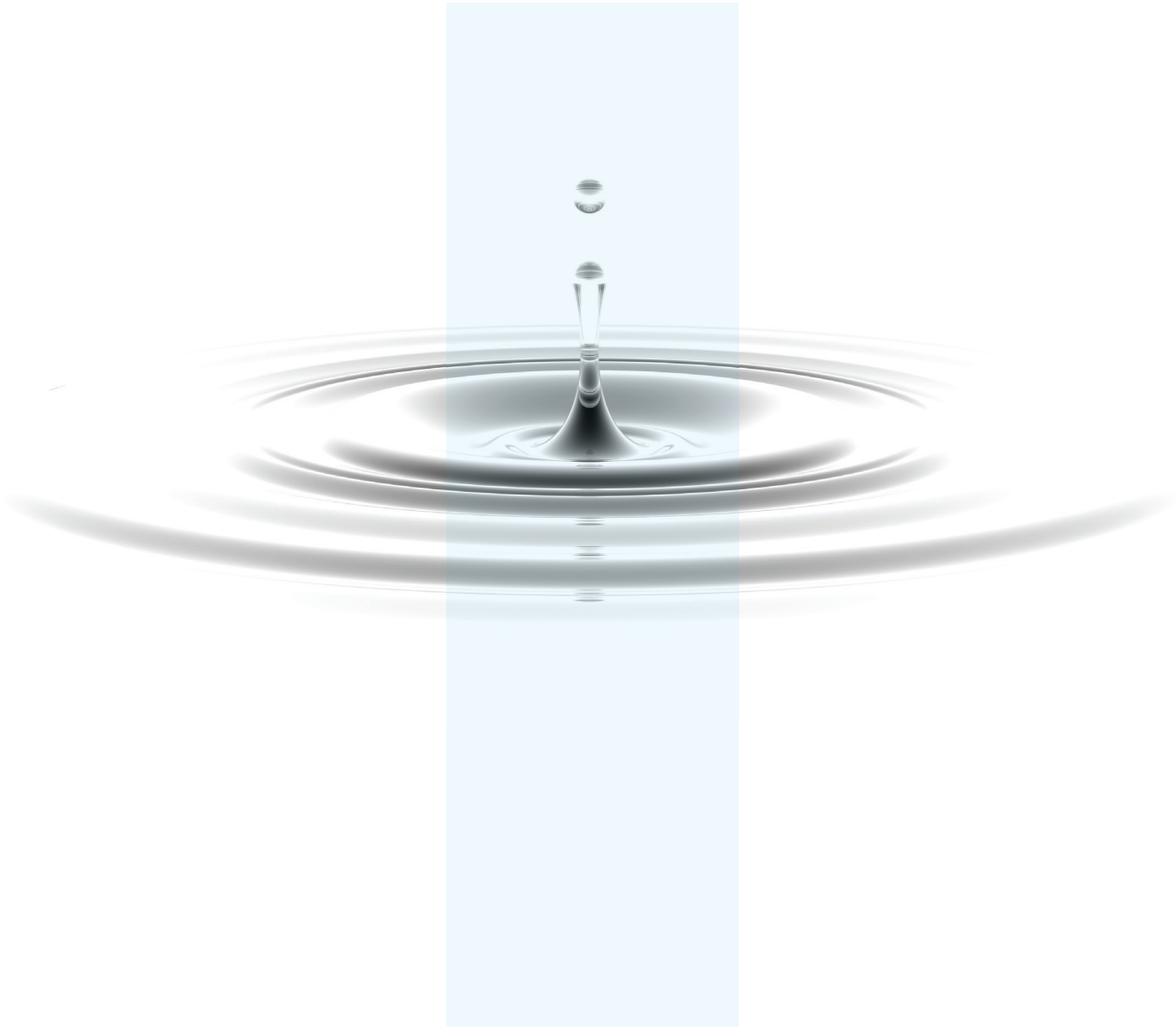
TRANSPARENCY RULES



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Non-US-based investors face the disclosure regime of the Corporate Transparency Act. What do you need to know?

Non-US-based investors that own or invest in US real estate have never been free from disclosure requirements. But the disclosure regime has historically been relatively inobtrusive. The Federal government has been ratcheting up the scope of required disclosure, in part as a response to the terrorist attacks of 9/11 and to rising concerns about money laundering through real estate ownership.

On January 1, 2021, Congress enacted the Corporate Transparency Act (CTA), the most significant expansion in over twenty years of requirements to disclose the identity of individuals who own or control entities engaged in business in the US. While the CTA applies both to domestic and to some non-US-based entities, and is not limited to real estate activities, when fully implemented its effect on non-US-based investors and sponsors of commingled vehicles in which these investors participate will be substantial. The CTA is very much a work in progress, and many of its significant provisions are to be defined in regulations due within one year from enactment. As a result, critical questions as to its reach and scope are unanswered. It will not be effective until these regulations are issued.

This article analyzes the principal provisions of the CTA and its effect on non-US-based investors. It offers some preliminary thoughts about issues to consider immediately, and unresolved issues to be tracked. Finally, it makes the point that the CTA should not be ignored.

In the past, governmental disclosure requirements have largely been confidential (e.g., Department of Commerce reporting), levied on third parties (e.g., financial institutions for know-your-customer vetting) or title insurance companies (e.g., Geographic Targeting Orders of the US Department of Treasury's Financial Crimes Enforcement Network [FinCEN]), and narrow in scope. In contrast, the CTA is imposed on entities themselves, information gathered is prescribed to be kept confidential but can be shared by FinCEN, and, for the entities involved, may be quite intrusive. There is a broad list of exempt classes of entities, but the remaining targets cover a substantial segment of owners, operators and investors.

Of particular interest, a non-US entity is not a "reporting company" unless it has qualified to do business in the US. It may have to be reported by others as a beneficial owner, but it may not have to report its own owners or control parties—it may effectively be a blocker. We await the regulations for confirmation.

The CTA will also affect lenders and other third parties. CTA compliance may create conflicts between sponsors and investors, as the former will favor compliance (due to civil and criminal fines and penalties) and the latter may resist disclosure. The existence of the CTA may have a retarding effect on foreign investment in US real estate or may reorient strategies for investment.

WHY THE CTA?

The US has been criticized for allowing investment through entities whose ultimate beneficial ownership and control parties are not disclosed to governmental authorities (let alone publicly). The use of "shell companies" to hide illegal activity, including money laundering by criminal or terrorist sources, has been a perennial concern. Efforts under the USA Patriot Act and other so-called anti-money laundering and combating the financing of terrorism (AML/CFT) enactments and of the FinCEN have been criticized as incomplete. The CTA culminates a multi-year effort to prescribe more robust disclosure.

THE BENEFICIAL OWNERSHIP REGISTRY

The CTA creates a beneficial ownership registry, which FinCEN will administer. This database is not publicly available, but can be used by FinCEN and made available to Federal and state law enforcement entities and some foreign governmental entities for law enforcement purposes, including tax administration. If a disclosing entity consents, data can be shared with financial institutions for use in their KYC and AML/CFT compliance activities. No doubt, some financial institutions will request or insist on a borrower's consent.

WHO MUST REPORT?

The CTA requires "reporting companies" to report, including corporations, limited liability companies and "similar entities" formed in the US or formed in foreign jurisdictions and qualified to do business in the US. The scope of the terms "reporting companies" and "similar entities" is left to the regulations, to be issued within one year of enactment. The important question of whether partnerships, trusts, and other forms of business organization are "similar" is unresolved.

There are at least twenty classes of entities exempted from reporting because they were deemed sufficiently regulated or carry too low a risk. A non-US-based entity that is not qualified to do business in the US is exempt from reporting. However, a reporting company in which an exempt entity has a substantial interest, directly or indirectly, or over which an exempt entity exerts substantial control, must still identify the exempt entity itself. An exempt entity can perhaps function as a kind of blocker, so that information about its investors and control parties need not be disclosed.

An illustrative list of exempt entities includes: public companies that have issued a class of securities registered under the Securities Exchange Act of 1934; certain investment companies, brokers or dealers; pooled investment vehicles operated by certain exempt entities and US persons owned or controlled by US persons, with a physical presence in the US and with at least twenty full-time employees and US$5 million of gross receipts or gross sales. Reference should be made to the CTA, and eventually to regulations, for a more precise definition.

WHAT INFORMATION MUST BE REPORTED?

Reporting companies must report the name and specified personal information of any individual who directly or indirectly, by contract, relationship, arrangement, understanding, or otherwise, exercises "substantial control" over (or owns or controls 25% or more of) the beneficial interests in the reporting company. These terms are to be further defined in regulations, but their scope could be quite broad and the definition is laced with ambiguities. Moreover, complex capital stacks and decision-making parameters may make a determination of ownership or control more a matter of art than an objectively determinable fact. Do the terms include officers, directors, holders of powers of attorney, members with major decision rights, lenders with consent rights over operations of borrowers, trustees, and beneficiaries of trusts? Do less formal and more disbursed networks of organization or cooperation constitute a cluster of individuals as control persons? To be determined.

WHEN ARE REPORTS DUE?

The CTA becomes effective when regulations thereunder are issued, which is to occur within one year after enactment.

Any reporting company formed after the effective date must, upon formation, file a beneficial ownership statement. Note that many entities are formed before the actual ownership is in place.

Any reporting company formed before the effective date must file its first beneficial ownership statement within two years after the issuance of final regulations.

Any reporting company must file an updated statement of a change to the previously reported information within one year after the change. Presumably, the regulations will clarify the materiality of changes that require an update.

FINES AND PENALTIES

Civil and criminal penalties are prescribed for a person who willfully provides false or fraudulent beneficial ownership information, or willfully fails to report, or who makes an unauthorized disclosure of such information.

Liability for individuals responsible to file, and perhaps even for their counsel, is a topic that should be tracked. At the very least, the threat of liability could create adversity between those who report (e.g., managing members, trustees, or sponsors) and those who possess the information (e.g., investors or beneficiaries), particularly since the scope of what to report is presently so uncertain. Among the open issues is the degree to which FinCEN can compel parties other than reporting companies to verify ownership and control information. However, there is no indication that parties otherwise dealing with a reporting company are affected by its failure to comply.

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INTEGRATION WITH EXISTING REQUIREMENTS (FOR LENDERS PARTICULARLY)

The CTA is not yet integrated with FinCEN's Customer Due Diligence Rule (CDD) and does not release financial institutions from compliance with the CDD. The CTA instructs FinCEN to bring the CDD into compliance with the CTA.

IMMEDIATE ISSUES

While the implementation of the CTA will be deferred, and its scope will remain undefined until regulations are issued, it is not too early to consider a preliminary response.

- The CTA bans the issuance of bearer shares evidencing ownership in covered entities. Entities that have or plan to issue bearer shares should address this.
- Familiarize oneself with the rules for exemption.
- Documentation for each newly formed non-exempt entity should address the obligation of each party to provide the information required by the CTA. It is not unlikely that partnerships will be included in the CTA regime, and perhaps trusts.
- Documentation for existing entities should be examined and, if practicable, revised to reflect the pendency of CTA obligations.
- Parties who control investment vehicles (including funds) will want to require investor cooperation and indemnification.
- Each investor should assess its ability to obtain and willingness to disclose the requisite information. The CTA regime spreads a wide net, but planning opportunities may be available.
- Financial institutions should be alert to changes in the CDD instituted to conform it to the CTA disclosure regime. One issue is the extent to which financial institutions will be allowed to rely on the beneficial interest registry in lieu of their own due diligence.
- Lenders and borrowers should address the right of lenders to obtain information if the borrower consents. Lenders may want to require permission to obtain the information; borrowers may want authorization from investors to grant permission; investors may want to decline permission.

CTA and its Regulations is and will continue to be a subject which non-US-based investors in US real property should track and respond to as they are implemented.

ABOUT THE AUTHOR

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