Initial Regulatory Flexibility Analysis for FinCEN Notice of Proposed Rulemaking: "Customer Due Diligence Requirements for Financial Institutions." Docket # FinCEN-2014-0001

When an agency issues a rule proposal, the Regulatory Flexibility Act (RFA) requires the agency to either provide an Initial Regulatory Flexibility Analysis or, in lieu of preparing an analysis, to certify that the proposed rule is not expected to have a significant economic impact on a substantial number of small entities. [1] When FinCEN issued its notice of proposed rulemaking (NPRM) for its Customer Due Diligence (CDD) Rule,[2] FinCEN believed that the proposed rule would not have a significant economic impact on a substantial number of small entities, and FinCEN certified that it would not.[3] Because numerous commenters asserted that the proposed rule would be more costly to implement than estimated by FinCEN, FinCEN is issuing this Initial Regulatory Flexibility Analysis (IRFA). As a result of this analysis, FinCEN continues to believe that, while the proposed rule would apply to a substantial number of small entities, it would not have a significant economic impact on a substantial number of small entities.

1. Statement of the reasons for, objectives of, and legal basis for, the proposed rule.

FinCEN is proposing the CDD Rule because it has determined that more explicit rules for covered financial institutions[4] are needed to clarify and strengthen CDD within the Bank Secrecy Act (BSA) regime, in order to enhance transparency and help safeguard the financial system against illicit use. The CDD Rule would advance the purposes of the BSA by (i) enhancing the

[1] 5 U.S.C. 601-612.

[2] 79 FR 45151 (Aug. 4, 2014).

[3] 79 FR 45151, 45168-45169.

[4] Defined to include federally regulated banks, brokers and dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities.

availability of beneficial ownership information to law enforcement, federal functional regulators, and self-regulatory organizations (SROs); (ii) increasing the ability of financial institutions, law enforcement, and the intelligence community to identify the assets and accounts of terrorist organizations, drug kingpins, and financial criminals; (iii) helping financial institutions to assess and mitigate risk and comply with existing BSA and related authorities; (iv) facilitating reporting and investigations in support of tax compliance, and advancing commitments made in connection with the Foreign Account Tax Compliance Act; and (v) promoting consistency in implementing and enforcing CDD regulatory expectations across and within financial sectors. FinCEN has authority to issue the CDD Rule under the BSA, which includes the authority to require financial institutions to maintain procedures to ensure compliance with the BSA and to guard against money laundering,[5] as well as the specific authority to impose anti-money laundering (AML) requirements on financial institutions.[6]

2. Description and estimate of the number of small entities to which the proposed rule would apply:

This proposed rulemaking would apply to all federally regulated banks and all brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities, as each is defined in the BSA. Based upon current data, for the purposes of the RFA, there are approximately 5088 small federally regulated banks out of a total of 6348 (comprising 80% of the total number of banks);[7] 6165 federally regulated credit unions (of which

[5] 31 U.S.C. 5318(a)(2).

[6] 31 U.S.C. 5318(h)(2).

[7] The Small Business Administration ("SBA") defines a depository institution (including a credit union) as a small business if it has assets of $550 million or less. The information was provided by the FDIC as of June 30, 2015.

approximately 93% are small credit unions),[8] 1349 small brokers or dealers in securities out of a total of 4269 (comprising 31.5% of the total);[9] 90 small mutual funds out of a total of 10,711 (comprising 8% of the total);[10] no small futures commission merchants; and a total of 1323 introducing brokers in commodities, the majority of which are small entities.[11] Because the proposed rule would apply to all of these small financial institutions, FinCEN concludes that the proposed rule would apply to a substantial number of small entities.

3. Description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rule:

A. Beneficial Ownership Requirement

The proposed rulemaking imposes on all covered financial institutions (including those that are small entities) a new requirement to identify and to verify the identity of the beneficial owners of their legal entity customers. Many of the comments received in response to the NPRM stated that FinCEN had underestimated the burden resulting from the proposal in the following areas: (i) additional time at account opening, (ii) training, and (iii) information technology (IT), but very few comments contained any specific cost estimates. To obtain more specific estimates regarding the burden of this requirement, FinCEN conducted telephone

[8] The information was provided by the NCUA as of June 30, 2015.

[9] With regard to the definition of small entity as it applies to broker dealers in securities and mutual funds, FinCEN is using the SEC's definitions found at 17 CFR 240.0-10(c), and 17 CFR 270.0-10, respectively. The information was provided by the SEC as of December 31, 2014.

[10] The information was provided by the SEC as of December 31, 2014.

[11] The CFTC has determined that futures commission merchants are not small entities for purposes of the RFA, and, thus, the requirements of the RFA do not apply to them. The CFTC's determination was based, in part, upon the obligation of futures commission merchants to meet the minimum financial requirements established by the CFTC to enhance the protection of customers' segregated funds and protect the financial condition of futures commission merchants generally. Small introducing brokers in commodities are defined by the SBA as those having less than $7 million in gross receipts annually. While the CFTC has no current data regarding the exact number of small entities, we understand that the majority are small. The information was provided by the CFTC as of June 30, 2015.

interviews with several financial institutions that had submitted comments, including three small financial institutions. FinCEN conducted this outreach to gather information for its Regulatory Impact Assessment (RIA) of the proposed rule pursuant to Executive Orders 13563 and 12866 as well for this IRFA. The RIA is published concurrently with this IRFA.

(i) Additional time at account opening. The proposed rule would require that the beneficial ownership requirement be satisfied by obtaining and maintaining a certification from each legal entity customer that opens a new account. The certification would contain identifying information regarding each listed beneficial owner. The financial institution would also be required to verify such identity by documentary or non-documentary methods and to maintain in its records for five years a description of (i) any document relied on for verification, (ii) any such non-documentary methods and results of such measures undertaken, and (iii) the resolution of any substantive discrepancies discovered in verifying the identification information.

The burden on a small financial institution at account opening resulting from the proposal would be a function of the number of beneficial owners of each legal entity customer opening a new account,[12] the additional time required for each beneficial owner, and the number of new accounts opened for legal entities by the small financial institution during a specified period. At the time of its certification in the NPRM, FinCEN had very little information on which to base its estimate of any of these variables. At that time FinCEN believed that it was reasonable to assume that the great majority of legal entity customers that establish accounts at small institutions are more likely to be small businesses with simpler ownership structures that will result in one or two beneficial owners. In addition, FinCEN believes that, since all covered

[12] The NPRM proposed to define beneficial owner as (1) each individual who owns, directly or indirectly, 25% or more of the equity interests of a legal entity, and (2) one individual with significant responsibility to control, manage, or direct the entity. Thus it is possible that a legal entity could have up to five beneficial owners.

financial institutions have been subject to Customer Identification Program (CIP) rules[13] for more than ten years, and the proposed rule utilizes CIP rule procedures, small institutions would be able to leverage these procedures in complying with this requirement. As a result, in its certification FinCEN estimated that it would require, on average, 20 minutes to fulfill the beneficial ownership identification, verification and recordkeeping requirements in the proposal. Also, for purposes of its certification FinCEN had no direct data on the aggregate number of legal entity accounts opened per year by small financial institutions, and (based in part on an estimate it obtained from one very large financial institution of the legal entity accounts it opens per year) FinCEN estimated that small institutions would open at most 1.5 new accounts for legal entities per day, and probably fewer. However, because statistical data does not exist regarding either the average number of beneficial owners of legal entity customers of small institutions or how many such accounts they establish in any time period, FinCEN sought comment on these questions.

As a result of the outreach referred to above, FinCEN now has some additional data on which to better estimate the additional costs at account opening. Because financial institutions are not currently required to collect beneficial ownership information, there is no way to estimate the average number of beneficial owners of legal entity customers of financial institutions, although FinCEN continues to believe that it is reasonable to assume that small financial institutions will generally have small businesses as customers, which are likely to have not more than two beneficial owners. Banks we surveyed estimated that it is likely to take an additional 10 to 15 minutes per beneficial owner. Assuming there would typically be two individuals identified as beneficial owners, FinCEN believes it is reasonable to estimate the additional time

[13] See 31 CFR 1020.220, 1023.220, 1024.220, and 1026.220.

between a low estimate of an additional 15 minutes and a high estimate of an additional 30 minutes to open a legal entity account. In its outreach FinCEN asked three small financial institutions the number of legal entity accounts they open each year. While financial institutions do not generally maintain information about the number of their legal entity customers, they typically maintain a database for their retail (i.e., individual) customers, and another database for their customers that are businesses or organizations. A significant number of a financial institution's business or organization customers are sole proprietorships that are not legal entities subject to the proposed rule.[14] As a result, it is very difficult to estimate with any degree of precision the number of legal entity customers of a particular small financial institution that would be subject to the proposed rule. However, based on data obtained from FinCEN's outreach, and utilizing the wage assumptions in the RIA, we estimate that this requirement would result in a cost to a small bank of between approximately $2000 and $4000 per year at account opening.[15]

(ii) Training. In its certification FinCEN noted that financial institutions generally conduct periodic training of their employees for BSA compliance and that this new requirement

[14] According to data obtained from the IRS regarding tax returns, approximately 75% of all businesses filing tax returns are sole proprietorships.

[15] One small bank we surveyed reported that it opened 471 accounts for organizations in 2014. This number includes an unknown number of sole proprietorships that would not be subject to the rule, as well as 179 accounts for loan customers, for which the bank would typically identify the beneficial owner(s) in order to obtain personal guarantees. A second small bank we surveyed reported that it opened 333 accounts in 2014 for legal entities, which includes an unknown number of sole proprietorships, as well as 106 loan customers. A small credit union we surveyed opens 24 to 36 accounts for businesses per year, which includes an unknown number of sole proprietorships. FinCEN believes its estimated range of costs may be high because the calculation is based on the small bank that opened the greater number of legal entity accounts, assumes that none of the accounts reported were opened for sole proprietorships, and includes loan customers, for which the bank would generally already identify beneficial owners. The estimated cost is based on the bank-reported 471 new accounts per year, additional time at account opening of 15 to 30 minutes, and the average wage of $16.77 for the financial industry "new account clerks" reported by the Bureau of Labor Statistics. FinCEN believes that utilizing this number of new accounts is more appropriate than the 1.5 new accounts per day stated in the NPRM, since it is based on actual data from a small bank.

would be included in that periodic training. Many commenters noted that it would be necessary to conduct additional training in order to comply with this requirement, although none gave any specific estimate of the cost. As a result FinCEN sought to determine this more specifically in its outreach. Based on the sampling it conducted it learned that financial institutions expect to train between 1/3 and 2/3 of their employees regarding this requirement. Assuming that a small financial institution has 125 employees and that the training would take one hour, and applying the wage assumptions used in the RIA, this would result in an estimated cost of between $1250 and $2500, depending on the percentage of employees trained, for the first year that the rule would be in effect.[16] The amount of necessary training would decrease thereafter.

(iii) Information Technology. In its certification FinCEN noted that financial institutions periodically update their IT systems, and that small financial institutions typically outsource their IT requirements to vendors, which would incorporate the required modifications into the programs that they supply to small financial institutions at minimal additional cost. FinCEN discussed with vendors the changes that would result from the adoption of the proposed rule and the likely additional costs that would be charged to customers in order to achieve compliant systems. The vendors told FinCEN that they normally bear the costs of system updates necessary to maintain compliance required during the term of a contract, but some stated that the changes necessitated for compliance with the new requirements would be too costly to implement without increasing the charges to their customer banks. The vendors also informed FinCEN that, until a rule were issued in final form, it would not be possible to determine how

[16] FinCEN believes that the estimated range of costs may be high because it is based on the small financial institution interviewed with the greatest number of employees, (FinCEN notes that the association that represents credit unions commented that approximately 3000 credit unions have five or fewer full-time employees.) The cost calculation is based on a weighted average wage of $29.92 for NAICS codes 5221 (Depository Credit Intermediation), 5222 (Nondepository Credit Intermediation), 5223 (Activities Related to Credit Intermediation), and 5231 (Securities and Commodity Contracts Intermediation and Brokerage), reported in the May 2014 Bureau of Labor Statistics National Occupational and Wage Estimates.

their systems would need to be modified, or to estimate the additional charges to their financial institution customers resulting from such changes.

B. Customer Due Diligence Requirement

The proposed rule would also require that covered financial institutions include in their AML programs customer due diligence procedures, including understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile and conducting ongoing monitoring of these relationships to maintain and update customer information and to identify and report suspicious activities. Because these are necessary measures that covered financial institutions must currently take in order to comply with existing requirements to detect and file suspicious activity reports,[17] they are implicit requirements and would not impose any new obligations, and therefore would have no economic impact, on any small entities.[18] FinCEN believes that proposing clear CDD requirements is the most effective means of clarifying, consolidating, and harmonizing expectations and practices across all covered financial institutions. Expressly stating the requirements facilitates the goal that financial institutions, regulators, and law enforcement all operate under the same set of clearly articulated principles.

Finally, in order to comply with both parts of the proposal, each covered financial institution would need to amend its AML program to include the new requirements contained in the proposed rule, and conduct additional internal control procedures to ensure compliance with the new requirements. In its certification FinCEN noted, based on its outreach prior to issuing

[17] See, e.g., 31 CFR 1020.320.

[18] Commenters representing certain types of covered financial institutions stated that these institutions are not currently required to conduct all of the proposed measures in order to comply with existing requirements. FinCEN is continuing to consider these comments, as well as others, in its deliberations regarding the proposed rule.

the NPRM, that most covered financial institutions (including those that are small entities) periodically update their AML programs. Based upon the very limited input FinCEN received in comments and its interviews, FinCEN is unable to estimate the time or cost these activities are likely to require.

4. Identification of duplicative, overlapping, or conflicting Federal rules

FinCEN has identified one conflict or overlap with the proposed beneficial ownership requirement. An existing regulation requires covered financial institutions to ascertain the identity of the beneficial owners of foreign private banking accounts for non-U.S. persons.[19] This implicates a relatively small category of accounts. The overlap is addressed in the proposal and would be addressed in any final rule. Other than this there no provisions that are duplicative, overlapping or conflicting.

5. Consideration of Significant Alternatives:

The proposed rule would apply to all covered financial institutions. FinCEN has determined that identifying the beneficial owner of a financial institution's legal entity customers and verifying that identity is a necessary part of an effective AML program. Were FinCEN to exempt small entities from this requirement, those entities would be at greater risk of abuse by money launderers and other financial criminals, as criminals would identify institutions without this requirement. FinCEN has considered as alternatives establishing a different threshold for ownership of equity interests in the definition of beneficial ownership. For example, if the ownership threshold were reduced to include each individual owning 10% or more of the equity interests of a legal entity, a financial institution would potentially have to identify more individuals as beneficial owners, which would result in greater onboarding time and expense in

[19] 31 CFR 1010.620.

such cases, with commensurately greater available information. Alternatively, should the ownership threshold be increased to owners of 50% or more of the equity interests, financial institutions would be required to identify and verify the identity of up to three individuals rather than five, thereby reducing marginally the cost of the initial onboarding time. However, this change would not impact the training or IT costs and therefore would not substantially reduce the overall costs of the proposed rule and also would provide less useful information. FinCEN has also considered applying the beneficial ownership requirement retroactively and requiring that financial institutions identify the beneficial owners of all their existing accounts as well as new accounts. While this would produce substantially larger benefits because it would make available beneficial ownership information for far more customers, it would also result in a significantly greater burden for financial institutions. After considering all the alternatives FinCEN has concluded that an ownership threshold of 25% is appropriate to maximize the benefits of the requirement while minimizing the burden.

In conclusion, as a result of this analysis, FinCEN continues to believe that, while the proposed rule would apply to a substantial number of small entities, it would not have a significant economic impact on a substantial number of small entities.

6. Questions for comment: Please provide comment on any or all of the provisions of the proposed rule with regard to their economic impact on small entities (including costs and benefits), and what less burdensome alternatives, if any, FinCEN should consider.

Comments: Please provide comment on or before January 25, 2016 on any or all of the provisions of the proposed rule with regard to their economic impact on small entities (including costs and benefits), and what less burdensome alternatives, if any, FinCEN should consider.