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Client Alert

International Trade & Litigation Practice Group

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FinCEN Proposes New Anti-Money Laundering Rule For Investment Advisers

On August 25, the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN) released a Notice of Proposed Rulemaking (NPRM), which would impose anti-money laundering (AML), suspicious activity reporting, currency transaction reporting, and information sharing obligations on investment advisers. The NPRM was published in the Federal Register on September 1 (**80 FR 52680**). Persons interested in commenting on the proposed rule will have until November 2 to file comments, after which FinCEN will issue a final rule.

The proposed rule follows a decade of FinCEN's efforts to regulate investment advisers and unregistered investment companies in an evolving financial environment. This proposed rule envisions the following key changes to FinCEN's regulations.

A New Definition

The NPRM expands the definition of "financial institution" under the Bank Secrecy Act (BSA) to include investment advisers. FinCEN proposes to regulate investment advisers because they "may be uniquely situated to appreciate a broader understanding of their clients' movement of funds through the financial system because of the types of advisory activities in which they engage." Investment advisers would be defined as those entities registered or requiring registration with the U.S. Securities and Exchange Commission (SEC). Specifically, the NPRM proposes to define investment advisers as "[a]ny person who is registered or required to register with the SEC under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(a))." In keeping with existing registration rules, small advisers (who have less than $25 million in regulatory assets under management) and mid-sized advisers (who have between $25 and $100 million in regulatory assets under management) will generally be excluded from the FinCEN investment adviser definition. FinCEN anticipates that the new definition will primarily cover large-sized investment advisers. The NPRM notes, however, that investment advisers meeting the criteria for registration "may be organized in a wide variety of legal forms," and thus may include, among others, dually registered investors; "certain foreign investment advisers; investment advisers to registered investment companies; financial planners; pension consultants; and entities that provide only securities

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newsletters and/or research reports." Both primary and subadvisers are covered. While the proposed definition is limited to entities registered or requiring registration with the SEC, FinCEN notes that it may have occasion to expand this definition in the future to include state-regulated investment advisers or investment advisers that are exempt from SEC registration, among others.

AML Programs

The proposed rule would require investment Advisers, like other financial institutions, to establish AML compliance programs, which must include at minimum:

- Creation of internal policies, procedures, and controls;
- Designation of a compliance officer (who should be an officer of the investment adviser);
- Implementation of an ongoing employee training program; and
- Establishment of an independent audit function.

The NPRM establishes that investment advisers should implement a compliance program within six months of the effective date of the regulation.

AML programs should be risk-based and tailored to meet the needs of the individual investment adviser. The AML policy as proposed would need to be approved by the investment adviser's organization through its board of directors or trustees or, if it does not have a board, by its sole proprietor, general partner, trustee, or other persons who have similar functions to a board. The AML policy also must be made available to FinCEN or the SEC upon request. The rule as currently proposed foresees an AML program that covers all of an investment adviser's advisory activity, including services that do not include the management of client assets, subadvisory services, and advisory services provided to real estate funds. The NPRM also sets out FinCEN's expectations for how an AML program may address risks from non-pooled investment vehicle clients, registered open-end fund clients, registered closed-end fund clients, private funds clients/unregistered pooled investment vehicle clients, and wrap fee programs. Investment advisers that already are regulated for AML purposes by FinCEN in a different capacity (*e.g.*, as broker-dealers) are under no obligation to have a separate AML program for their investment advisory activities provided that their single AML program addresses risks that arise from their activities in both capacities. In addition, investment advisers may delegate the implementation of certain aspects of their AML program to third parties, but ultimately remain responsible for compliance.

Suspicious Activity Reports

As it has with other financial institutions, FinCEN is mandating in the NPRM that investment advisers file Suspicious Activity Reports (SAR) in an effort to supply regulators with information to help with AML investigations and proceedings. The proposed rule would obligate investment advisers to implement a suspicious transaction monitoring program and to report suspicious transactions that are "conducted or attempted by, at, or through an investment Adviser and involve $5,000 in funds or other assets" within 30 days of detection. Investment advisers also may file voluntary SARs even when these threshold criteria are not met and are encouraged to do so.

The proposed regulations detail that SAR reporting is necessary in such instances where it is known, suspected, or there is reason to suspect that the transaction:

- Involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity;
- Is designed, whether through structuring or other means, to evade the requirements of the BSA;
- Has no business or apparent lawful purpose, and the investment adviser knows of no reasonable explanation for the transaction after examining the available facts; or
- Involves the use of the investment adviser to facilitate criminal activity.

If more than one financial institution detects suspicious activity from the same transaction, a single SAR filing will be deemed adequate for FinCEN compliance purposes. Investment advisers are immune from liability arising from the filing of a SAR; this "safe harbor" applies to both required and voluntary SAR filings.

Subject to certain exceptions, investment advisers may not disclose the filing of a SAR or any information that would reveal the existence of a SAR to any third party. This rule would prohibit investment advisers from sharing their SAR filings internally within their organization or disclosing the SAR filings in response to subpoenas, although FinCEN is seeking further input on these points. However, investment advisers may generally be permitted to disclose, provided that no person involved in the reported transaction is notified: 1) the SAR or information that reveals the existence of the SAR to FinCEN or any other federal, state, or local law enforcement agency, or any Federal regulatory authority that examines the investment adviser for compliance with the BSA; 2) the underlying facts and documents on which a SAR is based; and 3) subject to further guidance or rulemaking from FinCEN, the SAR or information that reveals the existence of the SAR within the investment adviser's corporate organizational structure in order to comply with Title II of the BSA.

Investment advisers must keep records of their SAR filings for five years. SAR requirements under the proposed rule would not remove any pre-existing obligations investment advisers may face under SEC regulations or the Investment Advisers Act. As with AML policies, investment advisers may delegate the implementation of certain aspects of their SAR program to third parties, but ultimately remain responsible for compliance. Investment advisers would be obligated to comply with the proposed SAR rule upon implementation of an AML program, but will be encouraged to begin filing SARs as soon as practicable upon issuance of the final rule.

Currency Transaction Reports and Information Sharing

The proposed rule requires investment advisers, like other financial institutions, to follow certain filing and record keeping requirements. For example, financial advisers would be required to file Currency Transaction Reports (CTRs) for transactions involving a transfer of more than $10,000 in currency by, through, or to the investment adviser. Note that this would replace the advisers' current obligation to file Form 8300 for the receipt of more than $10,000 in cash or negotiable instruments. Investment advisers also would need to comply with information sharing requests mandated by Section 314 of the Patriot Act.

No Customer Identification Requirement – For Now

While many financial institutions under the current regulatory framework are required to implement Customer Identification Programs, the NPRM is *not* aiming to impose such a requirement on investment advisers at this time. However, as the NPRM notes, FinCEN anticipates tackling customer identification jointly with the SEC in the future.

Delegation to the SEC

Under the NPRM, FinCEN is proposing to delegate to the SEC authority to examine investment advisers for compliance with the proposed AML obligations. This proposal is not without precedent, as FinCEN has previously delegated examination authority to the SEC for "broker-dealers in securities and certain investment companies."

Anticipated Regulatory Burden

The NPRM anticipates that the regulatory burden created by the proposed rule will be lessened due to the flexibility of the requirement to design a tailored AML compliance program and the fact that investment advisers are already subject to "comprehensive regulation." The obligation to file SARs also should not impose a heavy burden because investment advisers are already required to implement anti-fraud procedures. Similarly, as investment advisers are presently required to file Form 8300, the CTR requirement should not impose an additional burden.

FinCEN views this proposed rule as an important step in strengthening its ability to enforce AML laws. As stated by the proposed rule, "[a]s long as investment advisers are not subject to AML program and suspicious activity reporting requirements, money launderers may see them as a low-risk way to enter the U.S. financial system." **FinCEN Director Jennifer Shasky Calvery** also asserts that "[i]nvestment advisers are on the front lines of a multi-trillion dollar sector of our financial system," and "[i]f a client is trying to move or stash dirty money, we need investment advisers to be vigilant in protecting the integrity of their sector."

Opportunity To Comment

As detailed in Part V. of the NPRM, FinCEN is seeking comments regarding many aspects of its proposed regulations, and investment advisers are encouraged to review these requests for input. Comments must be filed by November 2. Please do not hesitate to contact us with questions regarding the proposed rule or comment process.