



Corporate Transparency Act: Who Can Exert Substantial Influence on My Company? Part I

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Part I: Substantial Influence

The Corporate Transparency Act (CTA)^[i] was enacted to combat the use of multi-layered shell company structures to hide the identities of individuals engaging in various types of criminal activities, such as terrorism, drug trafficking, money laundering, and financial fraud. CTA responds to the U.S. government's inability to mandate the collection of beneficial ownership information of corporate entities formed in the U.S., which has been identified as a vulnerability in the U.S. enforcement framework by the Financial Crimes Enforcement Network, an agency of the U.S. Department of the Treasury known as "FinCEN."^[ii]

CTA requires companies subject to its reporting mandate to disclose beneficial ownership information (BOI) about two classes of natural persons who are affiliated with the reporting company.

- Individuals who exercise, directly or indirectly, "substantial control" over the reporting company; and
- Individuals who own or control, directly or indirectly, at least 25% of the "ownership interests" of the reporting control.

CTA imposes substantial penalties for violations, aiming to deter the use of shell companies to obfuscate the identities of the actors controlling the criminal enterprise.^[iii]

This series of articles examines the first two categories of beneficial owners.

In our first piece, we look at the definition of Substantial Influence and discuss:

- Corporate Directors;
- Voting Power; and
- Exercise of substantial control

Click [here](#) to read our second article, which analyzes how and when some of the common techniques for allocating control of a business entity beyond voting power may constitute substantial control and trigger the BOI disclosure requirement.

The issue of “substantial control” will only be of concern to businesses that do not qualify for a CTA reporting exemption, particularly the large operating company exemption available to companies that both have 20 full-time employees and reported gross revenue of \$5 million on their most recent annual tax return. [\[iv\]](#) For example, a start-up company could have received multiple rounds of investment but not yet attained the annual gross revenue threshold. The business may operate through a multi-entity structure in which the parent company and some of its subsidiaries do not have 20 full-time employees. Entities funding operations with capital contributed by institutional investors who obtained important governance rights in their investment agreements must carefully evaluate the extent to which those investors have the ability, should they choose to exercise it, to influence the company’s management and strategy.

In addition, the company must repeat this assessment every time it admits a new round of investment because the CTA requires a reporting company to update its BOI report within 30 days of any change in the beneficial ownership information.

What Is “Substantial Influence”?

The regulations implementing beneficial ownership reporting under the CTA (“BOI Regs”) [\[v\]](#) provide that individuals can exercise “substantial control” in one of two ways:

- By serving as a “senior officer” of the company with the actual and apparent authority to make important decisions; [\[vi\]](#)
- Through a right to direct, determine, or exert substantial influence over important decisions through voting rights, contract rights, relationships, or some other arrangement.

Identifying a company’s senior officers should be a straightforward task. The BOI Regs state that specific leadership positions will qualify, as will any functionally equivalent position.

Likewise, identifying the individuals with the authority to “direct” and “determine” important decisions also should not be particularly troublesome, as those terms are largely unambiguous.

However, the ability to “exert substantial influence” can be interpreted very broadly. When is participation in the decision-making process “substantial influence?” Is there a threshold when an individual’s participation becomes “substantial?” Unfortunately, the BOI Regs intentionally offer little direct guidance.[\[vii\]](#)

Consider the penalties. The reporting company and its senior officers may be liable for deciding to omit the BOI of an individual who is subsequently determined to have been a beneficial owner if the omission is found to be intentional.[\[viii\]](#) The officers’ judgment may be questioned with 20/20 hindsight, and CTA’s safe harbor provision may not be available when a conscious decision is reasonable and made in good faith, in which case the penalties can be draconian. On the other hand, there is no penalty for including an individual whenever their ability to influence important decisions would be a judgment call. The prudent response will be to include an individual when there is any doubt about their degree of influence. However, the more complex the organizational structure is, the more cumbersome the information gathering, reporting and especially monitoring processes will become.

The requirement to update the reporting company’s beneficial ownership information within 30 days after a change occurs introduces additional considerations for the senior officers to assess. In light of the short window to amend beneficial ownership information, is it prudent to solicit ownership information in advance from investors who would not be beneficial owners at the time of the company’s initial report, but could become so if and when certain foreseeable events occur?

The lack of clarity as to when one’s ability to influence decision-making becomes “substantial,” and the risk it creates, will be a difficult issue for reporting companies to grapple with.

Corporate Directors

One surprising place this dilemma arises is the status of a corporation director under the CTA. All state corporation statutes plainly state that the board of directors is a corporation's ultimate authority.^[ix] Board approval is statutorily required for major organic changes to the corporation, such as mergers, asset sales, dissolutions and charter amendments, all of which the CTA specifically identifies as "important decisions." The BOI Regs also identify "board representation" as a direct way to exercise substantial control over a reporting company.^[x] One would expect there to be no doubt that every director of a corporation would be a beneficial owner for CTA reporting purposes.

However, FinCEN has complicated this issue. Consider the following [Frequently Asked Question](#) that FinCEN published in September 2023:

D.9. Is a member of a reporting company's board of directors always a beneficial owner of the reporting company?

No. A beneficial owner of a company is any individual who, directly or indirectly, exercises substantial control over a reporting company, or who owns or controls at least 25 percent of the ownership interests of a reporting company.

Whether a particular director meets any of these criteria is a question that the reporting company must consider on a director-by-director basis.

Given the statutory and fiduciary duties imposed on directors by governing state law noted above, on what basis could a reporting company ever safely conclude that the ability of a director to exert influence on important corporate decisions is not "substantial?" The FAQ seems to imply there is a threshold when a director's influence would be too diluted to be substantial. How many directors must there be so that a single director can no longer "exert substantial influence?" The BOI Regs offer no guidance on where that threshold lies.

For example, would a reporting company ever feel secure omitting the BOI of a director appointed by a majority shareholder on the

theory that the director merely represents the interests of a shareholder who is by definition a beneficial owner?

Voting Power

The language of the BOI Regs defining substantial control is identical to that of the SEC's rule defining a beneficial owner as one who has or shares voting or investment power of a security through any "contract, arrangement, understanding, relationship, or otherwise." [\[xi\]](#) For purposes of securities law, there is a presumption that a person possessing 10% of the voting power of an entity possesses the power to control or direct its management and policies, which can be rebutted by other facts. [\[xii\]](#) However, can one assume that any contract or arrangement involving less than 10% of the reporting company's ownership interests does not constitute "substantial control" and therefore safely elect not to file BOI of the parties to that contract or arrangement? Is it worth the risk to take the position that control does not become "substantial," and therefore BOI disclosure is not required unless a contract or arrangement covers at least 25% of the reporting company's ownership interests, the level where an individual must disclose BOI as a beneficial owner?

The operating agreements of limited liability companies, even those manager-managed, typically require that significant transactions and organic changes to the company must be approved by those holding a majority or more of the membership interests. These would include mergers, sale or lease of assets outside the ordinary course of business, incurring indebtedness in excess of a stated amount, and dissolution – all of which would be characterized as "important decisions" by the BOI Regs.

In these circumstances, the limited guidance from FinCEN to date will force the senior officers of the reporting LLC to make some difficult judgment calls. Absent the presence of any factors other than voting power, is it safe to assume that 25% of the voting power is the threshold where the ability to exert influence becomes "substantial"? If no single member owns 25% of the voting interests, and all the company's members can vote on important decisions, who can exert "substantial influence"?

In its release adopting the BOI Regs, FinCEN stated: “A reporting company may also be structured such that multiple individuals exercise essentially equal authority over the entity’s decisions—in which case each individual would likely be considered to have substantial influence over the decisions even though no single individual directs or determines them.”^[xiii]

Would it then be safe to submit BOI only for a “control group” comprised of the owners of larger ownership percentages who collectively represent the requisite voting power to approve “important decisions?” Or would the safest course, but also the most burdensome, be to collect and report the BOI of all the members who have voting rights?

The same issues arise for reporting companies that are corporations. As previously noted, state corporation statutes require shareholder approval of significant transactions and organic changes to the corporation, all of which qualify as “important decisions.” If no single shareholder controls 25% of the voting power, by what standard can one confidently identify the shareholders whose voting power constitutes “substantial influence”? Is it safe to list only the senior officers as the beneficial owners?^[xiv] Or should every holder of a voting share be included?

Voting Agreements. The parties to a voting agreement agree to vote as a block on specific matters spelled out in the agreement. Whether the parties to the agreement can exert substantial influence depends on the specific matters and their combined voting power. It’s safe to assume that matters important enough to be the subject of a voting agreement involve significant governance and control issues. However, a reporting company can only be responsible for considering the impact of a voting agreement if it is aware of the agreement’s existence.

As with all considerations relating to voting power, what percentage constitutes significant influence? When the parties to the agreement represent 25% or more of the voting power, it should be safe to assume they are able to exert substantial control. If the parties together hold less than 25% of the voting power, then the presence of other persons holding substantial voting power would be a factor in the assessment. The less clear it is who has the voting

power to influence management, the more pushback senior managers may encounter from investors unenthusiastic about being included as a beneficial owner.

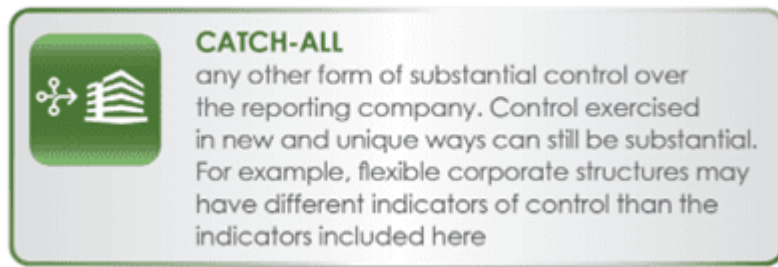
A voting agreement may include a covenant that certain parties have the right to nominate a representative to the board of directors, and then all of the parties will vote in favor of all of the designated nominees. This isn't a contractual right to board representation per se, but if it assures that the parties' designees will be elected, then it should be sufficient to represent substantial influence. But what if the voting arrangement substantially increases the likelihood of the parties' designees being elected? For example, if the two parties to a voting agreement exercise 40% of the voting power, they would start with a substantial advantage toward securing two positions on the board of directors.

Direct or Indirect Exercise of Substantial Control

The BOI Regs state that an individual may exercise substantial control over a reporting company directly or indirectly 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.

To emphasize the last point, and underscore the uncertainty, FinCEN's Small Entity Compliance includes the following graphic:[\[xv\]](#)



If FinCEN's interpretation of substantial control can overlook a director's statutory duties, how does it affect one's evaluation of contractual rights and other sources of authority that are not statutorily based? Can there be any assurance for certain types of management relationships only when and if they become the subject of enforcement actions?

As previously noted, whenever management must decide who among its investors has the ability, through voting power or contract rights, to "exert substantial influence" over important management decisions, the prudent response may be to include an individual when there is any doubt about their degree of influence. There is no penalty for including an individual whenever their ability to influence important decisions would involve a judgment call. However, that approach will increase the administrative burden of information gathering, reporting and especially monitoring processes.

For more information, contact the authors or any attorney with Frost Brown Todd's [Corporate Transparency Act Team](#).

Frost Brown Todd's Corporate Transparency Act Team is staying up to date on the important rule changes that will likely have significant impacts on your business operations. Click below to read the latest information about the Corporate Transparency Act.

- [**Corporate Transparency Act: Who Can Exert Substantial Influence on My Company? Part II**](#)
- [**Reporting Under the Corporate Transparency Act – Is My Company Exempt?**](#)
- [**FinCEN Announces Proposed Solution to Disclosure Dilemma in the Corporate Transparency Act**](#)

- [**Portfolio Company Reporting Under the Corporate Transparency Act**](#)
- [**The Corporate Transparency Act: Considerations for Effectively Using the FinCEN Identifier**](#)
- [**The Corporate Transparency Act's Impact on the Real Estate Industry: What You Need to Know to Comply**](#)
- [**The Corporate Transparency Act: Targeting Shell Companies for Money Laundering and Financial Crimes**](#)
- [**Transparency Enters A New Stage – Defense Act Anti-Laundering Provisions Now in Place**](#)

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[i] 31 U.S.C. § 5336, enacted as part of the National Defense Authorization Act for Fiscal Year 2021.

[ii] Beneficial Ownership Information Reporting Requirements, Adopting Release 87 FR 59498 (Sept. 30, 2022) (“Adopting Release”).

[iii] Any person who willfully provides false information to FinCEN, or willfully fails to report information to FinCEN as required: (i) will be liable for a civil penalty of not more than \$500 for each day that the violation continues or has not been remedied; and (ii) may be fined not more than \$10,000, imprisoned for not more than two years, or both. 31 U.S.C. § 5336(h).

In addition, the BOI Reg provides: It shall be unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with this section, or to willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with this section. 31 C.F.R. § 1010.380(g).

[iv] If the entity is part of an affiliated group of companies that filed a consolidated tax return, then the gross receipts or sales reported for the *entire group* can be used to satisfy this test. But only the companies within the group that each have 20 full-time employees satisfy the condition.

[v] 31 C.F.R. § 1010.380.

[vi] Decisions about the following matters are considered

“important decisions,” although the list is not exclusive:

- 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 reorganization, 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 programs for senior officers;
- The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts;
- 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.

31 C.F.R. § 1010.380(d)(1)(i)(C).

[vii] “FinCEN expects that most reporting companies that are small businesses will have simple ownership structures with easily identifiable beneficial owners, thereby minimizing the potential burden on such entities.... FinCEN believes that most reporting companies will not have complex ownership structures, and that the few that do previously chose their structures recognizing that costs associated with legal and tax advice and other filing and compliance obligations might be higher as a result. Moreover, in FinCEN’s experience administering the BSA and other AML efforts, small-but-complex entities often are the highest risk for money laundering, terrorist financing, and other illicit financial activity.” Adopting Release at 69936.

[viii] See note *iii*.

[ix] See, e.g., 8 Del.C § 141 (“The business and affairs of every

corporation organized under this chapter shall be managed by or under the direction of a board of directors....”)

[x] 31 C.F.R. § 1010.380(d)(1)(ii)(A).

[xi] 17 C.F.R. § 240.13d-3.

[xii] *American-Standard*, SEC No-Action letter, 1972 WL 19628 (Oct. 11, 1972).

[xiii] Adopting Release, 87 FR at 59527.

[xiv] FinCEN, Small Entity Compliance Guide v.1.0 Sept. 2023 available at [BOI Small Compliance Guide \(fincen.gov\)](https://www.fincen.gov/boi-small-compliance-guide).

[xv] “FinCEN expects that every reporting company will be substantially controlled by one or more individuals, and therefore that every reporting company will be able to identify and report at least one beneficial owner to FinCEN.” *Id.* Chapter 2.

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