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Beneficial Ownership Disclosure Soon to Be Required in the United States, Shifting the Burden from Financial Institutions to Companies

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After the U.S. House of Representatives passed on Tuesday, December 8 with an apparently veto-proof majority the reconciled 2021 National Defense Authorization Act ("NDAA"), the annual must-pass U.S. military and defense spending bill, the U.S. Senate followed suit on December 11, 2020, also with an apparent veto-proof majority, sending the bill to the President for signature.[1] Contained in this year's NDAA is a provision designed to eliminate the anonymity of beneficial owners of entities incorporated in all U.S. states and territories: the Corporate Transparency Act (the "Act"), which is one set of provisions in a broad set of changes to U.S. anti-money laundering legislation. We focus on the beneficial ownership disclosure requirements in this alert due to their particular importance.

A bipartisan effort, the Corporate Transparency Act was developed over the course of a decade.[2] It promises a significant shift in the burden and responsibility for the identification of beneficial ownership information from financial institutions obligated to collect and verify these details, to companies and individuals who will be obligated to report the information to centralized federal authorities themselves.

The basic premise of the Act is straightforward: if an entity qualifies as a "reporting company," it must submit a report to the Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") containing identifying information on the entity's beneficial owners. Reporting companies will not have to disclose this information publicly; FinCEN will retain this information and hold it in a confidential and secure database, only releasing information in specifically prescribed circumstances: (i) a request from certain federal or state agencies engaged in national security, intelligence, or law enforcement activity for use in furtherance of such activity; (ii) in certain types of requests from a federal agency on behalf of foreign authorities; (iii) a request by a financial institution "subject to consumer due diligence requirements," with the consent of the reporting company; or (iv) a request made by a "Federal functional regulator" or other regulatory agency to assess or otherwise ascertain compliance of financial institutions. The Act will be implemented by regulations promulgated by FinCEN within one year of the enactment of the 2021 NDAA.

How the Act Applies

Given the significant change in beneficial ownership reporting that the Act will bring to the United States, and the shift of reporting requirements to incorporators themselves, the Act raises some fundamental questions.

What Is a Reporting Company, and Who Must Report?

The definition of "reporting company" is broad, and includes any corporation, limited liability company, or "other similar entity" created by the filing of a document with the secretary of state or similar office in any U.S. state or territory or with a federally recognized Indian Tribe, or formed under the laws of a foreign country and registered to do business in the United States. Effectively, this means that all such entities—with the notable exception of foreign companies that do not formally register to do business in the United States—will be subject to these requirements *unless* they fall into one of 24 enumerated categories, including those otherwise regulated (e.g., publicly traded companies, financial services companies, and public utilities); investment advisers and investment vehicles operated or advised by them; and entities that have a physical presence in the United States, employ more than 20 people, and have filed Federal income tax returns demonstrating more than $5,000,000 in gross receipts or sales in the aggregate. Further, the Act grants the Secretary of the Treasury the discretion to add entities or "classes of entities" who should also be excluded from the reporting requirements where requiring beneficial ownership information would not serve the public interest and would not be "highly useful" in efforts to counter money laundering, terrorism financing, proliferation finance, serious tax fraud, and other crimes.

Who Qualifies as a Beneficial Owner?

Each reporting company will have to file a report encompassing each beneficial owner's name, date of birth, residential or business street address, and unique identifying number from an identification document. This information is required for any individual who, directly or indirectly, exercises "substantial control" over the entity *or* owns or controls 25 percent or more of the ownership interest of the entity. The term "substantial control" is not defined in the Act. Nevertheless, the regulations implementing FinCEN's beneficial ownership due diligence obligations for financial institutions are instructive, as they parallel the definitions in the Act.[3] For purposes of determining from whom a financial institution is required to obtain information to identify and verify beneficial owners, those regulations state that a beneficial owner includes not only persons who, directly or indirectly, own 25 percent or more of the equity interest a company, but also any individual with "significant responsibility to control, manage, or direct" the entity.[4] These individuals include "an executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or any other individual who regularly performs similar functions."[5] As FinCEN will release regulations to implement the Act and also bring these due diligence regulations into conformance with the Act, the implementing regulations may provide similar clarifying language.

Notably, however, the final version of the Act does not include in the definition of "beneficial owner" any person who "receives substantial economic benefits from the assets" of the reporting company. This provision was previously included in the version of the Act that was passed by the U.S. House of Representatives in October 2019.[6]

When Do the New Reporting Obligations Begin?

FinCEN has one year from the enactment of the 2021 NDAA to issue regulations implementing the Act. At that point, any entity formed or registered after the regulations' effective date will be required to submit its report to FinCEN at the time of formation. Further, any already-existing entity that qualifies as a reporting company will have two years following the effective date of the regulations to submit the requisite report. Changes in beneficial ownership must be reported to FinCEN within one year from the change in ownership.

The Impact of the Corporate Transparency Act

The inclusion of the Act in the NDAA, along with other anti-money laundering and anti-corruption-related provisions, is being lauded by supporters as a much-needed tool to combat financial crime.[7] The penalties for non-compliance, such as failing to report or providing false information, include fines of up to $10,000 and a prison term of up to two years. The Act will also facilitate financial institutions' compliance with customer due diligence obligations, as FinCEN will conform financial institutions' obligations based on the information required under the Act. These developments are singularly important for financial institutions—instead of those institutions bearing the burden of verifying beneficial ownership information, the burden is now on the reporting companies to file with FinCEN, against which financial institutions will verify information they collect from their customers and counterparties. Sanctioned individuals who may be operating in the United States cloaked by anonymous shell corporations will lose their corporate veil.

However, while the Act requires FinCEN to "seek to minimize the burden" of compliance on companies, opponents of the Act have emphasized that the carve-outs will not apply to small businesses. Indeed, the National Federation of Independent Business estimated that the increased burden would add 12.2 million new initial paperwork hours at a cost of $531 million at a time when many small businesses are already dealing with the effects of COVID-19 on their businesses.[8] Whether the lack of exemptions for small business and the costs imposed will be worth the seemingly significant anti-corruption and anti-money laundering benefits the Act is intended to provide remains to be seen.

The Act also may impact certain energy industry participants. For instance, LLC structures are frequently used for electric power projects—especially renewable energy, transmission, and energy storage projects. The Act excludes certain public utilities that provide "telecommunications services, electrical power, natural gas or water and sewer services within the United States." Renewable energy generation projects may have multiple levels of LLCs upstream of the LLC that directly owns the renewable energy project. Those upstream ownership entities are not considered "public utilities" under federal energy laws such as the Federal Power Act because they do not directly own or operate the energy asset. It is not immediately apparent that such upstream LLCs would be excluded from the Act's reporting obligations based on the current enumeration of excluded companies; for example, it is unclear whether the exclusion for "public utilities" would apply to transmission LLCs, given that such entities transmit and deliver electric power but do not generate it. This uncertainty underscores the need for industry participants to monitor and potentially file comments during the FinCEN rulemaking process that will be held to develop the Act's implementing regulations.

Conclusion

The U.S. Department of Justice described in 2016 that the United States had "lag[ged] behind our global partners in preventing the flow of illicit money through our banking system and financial markets," in part due to the failure to identify and collect information on beneficial owners.[9] This deficiency has been identified not only by the Financial Action Task Force, of which the United States is a member, but also by institutions that index countries' financial secrecy; currently, the Tax Justice Network ranks the United States behind only the Cayman Islands in its financial secrecy index.[10] The Act will eliminate one significant source of corporate anonymity that has been highlighted by recent financial scandals such as the Panama and Paradise Papers and reduce the compliance burdens on U.S.-based financial institutions. Whether those efforts make a meaningful impact on money laundering in the United States, or simply force additional financial flows abroad, will be one of the questions regulators will seek to address as the Act comes into force.

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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 Washington, D.C. lawyers:

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[1] Senate Passes Defense Bill, Setting up Veto Showdown with Trump, Politico (Dec. 11, 2020), https://www.politico.com/news/2020/12/11/senate-passes-defense-bill-444579.

[2] *See* Congress Bans Anonymous Shell Companies After Long Campaign by Anti-Corruption Groups, Washington Post (Dec. 11, 2020), https://www.washingtonpost.com/us-policy/2020/12/11/anonymous-shell-company-us-ban/.

[3] 31 CFR § 1010.230.

[4] 31 CFR § 1010.230(d).

[5] 31 CFR § 1010.230(d).

[6] Corporate Transparency Act, H.R. 2513, 116th Cong. (2019), https://www.congress.gov/bill/116th-congress/house-bill/2513/text.

[7] *See*, *e.g.*, In Historic Win for Beneficial Ownership Transparency the Senate Passes the Corporate Transparency Act, Global Financial Integrity (Dec. 11, 2020), https://gfintegrity.org/press-release/in-historic-win-for-beneficial-ownership-transparency-the-senate-passes-the-corporate-transparency-act/.

[8] *See* Senate Passes NDAA with Ban on Shell Companies, Politico (Dec. 11, 2020), https://www.politico.com/newsletters/politico-influence/2020/12/11/senate-passes-ndaa-with-ban-on-shell-companies-792239.

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[10] Financial Secrecy Index – 2020 Results, Tax Justice Network, https://fsi.taxjustice.net/en/introduction/fsi-results.