased person may be a company applicant, meaning that long-established reporting companies would be required to report “whatever identifying information the reporting company actually knows about the [deceased] company applicant.” This approach suggests that FinCEN expects reporting companies to obtain all required information for any living company applicants, even if the relevant individual no longer has any association with the entity (e.g., obtaining a current residential address and government identification number from a former employee who filed a foreign reporting company’s first US business registration in the 1980s).

## **C. WHAT INFORMATION MUST BE REPORTED?**

FinCEN requires the reporting company to provide its name, any alternative names through which it engages in business, its business street address, the jurisdiction of formation or registration and a unique identification number. With respect to beneficial owner and company applicant information (“BOI”), the reporting company must provide an individual’s names, birthdate, residential or business address (depending on whether the person is a beneficial owner or certain kind of company applicant) and a unique identifying number from an “acceptable identification document” (and the

image of such document). The proposed rule also allows a reporting company to report the Taxpayer Identification Number of its beneficial owners and company applicants on a voluntary basis.<sup>23</sup>

FinCEN recognized in the NPRM that commenters urged it to collect information with respect to the reporting company's relationships with intermediate legal entities, its parents, subsidiaries, affiliates and beneficial owners. However, commenters did not identify the statutory authority for collection of such information. Therefore, while FinCEN welcomes further comments on this topic, it remains to be seen if FinCEN will add any additional reporting requirements in the final rule regarding a reporting company's relationship to its closely connected entities and individuals.

#### **D. WHEN MUST REPORTS AND UPDATES BE FILED BY?**

FinCEN proposed new rules regarding the timing of reports, corrections and updates as part of the NPRM.<sup>24</sup> For domestic and foreign reporting companies created or registered on or after the final regulation, the rule would specify that the reporting company must file with FinCEN 14 days after formation or registration. Entities formed or registered before the effective date of the final regulations are required to file a report no later than one year after the effective date of the regulation.

The NPRM also addresses updates and corrections to already filed information. Generally, it requires reporting companies to file an updated report within 30 calendar days after the date on which there is any change with respect to any information previously submitted to FinCEN. These updates must include any change in beneficial ownership and changes in information reported about any particular beneficial owner or applicant. Reporting companies must also file updates when entities are no longer under an exemption, when entities fall under an exemption after reporting and when there is a transfer of interest through intestacy or testamentary disposition. A reporting company must also correct inaccurately filed information within 14 calendar days after the date on which the reporting company becomes aware or has reason to know of the inaccuracy.<sup>25</sup>

#### **E. WHAT ARE THE PENALTIES FOR VIOLATIONS?**

Under the CTA, if an individual commits a reporting violation (i.e., willfully provides false or fraudulent beneficial ownership information or willfully fails to report complete or updated beneficial information), that person will be liable for (1) a civil penalty up to \$500 each day a violation continues or has not been remedied and (2) a fine up to \$10,000, imprisonment up to two years or both.<sup>26</sup> For unauthorized disclosure or use violations, a person shall be liable for (1) a civil penalty up to \$500 each day a violation continues or has not been remedied and (2) a fine up to \$250,000, imprisonment up to five years or both.<sup>27</sup> More severe penalties apply to individuals who engage in unauthorized disclosures or use beneficial ownership information as part of a pattern of illegal activity.<sup>28</sup>

In the NPRM, FinCEN clarified that "any person" committing a reporting violation would include any individual, reporting company or other entity and that it is unlawful for such person to directly or indirectly provide false information in a report or application. A person "fails to report" beneficial ownership information if such person directs or controls another person to not report or is in substantial control of a reporting company when it fails to report. Although the proposed rule did not clarify the CTA provisions regarding individuals' unauthorized disclosure or use of BOI, FinCEN promised to address disclosure rules for BOI in the final rule.

### III. Implications for Financial Institutions

The CTA requires that FinCEN revise its existing beneficial ownership rules for financial institutions.<sup>29</sup> While the NPRM does not address the existing CDD Rule, FinCEN is expected to initiate a separate rulemaking amending the CDD Rule within one year of the effective date of the finalization of the proposed rule.<sup>30</sup> Once issued, we expect the revised CDD Rule to be harmonized with FinCEN's final rule and ultimately reduce the compliance burden on financial institutions.

In the interim, financial institutions will benefit from reporting company reports containing BOI maintained in the CTA Registry, as FinCEN "may disclose beneficial ownership information reported" pursuant to the CTA upon receipt of "a request made by a financial institution subject to customer due diligence requirements, with consent of the reporting company, to facilitate the compliance of the financial institution with customer due diligence requirements under applicable law."<sup>31</sup> Financial institutions that anticipate making requests for legal entity customers should consider whether or how to update customer agreements and related documentation to provide for such consent.

Additionally, the proposed rule's definition of whether a beneficial owner exercises "substantial control" over a reporting company is broader than in the existing CDD Rule, which may potentially allow financial institutions to access more information regarding their corporate customers. As noted above in our discussion of "substantial control," the proposed rule reflects an expansion over the universe of persons who must be reported by requiring reporting of senior officers and also adding a requirement to report any individuals who exert "direction, determination or decision of, or substantial influence over, important matters affecting the reporting company."<sup>32</sup> Moreover, under the current CDD Rule, the control prong requires new customers of a financial institution to provide beneficial owner information for one individual with a significant degree of control over the entity.<sup>33</sup> Under the proposed rule, FinCEN would not limit the number of individuals who exercise substantial control and whose BOI would be reportable to FinCEN and made available to financial institutions.<sup>34</sup>

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*For more information about the topics raised in this Legal Update, please contact any of the following lawyers.*

**Brad A. Resnikoff**

+1 202 263 3110

[bresnikoff@mayerbrown.com](mailto:bresnikoff@mayerbrown.com)

**Gina M. Parlovecchio**

+1 212 506 2522

[gparlovecchio@mayerbrown.com](mailto:gparlovecchio@mayerbrown.com)

**Matthew Bisanz**

+1 202 263 3434

[mbisanz@mayerbrown.com](mailto:mbisanz@mayerbrown.com)

**Jared B. Goldberger**

+1 212 506 2421

[jgoldberger@mayerbrown.com](mailto:jgoldberger@mayerbrown.com)

## Eliel Flores

+1 202 263 3351

[eflores@mayerbrown.com](mailto:eflores@mayerbrown.com)

## Grace Kim

+1 202 263 3892

[gkim@mayerbrown.com](mailto:gkim@mayerbrown.com)

## Endnotes

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<sup>1</sup> Beneficial Ownership Information Reporting Requirements, 86 Fed. Reg. 69,920 (Dec. 8, 2021) (*to be codified* 31 C.F.R. pt. 1010). The comment period for the NPRM closes on February 7, 2022.

<sup>2</sup> This NPRM is the first of three sets of rulemakings to implement the CTA. The first rulemaking, which we discuss here, implements the beneficial ownership information reporting requirements; the second will implement the CTA's rules for access to and disclosures of beneficial ownership information; and the third will review and revise the existing CDD Rule for consistency and alignment with the CTA requirements.

<sup>3</sup> [United States Strategy on Countering Corruption \(whitehouse.gov\)](https://www.whitehouse.gov/).

<sup>4</sup> We discuss this initiative in the recent Legal Update [First-Ever US Strategy on Countering Corruption Globally: Key Takeaways for Corporations to Match Enforcement's Increasingly Global, Integrated and Holistic Approach](#).

<sup>5</sup> 86 Fed. Reg. at 69,926.

<sup>6</sup> 86 Fed. Reg. at 69,922.

<sup>7</sup> 86 Fed. Reg. at 69,938.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 69,939.

<sup>10</sup> Corporate Transparency Act, 31 U.S.C. § 5336(a)(11).

<sup>11</sup> The 23 entities include the following: SEC-reporting issuers, domestic governmental authorities, banks, domestic credit unions, depository institution holding companies, FinCEN-registered money transmitting businesses, SEC-registered broker-dealers, securities exchange or clearing agencies, other Securities Exchange Act of 1934 entities, registered investment companies and advisers, venture capital fund advisers, insurance companies, state licensed insurance producers, Commodity Exchange Act registered entities, certain accounting firms, public utilities, financial market utilities, certain pooled investment vehicles, tax exempt entities, entities assisting tax exempt entities, large operating companies, subsidiaries of certain exempt entities and inactive businesses.

<sup>12</sup> 86 Fed. Reg. at 69,939-40.

<sup>13</sup> *Id.* at 69,940.

<sup>14</sup> The current CDD Rule requires certain financial institutions to identify and verify the beneficial owners of legal entity customers when those customers open new accounts as part of those financial institutions' customer due diligence programs.

<sup>15</sup> 86 Fed. Reg. at 69,944.

<sup>16</sup> *See infra* note 31.

<sup>17</sup> 31 U.S.C. § 5336(a)(3).

<sup>18</sup> 86 Fed. Reg. at 69,933-35.

<sup>19</sup> *Id.* at 69,935-36.

<sup>20</sup> *Id.* at 69,937.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 69,938-39.

<sup>23</sup> *Id.* at 69,970.

<sup>24</sup> *Id.* at 69,941-43.

<sup>25</sup> 86 Fed. Reg. at 69,942.

<sup>26</sup> *Id.* at 69,944; 31 U.S.C. § 5336(h)(3).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> 31 U.S.C. § 5336(d).

<sup>30</sup> 31 U.S.C. § 5336(a)(3), added by CTA Section 6403(d)(1).

<sup>31</sup> 31 U.S.C. § 5336(a)(3), added by CTA Section 6403(c)(2)(B)(iii).

<sup>32</sup> 86 Fed. Reg. at 69,972.

<sup>33</sup> 1010.230(d)(2). *See also*, FAQs for CDD Final Rule dated July 19, 2016. Both provide an illustrative list to assist in identifying a beneficial owner under the control prong of the definition, such as an executive or senior manager (e.g., chief executive officer, president, treasurer). This should be a high-level official with responsibility for how the organization is run and with access to information concerning day-to-day operations of the company.

<sup>34</sup> 86 Fed. Reg. at 69,934.

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