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Updated FinCEN CTA Guidance Impacts Private Equity Funds

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On January 12, 2024, FinCEN updated its interpretations of the Corporate Transparency Act ("CTA") that potentially will have a significant impact on private equity firms. This alert provides an overview of the CTA and certain issues relating to private equity firms[1] based on the new guidance. As this update of CTA FAQs demonstrates, FinCEN will be constantly updating its interpretations of the CTA regulations and it will be necessary for firms to be vigilant in assessing how subsequent guidance may modify previous analysis and developing market practices.

The Corporate Transparency Act

What to Know

When to File

- Newly formed entities (i.e., entities formed after January 1, 2024) have within 90 days of the date of their formation to make a report, unless a reporting exemption applies.
- Entities formed prior to January 1, 2024, will not need to make an initial filing until January 2025.

Who Should File

- Domestic entities that are a corporation, LLC or other legal entity formed by filing a document with a Secretary of State or foreign corporations, LLC or other legal entities registered to do business by filing with a Secretary of State.
- DIRECT EXEMPTIONS
  - The CTA includes 23 exemptions from filing (please see full list [HERE]). Given the scope of these exemptions, many operating entities should be directly exempt from CTA reporting. Exemptions include:
    - *Large Operating Companies* – Headquartered in the U.S. with more than 20 employees and more than $5 million in consolidated annual receipts

What to Know

- *Regulated/Registered Entities* – Most businesses that are registered with the Securities and Exchange Commission or subject to federal agency supervision will likely be exempt (e.g., publicly traded companies, regulated financial institutions, registered investment advisers, pooled investment vehicles relying on Section 3(c)(1) or Section 3(c)(7), registered investment companies)

- INDIRECT EXEMPTIONS
  - Even if an entity is not exempted directly, the CTA broadly exempts any entity that is wholly owned or controlled by one or more exempted entities (this excludes entities owned or controlled by money services businesses, pooled investment vehicles, tax-exempt entity advisers and inactive companies)
  - Holding vehicles, investment structuring vehicles and other similar entities are not likely to be directly exempt, and will require a case-by-case analysis to determine whether they are wholly owned or controlled by an exempted entity

What to File

- If no exemption is available, a filing entity must report:
  - Any individual (Beneficial Owner) with greater than 25% ownership interest or that exercises substantial control; and
  - For companies formed after January 1, 2024, the individual (Company Applicant) responsible for forming the company.
- For each individual, companies will report: 1) name; 2) date of birth; 3) address; 4) identification number; and 5) copy of the identification document.

Penalties for Filing Violations

- Any person that willfully provides false or fraudulent information, including by causing someone else to provide such information:
  - May be assessed a civil money penalty of $500 a day per day that the violation continues; and/or
  - May be criminally fined up to $10,000 and imprisoned for up to 2 years.

As a result of the CTA, which went into effect on January 1, 2024, certain U.S. entities are now required to report specified beneficial ownership information to the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN"), unless they fall under a specified exemption. Non-exempt U.S. entities that existed prior to January 1, 2024, have until January 1, 2025, to file their initial report to

FinCEN while non-exempt U.S. entities formed subsequent to January 1, 2024, must file their initial report with FinCEN within 90 days of their date of formation.

The purpose of the CTA is to obtain records to assist law enforcement, regulators, and the intelligence community in detecting, investigating, preventing and prosecuting money laundering, terrorist financing, and tax evasion. The U.S. government's primary concern focuses on the misuse of legal persons, including shell companies, to facilitate such financial crimes. In recognition of this purpose, the statute and implementing regulations provide 23 exemptions from the definition of "Reporting Company" (i.e., a U.S. entity that under the CTA is required to file a beneficial ownership information report) that attempt to focus the reporting requirements towards higher-risk entities. These exemptions primarily include entities subject to U.S. regulatory or governmental supervision or oversight (such as regulated financial institutions), entities that already are subject to governmental reporting requirements relating to beneficial ownership (such as publicly traded companies and non-profit organizations), and companies unlikely to be engaged in illicit financial activity (such as large operating companies and inactive entities).

Considerations for Certain Private Equity Firms

Private equity buyout fund[2] sponsors will need to carefully evaluate their own corporate and portfolio investment structures to assess potential CTA filing obligations. One or more of the CTA's 23 exemptions likely will apply to the operating entities and certain pooled investment vehicles within these structures, including private equity firms that are registered investment advisers (e.g., the exemption for registered investment advisers), their funds (e.g., the exemption available for Section 3(c)(1) and Section 3(c)(7) funds that are listed on Form ADV) and their portfolio companies (e.g., the large operating company exemption that applies to businesses with more than 20 employees and more than $5 million in annual receipts). There is no standalone CTA exemption for holding companies or such special purpose vehicles. Thus, in many cases, management company holding entities, ultimate general partner entities and other similar upper-tier entities may be subject to a CTA filing obligation.

Similarly, below-the-fund entities are not likely to directly meet the large operating company exemption because, although annual receipts are consolidated, the requirement to have more than 20 employees is entity-specific. Such special purpose vehicles and holding companies may still be exempt from beneficial ownership reporting if they qualify as a subsidiary of another exempt entity. In particular, the CTA exempts any entity that is controlled or wholly owned, directly or indirectly, by one or more exempt entities (excluding entities owned or controlled by money services businesses, pooled investment vehicles, tax-exempt entity advisers, and inactive companies). Many funds may likely be able to demonstrate complete ownership or control by securities reporting issuers, large operating companies, or registered investment advisers. Thus, the concept of control by an exempt entity is paramount in the analysis for structures that do not directly satisfy any other. The CTA does not define control, but a brief summary of key consideration relating to "control" is below.

In addition to the threshold question as to what filings may be required for a private equity firm and its related entities, CTA compliance may drive ancillary effects relating to fundraising and transaction process, including:

- Diligencing transaction counterparties for CTA compliance considerations;
- Ensuring appropriate representations and covenants from limited partners and transaction counterparties to enable a private equity firm sponsor to obtain appropriate information for any required CTA filing;

- Ensuring transaction documentation is clear with respect to CTA filing responsibility; and
- Establishing internal processes for monitoring for any required CTA filing updates.

Considerations Regarding Analysis of Control

The CTA exempts any entity that is controlled or wholly owned, directly or indirectly, by one or more exempt entities. While this language appeared to open a possibility that control could be satisfied by determining sole substantial control by exempt entities, recently FinCEN issued guidance that clarified the subsidiary exemption requires that the equity interest of the subsidiary is *entirely controlled* by one or more exempt entities. This guidance potentially rebuts an interpretation that many practitioners were seeking to apply in determining the scope of CTA filing obligations when considering certain common private equity investment structures. Accordingly, as is commonly the case with new regulation, sponsors should remain attentive to developing market practices, including any changes driven by recent and future FINCEN guidance. FinCEN's recent guidance may suggest that it is applying any exemption to the CTA narrowly. However, it remains the case that even subsidiaries that are not 100% wholly owned by exempt persons may still be exempt if one or more exempt entities exercise exclusive control over such subsidiary. Any analysis of such control provisions will be fact-specific, and the ability to comfortably leverage the subsidiary exemption will focus on the extent to which non-exempt parties can exercise any control.

Accordingly, private equity firms (and other investment structures, businesses and entities with U.S. touchpoints) should promptly engage with their legal counsel to determine any reporting obligations that they or their respective portfolio companies may currently have under the CTA. They should also do so prior to forming any new U.S. entities going forward so that their legal counsel can help them identify any resulting reporting obligations under the CTA and perhaps help them avoid such reporting obligations through alternative holding structures.

In addition to identifying and complying with any initial reporting requirements under the CTA, reporting firms should be aware that the CTA requires entities to file an updated beneficial ownership report with FinCEN when there are changes to the beneficial ownership information of an entity that previously filed such a report with FinCEN. Therefore, it will be important for acquiring entities to diligence and obtain appropriate disclosures and representations from target companies of any beneficial ownership reports that they previously filed with FinCEN.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] CTA applicability is not limited to private equity sponsors, and all entities with U.S. touchpoints should evaluate their exemption or filing status. This Client Alert is focused on private equity firms, primarily with respect to equity buyout firms and their portfolio company structures. Many of the CTA provisions summarized herein (including as they relate to the analysis of "control" under the CTA) will be applicable to private fund sponsors of other asset classes (e.g., real estate and credit fund sponsors), but the underlying investment structures of such asset classes may differ in ways that result in a different exemption analysis or outcome.

[2] A complete analysis of exemption applicability is beyond the intended scope of this Client Alert. It's worth noting that the evaluation of different asset classes (buyout, credit, real estate) may result in different conclusions based on adviser registration status, fund exemption and control structures. For example, while all registered investment advisers may avail themselves of the RIA exemption, there is not, for example, a categorical exemption for exempt reporting advisers. In addition, Section 3(c)(5)(c) funds are not within the scope of the private investment fund exemption. For purposes of the "control" exemption analysis, differing asset classes may utilize investment structures with entities that raise independent questions. In all events, each investment structure must be evaluated on a case-by-case basis for determining the applicability of the CTA's filing obligations and exemptions.