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## *FinCEN's proposed rules on reporting beneficial owners and their impact on private equity funds*

A recent notice of proposed rulemaking (NPRM) issued by the Financial Crimes Enforcement Network (FinCEN) on Dec. 7, 2021, would formalize a new corporate transparency framework whereby many private companies would be required to report beneficial ownership information to FinCEN. Under the NPRM, "reporting companies" that are not exempt under one of the 23 proposed exemptions included in the NPRM would need to submit certain identifying information related to the corporate entity, as well as identifying information for its "beneficial owners" and "company applicants."

In particular, in addition to the reporting company's name, address, jurisdiction of formation and taxpayer identification number (TIN), the company would be required to also report the full legal names, dates of birth, residential addresses and driver's license or passport numbers (as well as scanned copies of such identifying documents) for each of its beneficial owners and company applicants to be maintained in FinCEN's database. While the database will remain private and subject to strict access protocols, it will be available to authorized law enforcement agencies who will have access to the system.

While the NPRM would have broad reach across many industries, there are meaningful implications for private equity firms/funds (PE funds) and their portfolio companies. FinCEN is currently soliciting comments on the NPRM through Feb. 7, 2022.

### **Background on FinCEN's proposed rules**

On Jan. 1, 2021, Congress passed the Corporate Transparency Act (CTA) as part of the National Defense Authorization Act for fiscal 2021 (NDAA), which included major updates to the domestic anti-money laundering framework established by the Anti-Money Laundering Act of 2020. The CTA obligates reporting companies to provide certain identifying information regarding their organizations and beneficial owners to FinCEN. The CTA broadly defines "reporting companies" to include (1) domestic corporations, limited liability companies and other entities that are created through the filing of a document with a state, and (2) foreign entities registered to do business in the U.S. Twenty-three types of entities are excluded from the definition of "reporting company" and the associated requirements to report beneficial ownership information. These excluded entities are those for which beneficial ownership information is otherwise generally available and include:

- Public companies and other SEC-registrants;
- Banks, credit unions and bank holding companies;

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- Brokers and dealers;
- Certain venture capital fund advisers and investment advisers;
- Certain pooled investment vehicles; and
- “Large Operating Companies,” defined as companies with a physical office in the U.S., more than twenty full-time employees and more than \$5 million in annual gross revenues as shown on a domestic tax return.

The NPRM outlines FinCEN's framework for reporting companies to submit beneficial ownership and company applicant information, the types of information that such companies are required to submit, the timing, format and mechanics of making the submissions, and the penalties for failing to properly report. As proposed, reporting companies would be required to report to FinCEN their legal name, alternate names, business address, jurisdiction of formation and TIN. Such reporting companies would also need to report the following information for each “beneficial owner” and “company applicant” of the company:

- Full legal name;
- Date of birth;
- Current residential or business street address;
- Unique identifying number from an acceptable identification document (e.g. driver's license or passport); and
- An image of the acceptable identification document.

The proposal permits reporting companies to provide a unique FinCEN identifier in lieu of submitting the foregoing information. However, these identifiers are only provided by FinCEN after the companies and individuals submit the required information to FinCEN for inclusion in its database. The proposed deadline for providing the foregoing information to FinCEN is within one year of the final rule's effective date for existing domestic and foreign reporting companies, or within 14 calendar days of the date on which they were created or registered, if created or registered after the effective date of the new rule. Both civil and criminal penalties will apply for persons who willfully provide, or attempt to provide, false or fraudulent beneficial ownership information to FinCEN, or willfully fail to report complete or updated beneficial ownership information to FinCEN.

### **Definition of “beneficial owner” and “company applicant”**

The CTA defines “beneficial owner” as an individual who, directly or indirectly: (1) exercises “substantial control” over a reporting company or (2) owns or controls at least 25 percent of the ownership interests of the reporting company.

#### ***“Substantial control”***

The NPRM broadly defines “substantial control” by providing a list of indicators of persons who might substantially control a company, including serving as a senior officer, having authority over a senior officer or majority of the board of directors, or having a substantial influence over important matters affecting the company. FinCEN also clearly states in the NPRM that these indicators are not exhaustive and there may be other indicators of having substantial control over a company. Given the broad, open-ended approach that FinCEN took with respect to defining substantial control in the NPRM, we expect there to be wide criticism of this approach reflected in the comments to the NPRM.

#### ***“Ownership interests”***

Under the NPRM, ownership interests for purposes of determining whether the 25 percent threshold is met, include, among other things: equity, partnership and limited liability company interests; convertible debt; warrants; rights; and derivatives. FinCEN notes that an individual may directly or indirectly own or control an ownership interest through a variety of non-exhaustive means. These include joint ownership with one or more persons or through control of an ownership interest owned by another individual.

### ***“Company applicant”***

The CTA defines “company applicant” as the individual who files the document that forms the entity, or anyone who directs or controls the filing of the document by another.

FinCEN stated in the NPRM that it was intentional in broadly and ambiguously defining beneficial owner for a few reasons. First, it wanted to ensure that a reporting company would need to identify at least one beneficial owner regardless of whether any individual satisfies the ownership component, or any exclusions apply. Second, FinCEN wished to thwart the use of complex ownership structures and ownership vehicles designed to obscure real owners. These would serve to support the premise that beneficial ownership is about the underlying reality of ownership and not the form it takes.

### **Private equity implications**

PE funds should be aware of their potential reporting obligations under the current proposal because they are not specifically excluded from the definition of reporting company under the NPRM. While certain pooled investment vehicles (PIVs) are covered by the exemption, this only applies if the PIV is operated or advised by a bank, federal or state credit union, SEC-registered broker or dealer, SEC registered investment adviser, or an adviser relying on the venture capital exemption.

Additionally, because PE funds typically hold controlling interests in their portfolio companies, they will likely need to determine whether any individual investors indirectly own a controlling interest in the portfolio companies. The NPRM does not include explicit guidance about how far up the ownership chain portfolio companies would need to go to determine the beneficial owners that it would need to report. However, under separate FinCEN guidance issued in conjunction with the existing regulations that require financial institutions to obtain beneficial ownership information for their customers as part of their customer identification programs, financial institutions must obtain from their legal entity customers the identities of individuals who meet the 25 percent ownership threshold either directly or indirectly through multiple corporate structures. For instance, an individual that owned 50 percent of Entity A, which in turn owned 60 percent of Entity B, would be deemed to indirectly own 30 percent of Entity B (50 percent of 60 percent). Accordingly, it is likely that under the final rule when issued, portfolio companies will be required to submit identifying information for certain PE fund investors to the extent that their indirect ownership of a portfolio company exceeds 25 percent. Given the broad and ambiguous definition of “beneficial owner,” it is also possible that portfolio companies will be required to submit identifying information on certain persons associated with PE funds, such as fund managers. This ultimately depends on whether fund managers or others are determined to substantially control the portfolio company through the PE fund, whether because they sit on boards of directors of the portfolio company, they have authority to substantially influence important matters of the portfolio company, or otherwise.

### **Final details yet to emerge**

It remains to be seen what will make it into the final rule implementing the CTA once issued. FinCEN is still soliciting comments on the NPRM and written comments may be submitted until Feb. 7, 2022, via the Federal E-rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) or by mailing them to the FinCEN Policy Division, P.O. Box 39, Vienna, VA 22183. To date, almost 300 comments have been submitted.

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