NAVEX®

Whitepaper

The Significance of UBO – Practical Considerations and the Current Landscape

In the context of corporate compliance, the phrase *ultimate beneficial ownership* (UBO) refers to the person(s) who stand to benefit from a potential transaction. Determining UBO is an increasingly critical component of a well-designed third-party risk management program. Key international regulators – including, most prominently, those in the United States and Europe – are implementing both legislation and regulations aimed at curbing money laundering, illicit financing, and questionable dealings with sanctioned parties.

UBO is a fundamental component of the overall **due diligence** process. Due diligence is defined as the method by which a corporation collects, corroborates, analyzes, and synthesizes information provided by a prospective business partner. That information is then prioritized according to the risk posed by the prospective partner in line with its own internal policies and procedures. Finally, UBO is arguably the most critical component of prevailing Know Your Customer (KYC) norms, not only for financial institutions, but for practically any enterprise providing products and services to the public at-large – especially on an international basis.

In an era of increased regulatory complexity and enforcement, it is imperative that legal and compliance professionals become acquainted with the significance of UBO and update their own organization's policies and procedures in line with both regulator expectations and industry best practices.

Implications and Practical Considerations for Businesses

The relentless focus of the international community on combatting money laundering and illicit finance should cause legal and compliance professionals to evaluate whether their current compliance policies and procedures meet regulator expectations. As the 2020 U.S. Department of Justice (DOJ) Guidelines for the Evaluation of Corporate Compliance Programs (Guidelines)[1] make clear, regulators expect an organization to adopt a risk-based approach to compliance with all applicable laws and regulations.

1 U.S. Dep't of Justice, Criminal Division, "Evaluation of Corporate Compliance Programs" (June 1, 2020), available at https://www.justice.gov/criminal-fraud/page/file/937501/download.

The Guidelines also emphasize that an organization's program be subject to continuous improvement based on internal audit results, lessons learned, periodic testing of internal controls, and 'evolving' updates to an organization's compliance risk assessment. With respect to the latter factor, the Guidelines specifically ask prosecutors to consider:

1. How often the company has updated its risk assessments and reviewed its policies, procedures, and practices
2. If the company has undertaken a gap analysis to determine if particular areas of risk are not sufficiently addressed
3. Whether the company has taken any steps to determine if its standard policies, procedures, and practices make sense for particular business segments and/or subsidiaries
4. Whether the company has reviewed and adapted its compliance program based upon lessons learned from its own misconduct, as well as the misconduct of other companies facing similar risks

In the anti-money laundering (AML) space, it is clear that the trajectory of regulator expectations includes a focus on the solicitation and evaluation of beneficial ownership information. This applies not only on the part of financial institutions, but all organizations in the context of even the most routine transactions.

> A crucial element of meeting these expectations is revisiting an organization's third-party due diligence process. To the extent an organization does not regularly solicit and evaluate beneficial ownership information as part of its initial onboarding or intake process, it must start doing so **immediately**.

Failure to obtain and verify UBO information is a recipe for disaster. This is because overlapping statutes and complex regulatory schemes often prohibit a business from engaging with a sanctioned or blacklisted individual or entity with beneficial ownership interests meeting or exceeding a certain threshold. To that end, organizations should invest in automated screening solutions to bring efficiency and accuracy to the compliance function of their operations.

While sporadic, manual screening of counterparties, customers, vendors, suppliers, intermediaries, and other agents may have been sufficient in the past, the burden of executing due diligence without some automation at scale is prohibitive for an organization's compliance function to handle in isolation. Manual screening is also arguably insufficient to meet an organization's duty to comply with the letter of the law – especially as international sanctions lists related to the Russian Federation and the war in Ukraine are subject to frequent change. Organizations with business ties to affected regions that are overly reliant on manual processes are likely incapable of preventing prohibited transactions with a sanctioned party.

> ***In short,*** manual processes are antiquated, inefficient, and practically useless in a dynamic regulatory environment.

Not all automated systems are created equally. To accomplish KYC and due-diligence requirements involving UBO, organizations should carefully evaluate their alternatives – seeking expertise not only in the underlying technology, but familiarity with the realities facing compliance professionals on a daily basis. To that end, organizations that are

new to compliance automation should partner with established and reputable industry leaders in the compliance solutions space. Such companies should seek to incrementally implement automated solutions that can be integrated with existing processes. Rather than striving for perfection, the organization can act to mitigate larger, known risks immediately, and address lower risks at a later date. **Worth noting:** while an organization can significantly reduce the risk of a legal or regulatory infraction, it is virtually impossible to ensure that one will never have an infraction. Regulators are *not* expecting perfection; they *are* expecting action.

Global Landscape & Items to Consider

Current Landscape in the United States

Historically, the collection and analysis of UBO information was largely the domain of federal regulations, focused squarely on financial institutions and the corresponding duty of those institutions to avoid facilitating financial transactions with questionable parties. One example of this is the longstanding Beneficial Ownership Rule[2] publicized by the U.S. Federal Financial Institutions Examination Council (FFIEC). This rule legally requires banks to establish and maintain written policies and procedures "reasonably designed" to identify and verify beneficial owners of legal entity customers – and to incorporate such procedures into their overall anti-money laundering (AML) compliance programs.

Using this rubric, UBO is determined though conducting both a control and ownership test. Under the control prong, a beneficial owner is deemed to be any individual with significant responsibility to control, manage or direct the overall operations of a legal entity. Such individuals would include, but are not limited to, the principal officers of a corporation (*e.g.*, CEO, CFO, COO, etc.) and any other members of senior management exercising the aforementioned functions.[3] Conversely, the ownership prong instructs that financial institutions are to consider as a beneficial owner, each individual who directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests in a legal entity customer.[4]

Financial institutions may generally rely on information provided by the legal entity customer regarding the identity of its beneficial owner(s). This is provided, of course, that it has no knowledge of facts or circumstances that would reasonably call into question the validity of the information furnished to the financial institution. Where the financial institution does have a credible basis for believing that the information furnished by the legal entity customer is fraudulent, then a reporting obligation under the guidance of a suspicious activity report (SAR) may be required.

The importance of UBO has increased significantly in light of legislative changes aimed at updating the United States' AML enforcement framework. In December 2020, the United States Congress passed the National Defense Authorization Act for Fiscal Year 2021 (NDAA), with the act becoming law on January 1, 2021. The act incorporates the Corporate Transparency Act (CTA)[5], which, among other things, requires "small corporations" and limited liability companies (LLCs) to disclose certain information concerning their beneficial owners to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). Specifically, the CTA requires that certain corporations and LLCs (including existing corporations and LLCs) furnish information concerning the full legal name(s), date(s)

2 *See* 31 CFR 1010.230.
3 *See* 31 CFR 1010.230(d)(2).
4 *See* 31 CFR 1010.230(d)(1).
5 *See* 31 U.S.C. Section 5336.

of birth, current residential or business street address(es), and unique identifying number from acceptable identification documents concerning each beneficial owner to FinCEN at the time of formation.

In harmony with existing UBO regulations, the act defines "beneficial owner" as any individual who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise (i), exercises substantial control over the entity or (ii) owns or controls not less than 25 percent of the ownership interests of the entity."[6] With numerous notable exceptions, the act applies to both domestically incorporated and organized entities (i.e., those filing articles of incorporation/organization with their respective secretary of state or similar office) and entities formed under the laws of a foreign jurisdiction but authorized to conduct business in the United States by virtue of domestic qualification.

As recently as December 8, 2021, FinCEN published a notice of proposed rulemaking (NPRM) echoing the reporting requirements imposed by the CTA.[7] Notably, however, the NPRM deviated from the CTAs suggestion that either a beneficial owner's residential or business address be used to satisfy the reporting requirements. In interpreting that provision of the CTA to afford FinCEN the discretion to determine whether to require reporting of a residential or business address, FinCEN chose to require reporting entities to disclose a beneficial owner's residential address. This is because, as in the opinion of FinCEN, the use of a business address would, "unduly diminish the usefulness of the reported information to national security, intelligence and law enforcement activity." The commentary period for the December 2021 NPRM expired in February 2022, and, according to information retrieved from the Office of Information and Regulatory Affairs (OIRA) within the Executive Office of the President, FinCEN continues to evaluate those comments with a view towards finalizing the disclosure rule and related regulations in the near future.[8]

The purpose of centralized UBO data collection is to enhance law enforcement's ability to protect the U.S. financial system from illicit use and impede malign actors from abusing the obscurity of legal entities to conceal proceeds derived from criminal acts. Because of this, the CTA is the single most aggressive effort by the United States in modern times to update its aging AML enforcement framework.

Furthermore, UBO is especially crucial for companies to comply with trade sanctions regulations issued by the Department of Treasury's Office of Foreign Assets Control (OFAC). In order to effectuate its national security policy goals, OFAC has established a list of prohibited entities known as the Specially Designated Nationals List (SDN List) and related regulations.

To ensure its goals are met through these prohibitions, OFAC notes that property blocked under these regulations "include any property or interest in property."[9] OFAC's "50-Percent Rule" warns that an indirect interest exists in any entity in which an SDN owns, "whether individually or in the aggregate, directly or indirectly, a 50 percent or greater interest."[10] In sum, "any entity owned in the aggregate, directly or indirectly, 50 percent or more by one or more blocked persons is itself considered to be a blocked person."[11] As such, companies must ascertain the UBOs for many transactions in order to ensure compliance with OFAC sanctions. Failure to obtain and analyze UBO information can have significant legal repercussions.

6 31 U.S.C. Section 5336(a)(3).
7 *See* 86 FR 69920.
8 https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=1506-AB49
9 REVISED GUIDANCE ON ENTITIES OWNED BY PERSONS WHOSE PROPERTY AND INTERESTS IN PROPERTY ARE BLOCKED available at https://home.treasury.gov/system/files/126/licensing_guidance.pdf.
10 *Id.*
11 *Id.*

Current Landscape in the European Union and United Kingdom

The European Union's (EU) Fourth Anti-Money Laundering Directive (also known as 4AMLD)[12] was the first directive of its kind to require EU member states to establish a centralized mechanism for the reporting of UBO information.

Under 4AMLD, member states became obliged to require entities in their respective jurisdictions to keep up-to-date ownership information in a central registry that is accessible to competent authorities, obliged entities, and public persons with a legitimate interest. Pursuant to 4AMLD, a beneficial owner is defined as any person who ultimately owns or controls a legal entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights or ownership interest in that entity. A presumption exists that shareholding in excess of 25 percent plus one share or ownership in excess of 25 percent, by a natural person is an indication of direct ownership.

Crucially, similar to AML regulations in the United States, the EU's AML regulations apply with equal force to indirect ownership as well. For example, under 4AMLD, shareholding in excess of 25 percent plus one share, or an ownership interest of more than 25 percent held by a corporate entity and under the control of a natural person, is a legal presumption of indirect ownership.

Since the announcement of 4AMLD by the parliament and council of the EU in 2015, two additional iterations of the EU's AML directive have been issued. While the basic framework described above remains unaltered, 5AMLD[13] and 6AMLD[14] – enacted in June and October 2018, respectively – increased transparency by making national beneficial ownership registers public and interconnected, extending AML and counter-terrorism financing rules to virtual currencies, and harmonizing the definition of what constitutes a money laundering offense.

Specifically, 6AMLD established minimum rules regarding the definition of AML-related criminal offenses – in some cases, prescribing maximum penalties for those offenses. 6AMLD also directed member states to impose both criminal and non-criminal penalties and fines on persons found to have violated AML criminal statutes. These penalties include but are not limited to exclusion from entitlement to public benefits or aid; temporary or permanent exclusion from access to public funding and disqualification from the practice of commercial activities; and the closure of any establishments used for the commission of the underlying offense. 6AMLD further bolsters deterrence efforts by directing member states to, "take the necessary measures to ensure, as appropriate, that their competent authorities freeze or confiscate…the proceeds derived from and instrumentalities used or intended to be used in the commission or contribution to the commission of [a predicate offense]."[15] Finally, 6AMLD boldly directs EU member states to punish the offenses of "aiding and abetting" and "inciting and attempting" to commit an AML-related crime.

Post-Brexit, the United Kingdom (UK) has largely retained provisions of EU law related to the disclosure and publication of beneficial ownership information with a shared view that greater transparency will operate to deter illicit financial activity. Most recently, in response to the Russian Federation's incursion into Ukraine, parliament

12 Directive 2015/849 of the European Parliament and of the Council of 20 May 2015 on the Prevention of the use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, 2015 O.J. (L 141) 73.

13 Directive 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive 2015/849 on the Prevention of the use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, 2018 O.J. (L 156) 43.

14 Directive 2018/1673 of the European Parliament and of the Council of 23 October 2018 on Combating Money Laundering by Criminal Law, 2018 O.J. (L 284) 22.

15 Directive 2018/1673, Article 9, 2018 O.J. (L 284) 22, 29.

passed sweeping legislation calling for the implementation of a registry of overseas companies owning UK property. Aptly titled the Economic Crime (Transparency and Enforcement) Act 2022, Part 1 of the act establishes a register of beneficial owners of non-UK entities that own or acquire land in the UK operated by Companies House—the principal registrar of companies in England and Wales, falling under the remit of the Department of Business, Energy, and Industrial Strategy.

In accordance with part one of the act, any overseas entity wishing to own or acquire UK land must both identify and register UBOs. For the purposes of the act, UBO is presumed where the individual holds more than 25 percent of the shares or voting rights in an entity, can appoint a majority of its directors or can exert significant influence and control over the entity in question. Information supplied to Companies House in conformity with the act must be updated annually and monetary penalties may be imposed on a daily basis for continued contravention.

Finally, failure to register and submitting false information are considered criminal offenses and preclude the entity from being able to buy, sell or mortgage any UK property in the future. Notably, the act has retroactive effect, applying to land bought on or after January 1, 1999, in England and Wales and December 8, 2014, in Scotland. The act has prospective effect only with respect to land owned by a non-UK entity in Northern Ireland.

In Summary

As organizations work to keep up with the everchanging environment of third-party risk, a crucial component to always consider is ultimate beneficial ownership. A comprehensive third-party due diligence program can automate the process of uncovering the risks direct third parties present, while also uncovering beneficial owners and screening them for potential risks. Understanding the ownership structure of third parties can help an organization protect itself from regulatory enforcement action and reputational risk, advancing existing third-party due diligence efforts.