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UNDERSTANDING THE CUSTOMER DUE DILIGENCE FINAL RULE

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Objectives

By the end of this session, you will gain a better understanding of:

1. The four core elements of the Customer Due Diligence (CDD) Final Rule
2. How to apply the concepts within your CDD operations
3. The NY DFS Final Rule and model risk management across the three lines of defense

CDD FINAL RULE

Core Elements

Core Elements: Overview

Final Rule for Customer Due Diligence Requirements for Financial Institutions (May 11, 2016): FinCEN published the final rule enhancing customer due diligence (CDD) for financial institutions by requiring covered financial institutions to identify and verify beneficial owners of legal entity customers, with certain exclusions and exemptions.

Core Elements: Overview

The CDD final rule is intended to do the following:

- Assist law enforcement with information gathering for financial investigations
- Advance counter-terrorism, anti-money laundering and broader national security interests
- Assist financial institutions assess and mitigate AML risk
- Facilitate reporting and investigations for tax compliance (FATCA)
- “Level the playing field” by promoting consistency in implementing and enforcing CDD regulatory expectations, and aligning U.S. requirements with international standards
- Improve OFAC sanctions enforcement
- Create the fifth pillar for BSA/AML programs of covered financial institutions

Core Elements: Overview

As stated in the final rule, FinCEN believes there are four core elements of customer due diligence that serve as a minimum standard as follows:

- 1) Customer identification and verification – Customer Identification Program (CIP);
- 2) Beneficial ownership identification and verification;
- 3) Understanding the nature and purpose of customer relationships to develop a customer risk profile; and
- 4) Ongoing monitoring and reporting of suspicious transactions, as well as a risk-based approach for maintaining and updating customer information.

The **first** is already required and the **second** will be required as stated within the final rule. The **third** and **fourth** elements are already “implicitly required” for covered financial institutions.

Core Elements: Overview

The CDD final rule for beneficial ownership is summarized as follows:

- Covered financial institutions must identify and verify the identity of beneficial owners of all legal entity customers (other than those that are excluded or exempted) at the time of account opening
- There are two prongs for the definition of beneficial ownership – the “ownership prong” and “control prong”
- Beneficial owners are defined as each individual (natural person) who owns, directly or indirectly, 25% or more of the equity interests of the entity, and one individual with significant responsibility to control, manage or direct the entity (e.g., president, CEO, CFO, managing partner)
- The identification and verification procedures for beneficial owners are very similar to existing CIP requirements

Core Elements: Overview

The CDD final rule summary (*continued*):

- Financial institutions may comply either by obtaining the required information on a standard certification form (Certification Form) or by any other means that comply with the substantive requirements of this obligation
- The financial institution may rely on the beneficial ownership information supplied by the customer, provided that it has no knowledge of facts that would reasonably call into question the reliability of the information
- Updating of beneficial ownership should be event-driven or risk-based and may occur as a result of normal monitoring
- The final rule is effective on **July 11, 2016**
- Covered institutions must comply by **May 11, 2018**

Core Elements: Covered Financial Institutions

“Covered financial institutions” include the following:

- Federally regulated banks and federally insured credit unions
- Brokers or dealers in securities
- Mutual funds
- Futures commission merchants
- Introducing brokers in commodities

Core Elements: Beneficial Ownership

Beneficial ownership must be collected for all “legal entity customers” opening new accounts, subject to exclusions and exemptions as defined by the rule.

- **Legal entity customer** is defined as a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, or any similar entity formed under the laws of a foreign jurisdiction

Core Elements: Beneficial Ownership

Beneficial ownership is defined by two prongs within the rule as follows:

- **Ownership prong:** Individuals, if any, who directly or indirectly own 25% or more of the equity of a legal entity customer
- **Control prong:** Single individual with significant authority to control, manage or direct a legal entity (e.g., president, CEO, CFO, managing partner)

Both prongs must be satisfied, as applicable. There is a minimum of at least one beneficial owner and maximum of five based on the requirements outlined within the rule.

Core Elements: Beneficial Ownership

Other beneficial ownership attributes and requirements based on the rule include:

- 25% threshold is consistent with FATF and FATCA thresholds, but higher than some existing expectations
- A single individual may satisfy both prongs
- Must identify natural person(s) and verify their identity, but not necessarily their status as beneficial owner
- If a trust owns 25% or more, then the trustee should be the beneficial owner under the ownership prong
- Reliance provisions (on other financial institutions) are identical to those for CIP
- Updating of beneficial ownership is event driven, and it occurs as a result of normal monitoring

Core Elements: Beneficial Ownership

Required information for beneficial owners must be obtained on a standard “**Certification Form**” or by any other means that comply with the substantive requirements of the rule as follows:

- Name
- Date of Birth
- Address
- SSN (U.S. persons) or passport number or other similar information (foreign persons)

Customer must certify that information provided on the Certification Form (or other similar means) for beneficial owners is accurate to the best of their knowledge.

Core Elements: Beneficial Ownership

Covered financial institutions are required to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of new accounts opened by legal entity customers.

Beneficial owners should be identified and verified in accordance to CIP procedures* established for beneficial ownership. The procedures should be risk based and may include documentary (copies permitted) and non-documentary procedures.

*The clause “in the covered financial institution’s Customer Identification Program procedures” in the proposed rule text have been deleted, because the verification procedures for beneficial owners of legal entity customers may be different from the procedures in the covered financial institution’s CIP that apply to individual customers.

Core Elements: Beneficial Ownership

The procedures should include steps to maintain a record of the identifying information obtained as follows:

- Certification Form or similar means
- Description of any document relied upon
- Any non-documentary verification methods and the results of any measures undertaken
- Resolution of each substantive discrepancy
- Recordkeeping requirements are five years after account closure

The covered financial institution's procedures may include a reliance on photocopies of documentations, but they must determine if reliance on documents provided is reasonable.

Core Elements: Beneficial Ownership

Excluded legal entities:

- Federally regulated financial institution or state regulated bank
- Department, agency or political subdivision of federal or state government
- Entity established under law of federal or state government exercising authority on behalf of the government
- Entity other than a bank publicly traded on NYSE, NASDAQ or ASE
- Domestic entity with at least 51% owned by entity traded on NYSE, NASDAQ or ASE
- Issuer of securities under section 12 of Securities Exchange Act
- Investment company
- Investment adviser
- Exchange or clearing agency
- Other entities registered with the SEC
- Entities registered under Commodity Exchange Act, registered with CFTC
- Public accounting firm registered under Section 102 of Sarbanes-Oxley Act

Core Elements: Beneficial Ownership

Excluded legal entities (*continued*):

- Bank Holding Company
- Pooled investment vehicle operated by an excluded financial institution
- Insurance company regulated by a state
- Financial market utility designated by FSOC
- Foreign financial institutions where home regulator retains beneficial owner information non-U.S. government department, agencies and political subdivisions
(control prong applies)
- Legal entities opening private banking accounts subject to FinCEN Private Banking Rule
- Non-excluded pooled investment vehicles (control prong applies)
- Charities, non-profits, public benefit corporations (control prong applies)
- Small local community organizations (e.g., Girl Scout troops, sports leagues)

Core Elements: Beneficial Ownership

Exempt accounts:

- An account that is opened for a legal entity customer for the following activities is exempt from the beneficial ownership requirements since it presents a low risk of money laundering:
 - Point of sale credit products, including private label credit card accounts, solely for purchase of retail goods/services
 - Financing purchase of postage
 - Financing insurance premiums
 - Financing purchase or lease of equipment
- Limits on exemptions → The above do not apply to transaction accounts where customer can make payments to, or receive payments from, third parties.

Core Elements: Nature and Purpose to Develop Customer Risk Profile

The final rule provides an explicit statement of existing expectations and requirements with the third core element.

An understanding of the nature and purpose of a customer is required in order to form a customer risk profile, which may include:

- Purpose of account, and type of account
- Type of customer
- Bank products and services used
- Source of funds and wealth; source of income
- Beneficial ownership and/or control over an account
- Occupation or type of business
- Domicile (where business is located) and/or location relative to the bank
- Description of customer's primary trade area and business operations
- Anticipated transactions and activity levels

The risk profile may be used to risk rate customers and/or integrate into transaction monitoring systems and processes.

This information is considered fundamental for establishing a baseline and identifying unusual or suspicious activity.

Core Elements: Ongoing Monitoring and Updating of Customer Information

As required by the fourth core element of the final rule, covered financial institutions must conduct the following:

- Risk-based ongoing monitoring to identify unusual and suspicious activity
- Risk-based processes to maintain and update customer information, including beneficial ownership
- The updating requirement is event driven, including for beneficial ownership, and occurs as a result of normal monitoring

CDD FINAL RULE

Application of Rule

Application of Rule

Beneficial ownership certification is summarized as follows:

- FinCEN’s standard “Certification Form” found in Appendix A of the final rule is optional and will be available as an electronic form
- Regardless of form used, the person opening the account must certify to “best of their knowledge” that beneficial ownership information is complete and accurate
- The covered financial institution cannot rely on previously obtained documents instead of certification
- Certification must be obtained each time a new account is opened for existing customers, even if certification was previously obtained
- Required information and verification methods (documentary and non-documentary) are essentially the same as CIP for customers

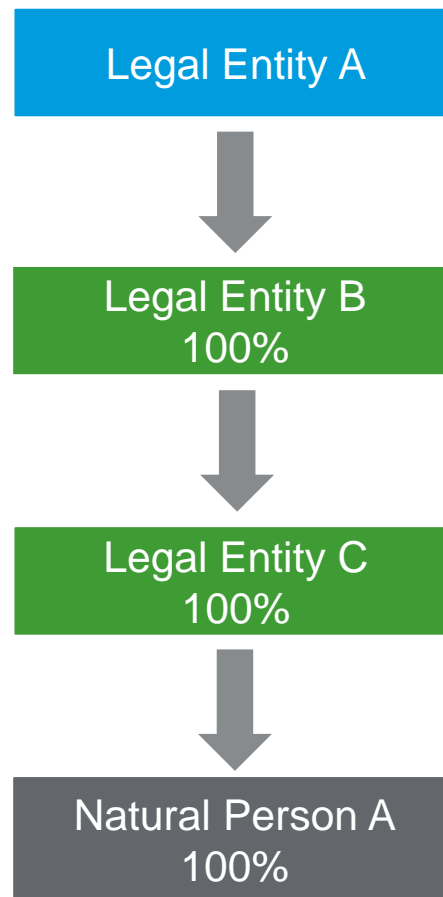
Application of Rule

Beneficial ownership summary (*continued*):

- Beneficial ownership must be updated “in the course of its normal monitoring” of customer risk
- Beneficial owners must be natural persons
- Complex ownership structures may require digging through multiple layers of entities
- Intermediated account relationships with underlying clients (e.g., mutual funds): Only the intermediaries are considered legal entity customers and not their customers
- Remember that the 25% threshold is a floor, not a ceiling

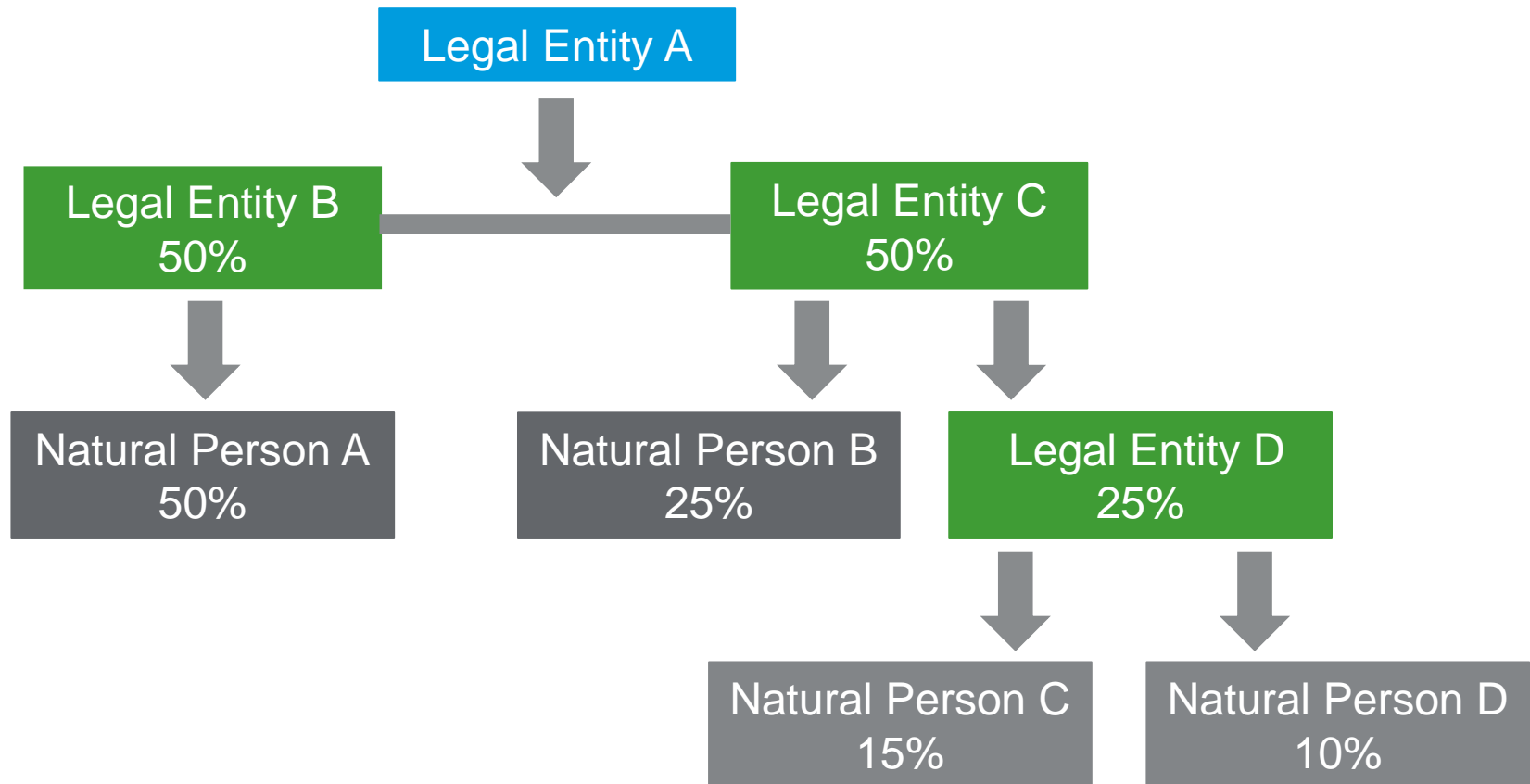
Application of Rule

Here is an example of a simple ownership tree.



Application of Rule

Here is an example of a more complex ownership tree.



Application of Rule

There are other applications of the final rule. For example, beneficial owners should be included in initial and ongoing OFAC screening activities.

There are also applications of the final rule to CTR reporting. CTR implications are summarized as follows:

- Collecting beneficial ownership may provide new information to identify cash activity that should be aggregated
- Institutions may aggregate transactions if businesses with common ownership do not operate independently
- See FIN-2012-G001 for guidance on aggregating cash activity for related entities

Application of Rule

Regulatory deference within the rule states:

“Nothing in this final rule is intended to lower, reduce, or limit the due diligence expectations of the Federal functional regulators or in any way limit their existing regulatory discretion.”

- This rule will not provide shelter from more stringent requirements imposed or recommended by examiners
- Many higher risk institutions are currently expected to have standards that exceed the final rule

MODEL RISK MANAGEMENT

Three Lines of Defense

AML Model Risk Management

Regulatory bulletin OCC 2011-12 (SR 11-7) provides regulatory guidance on how financial institutions should monitor and manage model risks. This guidance applies to AML models as well.

Typically, there are three (3) models within the BSA/AML area. They are as follows:

- suspicious activity
- customer risk scoring
- OFAC/sanctions screening

Some institutions may include more (e.g., risk assessments).

AML Model Risk Management

First Line: Model Users

- Use models to mitigate risks
- Select systems best suited for purpose
- Develop/document model assumptions
- Monitor data quality
- Monitor model effectiveness (e.g., back testing)
- Identify model limitations (e.g., conducting sensitivity or other analysis)

Second Line: Risk Management

- Model risk policy and procedures
- Model inventory and risk rating of models
- Periodic monitoring and independent validation of models
- Independent validation entails data input testing (completeness and accuracy of data), “effective challenge” of model assumptions and data output testing

Third Line: Internal Audit

- Assess adequacy of model governance, policies, procedures, systems, processes and internal controls
- Evaluate data input controls
- Provide “effective challenge” to model assumptions
- Evaluate model output and reporting controls (completeness and accuracy)

AML Model Risk Management

A typical **AML model validation** (conducted at the second line) will cover the following elements and activities:

- Model governance, oversight and reporting
- Policies and procedures, including roles and responsibilities
- System access controls and monitoring
- Management's monitoring and tracking of the effectiveness of models, systems and data quality
- Change management procedures
- Suspicious activity monitoring, inclusive of system(s), transactional data, scenarios, parameters and alerts
- Customer risk scoring, inclusive of system(s), customer data and customer risk scoring

The scope for **OFAC and sanctions model validation testing** typically will cover the following elements and activities in addition to several items above:

- OFAC and sanctions screening, inclusive of system(s), sanctions lists, customer data, search logic and filtering

OTHER RECENT CHANGES

NY DFS Anti-Money Laundering Rule

NY DFS Anti-Money Laundering Rule

On June 30, 2016, the New York Department of Financial Services (NY DFS) issued the final rule imposing new requirements for BSA/AML programs and certification of the adequacy of the programs as follows:

- Financial institutions must establish risk-based transaction monitoring and watch list filtering programs, which may be manual or automated
- The programs must be based on the financial institution's BSA/AML and OFAC risk assessments
- The programs must have governance and oversight, including policies and procedures, they must have complete and accurate data, and the programs must be validated
- Annual certification must be completed by board or senior compliance officer certifying programs as follows:
 - Reports and documentation were reviewed to make certification
 - Necessary steps were taken to confirm compliance with final rule
 - Programs are compliant with final rule

NY DFS Anti-Money Laundering Rule

NY DFS issued final rule (*continued*):

- Transaction monitoring program assumptions, parameters and thresholds must be documented and periodically evaluated to assess continued relevancy
- Transaction monitoring program must include protocols establishing how generated alerts will be investigated and documented
- Watch list filtering program tools, processes and technology must be documented, and search logic and performance of tool must be periodically assessed

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