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Corporate Transparency Act: identification of individuals who exercise substantial control over reporting companies

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Introduction

Following the enactment of the Corporate Transparency Act 2021 (CTA), the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) explained that the CTA and FinCEN regulations "would help protect the US financial system from illicit use by making it more difficult for bad actors to conceal their financial activities through entities with opaque ownership structures". This article sets out the definition of "beneficial owner" and the current understanding of the requirement to report individuals who exercise "substantial control" over a reporting company, including indirectly or through intermediary entities. As FinCEN releases further guidance and frequently asked questions (FAQs), this understanding may change.

CTA

Beginning in 2024, US corporations, limited liability companies and statutory partnerships must all file to be included on the FinCEN beneficial owner register, unless an exemption applies (for further details please see "Complying with new US FinCEN beneficial owner register: substantial control and 25% ownership interest tests", "Using 2023 to get ready to comply with new US FinCEN beneficial owner register" and "Reporting beneficial owners of certain US companies: details of new Corporate Transparency Act").

Definition of "beneficial owner"

To file its initial report with FinCEN, a reporting company must identify its beneficial owners. The CTA provides that a beneficial owner of a reporting company is any individual who, directly or indirectly, either:

- exercises substantial control over a reporting company (the "substantial control" prong); or
- owns or controls at least 25% of the ownership interests of a reporting company (the "ownership interest" prong).

The final regulations provide details regarding the "direct or indirect exercise of substantial control" and the "ownership or control of [an] ownership interest". Both lists of details are expansive. In addition to specifics, both lists include a catch-all provision that scoops in any contract, arrangement, understanding or otherwise. This article focuses on the "substantial control" prong of the beneficial owner definition.

Definition of "substantial control"

An individual exercises substantial control over a reporting company if the individual:

- serves as a senior officer of the reporting company;
- has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);
- directs, determines or has substantial influence over important decisions made by the reporting company, including decisions regarding:
  - the nature, scope and attributes of the business of the reporting company, including the sale, lease, mortgage or other transfer of any principal assets of the reporting company;
  - the reorganisation, dissolution or merger of the reporting company;
  - major expenditures or investments, issuances of any equity, incurrence of any significant debt or approval of the operating budget of the reporting company;
  - the selection or termination of business lines or ventures, or geographic focus, of the reporting company;
  - compensation schemes and incentive programmes for senior officers;

    - the entry into or termination, or the fulfilment or non-fulfilment, of significant contracts; or
    - amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures; or
- has any other form of substantial control over the reporting company.

Senior officer

FinCEN's final regulations provide that the term "senior officer" means any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer or any other officer, regardless of official title, who performs a similar function.

FinCEN omitted the roles of corporate secretary and treasurer from the definition as they tend to entail ministerial functions with little control of the company. But FinCEN considers the role of general counsel to be ordinarily more substantial and the final regulations retained this role in the definition of "senior officer".

FinCEN notes that the title of the officer ultimately is not dispositive: "Rather, the underlying question is whether the individual is exercising the authority or performing the functions of a senior officer, or otherwise has authority indicative of substantial control".

Direct or indirect exercise of substantial control

In addition to the definition, the final regulations provide an illustrative, non-exhaustive list of examples of how substantial control could be exercised. An individual may exercise substantial control over a reporting company, directly or indirectly, including as a trustee of a trust or similar arrangement, through:

- board representation;
- ownership or control of a majority of the voting power or voting rights of the reporting company;
- rights associated with any financing arrangement or interest in a company;
- control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;
- arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or
- any other contract, arrangement, understanding, relationship or otherwise.

Reporting companies are to be guided by these specific examples but should also consider how individuals could exercise substantial control in other ways as well. FinCEN notes that a reporting company may be structured such that multiple individuals exercise essentially equal authority over the entity's decisions. In that case, each individual would likely be considered to have substantial influence over the decisions even though no single individual directs or determines them.

The final catch-all example is designed to ensure consideration of any other forms of substantial control that might exist beyond the criteria specifically listed. It operates to address any efforts to evade or circumvent the CTA and FinCEN's regulations. It is intended to "prevent sophisticated bad actors from structuring their relationships to exercise substantial control of reporting companies without the formalities typically associated with such control in ordinary companies" and "serves an important purpose to disincentivise unusual structures that may only serve to facilitate illegal activities".

Third-parties not exercising substantial control

FinCEN's "Supplementary Information" states that FinCEN:

> *does not envision that the performance of ordinary, arms-length advisory or other third-party professional services to a reporting company would provide an individual with the power to direct or determine, or have substantial influence over, important decisions of a reporting company.*

In reviewing a particular reporting company, consideration should be given to whether its senior officers or board members remain primarily responsible for making important decisions based on the external input provided by such third-party service providers. Similarly, a tax or legal professional who is designated as an agent of the reporting company is not reportable under the exception to the "beneficial owner" definition with respect to nominees, intermediaries, custodians and agents.

Overall approach

FinCEN believes that the definition of "substantial control" in the final regulations is based on established legal principles and usages of the term in a range of contexts. The final regulations provide specificity that should assist with compliance, while at the same time being flexible enough to account for the wide variety of ways that individuals can exercise substantial control over an entity. The enumerated ways in which substantial control can be exercised support the basic goal of requiring a reporting company to identify the key individuals who stand behind the reporting company and direct its actions, including both individuals with nominal or de jure authority and individuals with functional or de facto authority.

Furthermore, FinCEN envisions situations in which individuals may not have the power to direct or determine important decisions made by the reporting company, but nevertheless play a significant role in the decision-making process and outcomes with respect to those important decisions. The result is that a reporting company may need to include details for an individual who, through an agent, nominee or other arrangement, has substantial influence over important decisions of the reporting company, even if the individual themselves does not have a formal title or fiduciary position to direct or determine those decisions.

Control exercised in novel and less conventional ways can still be substantial. Family structures utilising varying and flexible governance structures, such as series limited liability companies and decentralised autonomous organisations, may have different indicators of control which may be relevant and cause individuals to be reportable to FinCEN.

It is important to note that no numerical limit is imposed on the individuals to be reported as exercising substantial control over the reporting company. FinCEN believes that limiting reporting of individuals exercising substantial control to one person, as in its 2016 Customer Due Diligence Rule, or imposing any other numerical limit:

> *would artificially restrict the reporting of beneficial owners who may exercise substantial control over an entity, and any such artificial ceiling could become a means of evasion or circumvention. Requiring reporting companies to identify all individuals who exercise substantial control would—as the CTA envisions—provide law enforcement and others a much more complete picture of who makes important decisions at a reporting company.*

Practical application

A reporting company in a family's succession planning structure may have a corporate director or an LLC manager. The role of director or manager is that of a fiduciary exercising substantial control over the reporting company. When gathering beneficial owner information (BOI) data for the reporting company one must look to the individuals who control the corporate director or LLC manager and, thus, make decisions for the reporting company. Those individuals, who are likely the directors of the corporate director or managers of the LLC manager, will be included on the reporting company's BOI report as beneficial owners under the substantial control prong of the definition.

The corporate director or LLC manager may itself be a reporting company. In this case, it analyses its own beneficial owners under the two-prong definition, files its own BOI report, and is issued a "FinCEN Identifier". FinCEN is considering whether to allow a reporting company to report the FinCEN Identifier for its registered corporate director or LLC manager, instead of the details for the individuals who control the reporting company through the corporate director or LLC manager.

In situations where an entity beneficial owner is an exempt entity (eg, a large operating company or bank, rather than a reporting company), the information to be provided depends on the type of beneficial owner. If the exempt entity is a beneficial owner of the reporting company under the "substantial control" prong of the definition, then details for the individuals behind the exempt corporate director or LLC manager must be provided by the reporting company. On the other hand, if the exempt entity is a beneficial owner of the reporting company under the "owns or controls at least 25% of the ownership interests" prong of the definition, then, the reporting company reports just the name of that exempt corporate director or LLC manager.

Until FinCEN issues further guidance, it appears that, with regard to individuals with substantial control over a reporting company because they exercise control over "one or more intermediary entities that separately or collectively exercise substantial control over a reporting company," it is the individuals making decisions for the reporting company that are relevant. If this interpretation is correct, the result is that, in most cases, it will not be necessary for the reporting company to include details of the individuals who own its corporate director or LLC manager – rather, details would be included for the individuals who make the decisions for the reporting company. Guidance and FAQs may eventually provide more clarity.

Further guidance expected

FinCEN recognises that additional guidance or FAQs may help provide clarity for reporting companies in specific circumstances. As it implements and ensures compliance with the final regulations, FinCEN expects to gain greater experience with the spectrum of arrangements or relationships that bad actors may establish to circumvent reporting requirements and engage in illegal activity. FinCEN will assess the need for additional guidance, notices or FAQs accordingly.

Comment

A family's succession planning structure may include a limited liability company (LLC) or corporation (established by a filing in Delaware or other US state) which will be required to file a BOI report in 2024. The manager of the LLC and the board of directors of the corporation exercise substantial control over the LLC. If these roles are held by individuals, each individual's name, address birth date and driver's license or passport will be provided on the initial BOI report filed in 2024. If held by another entity, the individuals who control that other entity and make decisions for the reporting company will be included on the reporting company's initial BOI report.

Advisors must look through intermediary entities that separately or collectively exercise substantial control over a reporting company. At present, details regarding another entity exercising substantial control are not included on the BOI report, but FinCEN has reserved a section in the final regulations that may allow for reporting the FinCEN identifier of another entity that is itself a reporting company that has filed a BOI report with FinCEN. In addition, care must be taken to identify family members who direct, determine, or have substantial influence over important decisions made by the reporting company. Willfully failing to report complete BOI data or providing false BOI data could result in a fine of up to $10,000, imprisonment for not more than two years, or both.

For further information on this topic please contact Jennie Cherry, Rashad Wareh or Elizabeth Martin at Kozusko Harris Duncan by telephone (+1 212 980 0010) or email (jcherry@kozlaw.com, rwareh@kozlaw.com or emartin@kozlaw.com). Please note that the authors are unable to provide legal advice to non-clients. The Kozusko Harris Duncan website can be accessed at www.kozlaw.com.