STRUCTURED FINANCE SPECIAL PURPOSE VEHICLES
AND FINCEN’S CDD RULE

Compliance with FinCEN’s new customer due diligence rule can present significant difficulties for financial institutions that do business with SPVs in structured finance transactions. The author discusses the rule, the difficulties it presents, and the many exclusions it allows. He finds that similarly situated SPVs may be subject to dissimilar treatments under the rule and that a compelling case can be made for FinCEN to exclude SPVs more broadly from the rule’s definition of “legal entity.”

By Jeremy Kuester *

Structured finance is a common way for companies to share their risks and more efficiently access capital. In the course of a structured financing, legal entities are created to hold an asset, which in turn issues securities (primarily fixed income) that are offered to investors. These structured finance entities, called special purpose vehicles or special purpose entities (collectively, “SPVs”), can create compliance challenges under the Financial Crimes Enforcement Network’s (“FinCEN”) Customer Due Diligence Rule (“CDD Rule” or “the Rule”) for the banks, brokers or dealers in securities, mutual funds, and futures commission merchants or introducing brokers in commodities (“covered financial institutions”) with which they have formal financial relationships.

Because SPVs may be considered “legal entities” under the CDD Rule, covered financial institutions must collect and verify information regarding the SPV’s beneficial owners. However, there are many exclusions to the CDD Rule’s definition of “legal entity,” including one excluding pooled investment vehicles (“PIVs”) managed or advised by an otherwise excluded financial institution, which could include some versions of SPVs. SPVs may come in several forms, including as PIVs or other types of entities not excluded under the CDD Rule, leading to situations where similarly situated SPVs with similar purposes, similar organizations, and similar associations with regulated financial institutions may be subject to dissimilar treatments under the CDD Rule. Given the similarities between excluded PIVs and otherwise not-excluded SPVs, a compelling case can be made for FinCEN to exclude such SPVs from the CDD Rule’s definition of “legal entity.”

STRUCTURED FINANCE

Structured finance is a technique companies may employ to restructure debt, raise capital, transfer assets, or manage risk, among other purposes. While the dominant form of structured finance is securitization, whereby typically illiquid debt assets or receivables are...
pooled and then the revenues are sold to investors in the form of securities, companies may also employ the same techniques for project financing and syndicated loans.

**Special Purpose Vehicles**

A key component of structured finance, whatever the form, is the use of SPVs. In a typical financing, a sponsor (the company holding the assets that need financing) transfers a pool of assets to one or more SPVs that hold the assets and issue fixed-income securities to investors. Payment on the securities depends primarily on the cash flows generated by the pooled assets. A servicer administers the pool by collecting payments on the underlying assets when due and ensuring that funds are available so that investors are paid in a timely manner. In most cases, an independent trustee, usually a large commercial bank, monitors an SPV’s fulfillment of its obligations as issuer.

SPVs can be created as nearly any legal entity, and most commonly are corporations, limited partnerships (“LPs”), limited liability companies (“LLCs”), or trusts. In almost all cases, the SPVs are passive entities that generally only hold assets and receive cash flow from those assets. They, therefore, conduct no business and have no need for employees or management structures.

Because the SPVs hold assets that the Securities and Exchange Commission (“SEC”) has deemed to be securities, they fall within the definition of “investment company” under section 3(a) of the Investment Company Act of 1940 (“the Act”), and must register with the SEC and comply with the Act’s requirements, unless an exclusion is available. The nature of the SPV’s operations, however, makes compliance impractical or even impossible, and in most cases, SPVs seek an exclusion under section 3(c) of the Act and the rules promulgated thereunder. Before 1992, many private sector sponsored financings avoided regulation under the Act by: (1) relying on section 3(c)(5), which generally excepts from the definition of investment company any person who is not engaged in the business of issuing redeemable securities and who is primarily engaged in one of the finance businesses enumerated in the section or (2) selling their securities in private placements in reliance on section 3(c)(1), the “private” investment company exception, or outside the United States. In 1992, the SEC issued Rule 3a-7 to exclude structured financings from the definition of “investment company,” to reflect the distinctions between registered investment companies and structured financings, and to incorporate investor protections and allow for future innovations in the structured finance market.

**CUSTOMER DUE DILIGENCE RULE**

On May 11, 2016, FinCEN issued the CDD Rule as a final rule to clarify customer due diligence requirements for covered financial institutions. The Rule codified FinCEN’s existing regulatory expectations to conduct sufficient due diligence on a customer to understand the nature and purpose of the customer relationship. The Rule also included a new requirement to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exclusions.

In relevant part, the CDD Rule requires covered financial institutions to identify and verify beneficial owners of certain legal entity customers pursuant to written procedures that the covered financial institutions establish and maintain. Under the Rule, beneficial

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1 In contrast to asset securitizations, institutions in the insurance sector have used SPVs in products that transfer exposures to liabilities, such as bonds that transfer catastrophic event risk to the capital markets. The Joint Forum, Basel Committee on Banking Supervision, Report on Special Purpose Entities, (Sept. 2009), p. 2, https://www.bis.org/publ/joint23.pdf.


3 For example, the limitations of section 18 on the issuance of senior securities and the prohibitions of section 17 on transactions involving affiliates conflict with the operation of structured financings. 18 U.S.C. §§ 80a-18 and 80a-17, respectively.


5 Id. at 56248 - 56249.

owners are (1) each individual, if any, who directly or indirectly owns 25 percent or more of the equity interests of a legal entity customer (“ownership prong” and (2) a single individual with significant responsibility to control, manage, or direct a legal entity customer (“control prong”).

Additionally, the Rule defines a legal entity customer to mean “a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account.”

Despite a two-year runway to come into compliance with the Rule, some covered financial institutions have struggled to develop appropriate required procedures, particularly involving more nuanced products, services, or customers that have no clear corollary in the retail bank context that has heavily influenced the anti-money laundering regime in the United States.

**Challenges in Applying the CDD Rule to SPVs**

Since they are corporations, LLCs, LPs, or trusts, SPVs generally meet the definition of “legal entity customers” under the CDD Rule. As a result, when an SPV enters into a formal financial relationship with a covered financial institution, it must provide to the financial institution a certification regarding its beneficial owners and verification of their identities, which can be a difficult task. These types of SPVs are not operational and may not have any employees. They do not have management structures, and may not have individuals identified as a chief executive officer, president, or general manager, making it difficult to identify a single individual who would meet the control prong of the Rule.

Identifying individual beneficial owners under the ownership prong can also be a challenge. An SPV can be owned by its sponsor or investors or, interestingly, no one. Some SPVs are established as so-called “orphan trusts” — the sole shareholder is a trust controlled by a corporate trustee. In this situation, no single individual can be identified as a beneficial owner under the CDD Rule’s ownership prong.

Furthermore, in securitizations, many SPVs — potentially hundreds at a time — may be formed at the same time by a sponsor. Relationships may be entered into on behalf of the SPVs, even though assets have not yet been transferred to them. Given the challenges in identifying the beneficial owners of structured finance SPVs it would be extremely burdensome for covered financial institutions if such SPVs were considered legal entities under the Rule.

**Exclusions to the Definition of “Legal Entity Customer”**

In the CDD Rule, FinCEN excludes 19 types of entities from the definition of “legal entity customer,” where collection of beneficial ownership information is duplicative or unnecessarily burdensome. FinCEN was careful to note that “exempting these entities from the beneficial ownership requirement does not necessarily imply that they all present a low risk of money laundering or terrorist financing.”

Rather, most of the excluded entities are heavily regulated and must disclose beneficial ownership as part of their registration with a government authority. Some of the entities were already excluded from the customer identification requirements under the Customer Identification Program (“CIP”) rules, while others were excluded because their beneficial ownership information is generally available from other credible sources. One exclusion that is slightly different from the others is the exclusion for PIVs that are advised by otherwise excluded financial institutions. Unlike other entities that are excluded because their beneficial ownership is available from other credible sources, these PIVs are excluded because the beneficial ownership information regarding the operator or adviser of such PIVs would be available.

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7 31 CFR § 1010.230(d).
8 31 CFR § 1010.230(e)(1).
9 In regard to trusts, only statutory trusts created by a filing with a Secretary of State or similar office are considered legal entities under the CDD Rule. 81 FR 29412.

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10 Final Rule at 29413. The 19 types of entities excluded from the definition of “legal entity customer” are identified at 31 CFR § 1010.230(e)(2), including: “A pooled investment vehicle (“PIV”) that is operated or advised by a financial institution excluded under paragraph (e)(2) of [31 CFR 1010.230].”
12 Banks – 31 CFR § 1020.100(c)(2), Brokers or Dealers in Securities – 31 CFR § 1023.100(d)(2), Mutual Funds – 31 CFR § 1024.100(c)(2), and Futures Commission Merchants and Introducing Brokers in Commodities – 31 CFR § 1026.100(d)(2).
13 FinCEN, Notice of Proposed Rulemaking at 45159.
14 FinCEN, Final Rule at 29414.
SIMILARITIES BETWEEN PIVS AND STRUCTURED FINANCE SPVS

PIVs excluded under the CDD Rule and SPVs share many key characteristics. Both would be required to register as investment companies, absent a specific exclusion. The operations of both typically rely upon the involvement of a separate legal entity that is otherwise excluded from the definition of “legal entity customer” under the CDD Rule. And, fundamentally, collection of beneficial ownership information regarding either type of entity would not return a level of value relative to the level of effort it would take to collect.

Exclusion from the Definition of “Investment Company”

Both PIVs and SPVs would be required to register as investment companies under section 3 of the Act if they were not entitled to rely on an exclusion from the definition. Generally speaking, an investment company is an issuer that is in the business of investing, trading, or holding of securities. It is a broad definition that could encompass a broad variety of companies, if not for several exclusions written into the Act and through regulation by the SEC.

FinCEN refers back to the Act in its own definition of the term “non-exempt pooled investment vehicle” in the Notice of Proposed Rulemaking for the CDD Rule. There FinCEN defined a non-exempt PIV as “[…] any company [presumably including SPVs] that would be an investment company as defined in section 3(a) of the [Act], but for the exclusion provided by either section 3(c)(1) or section 3(c)(7) of that Act[.]” Section 3(c)(1) of the Act refers to an issuer the outstanding securities of which are beneficially owned by not more than one hundred persons and which is not making and does not at that time propose to make a public offering of such securities.”

Because SPVs invest in assets that generate income and investors acquire interests in the SPVs that are often securities (or deemed to be securities by the SEC) such as notes, profit sharing agreements, or stocks, SPVs would generally be considered an investment company under section 3 of the Act. However, as it would be impractical for SPVs to comply with the obligations of being a registered investment company, they ordinarily rely on the SEC’s Rule 3a-7, section 3(c)(5), and section 3(c)(1) of the Act for applicable exclusions.

Rule 3a-7 Exclusion. Rule 3a-7 excludes from the definition of “investment company” any issuer who is engaged in the business of acquiring and holding eligible assets, and who does not issue redeemable securities. Of particular note, an issuer taking advantage of this exclusion that issues securities other than short-term securities must appoint a trustee that meets the requirements of section 26(a)(1) of the Act and fulfills other conditions. The issuer must take reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in those eligible assets that principally generate the cash flow needed to pay the fixed-income security holders. The issuer must also take actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed-income securities.

Section 3(c)(5) Exclusion. Section 3(c)(5) of the Act is another vehicle that holders of asset-backed securities can use to be excluded from the definition of “investment company” and the obligations of the Act. The exclusion applies to persons that are primarily engaged in other activities, such as purchasing receivables or making loans that relate to the purchase or sale of specific merchandise, insurance, or services, or purchasing mortgages and other interests in real estate.

Section 3(c)(1) Exclusion. While the requirements of section 3(c)(1) have already been addressed, for purposes of the CDD Rule the issue may be moot: SPVs that claim this exclusion from the Act, and there are SPVs that do, will be considered to be PIVs for the purpose of the CDD Rule and subject to an outright exclusion from the Rule or relief from the ownership

15 Registered investment companies are excluded from the definition of “legal entity customer” under the CDD Rule. 31 CFR § 1010.230(e)(2)(iv).
16 Section 3(a) of the Investment Company Act.
17 FinCEN, Notice of Proposed Rulemaking, at 45161. The term is not formally defined under the Final Rule, however FinCEN’s definition in the Notice of Proposed Rulemaking mirrors the SEC’s definition of the term at 17 CFR § 275.206(4)-(8)(b).
18 17 CFR § 270.3a-7(a)(4)(ii).
19 Id. at (a)(4)(iii).
prong of the Rule, depending on the involvement of otherwise excluded financial institutions. It is important to note that in excluding, either wholly or partially, PIVs from the CDD Rule, FinCEN may treat SPVs used in structured financings inconsistently, solely based on how the SPV markets its securities and not with regard to its AML risk or availability of useful information to law enforcement, which are more common factors for determining need for AML regulatory coverage.

Involvement of Excluded Entities

PIVs that are operated or advised by entities that are otherwise excluded from the CDD Rule are also excluded from the definition of “legal entity customer” for purposes of the Rule. For example, many US PIVs are advised by registered investment advisers that are excluded from the definition of “legal entity customer” because the beneficial ownership information of those advisers is required to be disclosed as part of the adviser’s registration with the SEC.

Similar to PIVs excluded from the CDD Rule, many SPVs could not exist or function without the involvement of an entity that is otherwise excluded from the definition of “legal entity customer” under the Rule. For example, US-regulated financial institutions and companies publicly listed on US exchanges often sponsor SPVs. These types of entities also often serve as servicers for the SPVs, ensuring that the proceeds of the assets being held by the SPV are received by the SPV and subsequently distributed to its investors. Both US financial institutions subject to federal functional regulation and publicly listed companies are excluded from the definition of “legal entity customer.”

Additionally, SPVs that claim the exclusion from the Act under Rule 3a-7 are required to have a trustee that oversees the disbursement of revenues derived from the underlying asset(s) to the SPV’s investors. The trustee is required to be a bank that would otherwise be subject to the BSA and would also be excluded from the CDD Rule. As a bank regulated by a Federal functional or state regulator, the trustee of an SPV relying on the Rule 3a-7 exclusion, but not the SPV itself, would be excluded from the definition of “legal entity customer” under the CDD Rule.

FinCEN, in its Rule, stated that it would be “unreasonable to impose . . . collection obligations [with regards to non-excluded PIVs] for information that would likely be accurate only for a limited time.” It appears that SPVs and PIVs sponsored, serviced, or advised by excluded legal entities are similarly situated. It, therefore, is similarly unreasonable to force covered financial institutions to collect beneficial ownership information on structured finance SPVs, given the nature of these SPVs’ operation and the availability of such information regarding the entities that have a meaningful influence on the SPV’s composition and administration.

WAY FORWARD

FinCEN has already demonstrated that it is willing to extend relief to the industry in situations where the collection of beneficial ownership would be unreasonable given the burden of collection and the limited value of the information collected. Given the parallels and, in some cases, overlap between excluded PIVs and structured finance SPVs, a similar case for relief from the requirements of the CDD Rule could be made for those SPVs.

The author would like to thank Max Bonici, Claudette Dreuhl, Katherine Madriz, Aseel Rabie, David Thatch, and Duane Wall for their contributions to this article. Any views expressed in this article are strictly those of the author and should not be attributed in any way to White & Case LLP. White & Case includes the international legal practice comprising White & Case LLP, a New York State-registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law, and all other affiliated partnerships, companies and entities. This article is prepared for the general information of interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.

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20 A PIV that is operated or advised by a financial institution not excluded from the definition of “legal entity customer” is only subject to the control prong of the CDD Rule. 31 CFR § 1010.230(e)(3)(i).

21 31 CFR 1010.230(e)(2)(i) and 1010.230(e)(2)(ii).

22 Compare Section 2(a)(5) of the Investment Company Act, defining “bank” and 31 CFR 1010.100(d).

23 FinCEN, Final Rule at 29416.