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FinCEN Proposes Anti-Money Laundering and Suspicious Reporting Rules for Registered Investment Advisers

By Jay G. Baris

On August 25, 2015, the US Treasury Department's Financial Crimes Enforcement Network (FinCEN) proposed rules that would require registered investment advisers to adopt anti-money laundering (AML) programs and report suspicious activity to FinCEN.¹

FinCEN said that it proposed the rules to regulate investment advisers that may be at risk of attempts by money launderers or terrorist financiers to access the US financial institutions that currently are not required to maintain AML programs or file suspicious activity reports (SARs). The rules would apply to investment advisers registered with the Securities and Exchange Commission (SEC) or required to be registered with the SEC. They would not apply to investment advisers exempt from registration.

Notably, FinCEN did not propose to require investment advisers to adopt "customer identification programs" or subject them to certain other requirements applicable to financial institutions, but will address these requirements in future rulemaking.

FinCEN set November 2, 2015, as the deadline for submission of public comments. At the time of this writing, it is not certain whether FinCEN will adopt final rules as proposed or with modifications.

Below, we summarize the proposal and the implications for investment advisers and their compliance officers.

Background

What Is Money Laundering?

Money laundering is the process used to conceal the origins of illegally obtained gains—"dirty" money—by introducing them into the financial system or promoting an illegal activity with illicit or legal source funds. For example, drug traffickers or terrorists may hide the sources of funds they obtain through a series of transactions that allows them to write checks or wire funds through otherwise legitimate bank accounts.

What Are the Stages of Money Laundering?

Criminals accomplish money laundering in three stages²:

- **Placement** refers to physically moving currency or other funds derived from illegal activity to a place or into a form that is less suspicious to law enforcement authorities and more convenient for the criminal. The funds are introduced into traditional or nontraditional financial

institutions—laundering money through an investment advisory account, for example—or into the retail economy.

- **Layering** refers to the separation of proceeds from their illegal source by using complex layers of financial transactions (for example, wire transfers and monetary instruments) to obscure the audit trail and hide the funds. Criminals could accomplish layering by establishing discretionary accounts in the name of fictitious entities with money managers in an attempt to distance the money from its true owner, then directing the manager to liquidate the account and wire the proceeds elsewhere.
- **Integration** refers to converting illegal proceeds into apparently legitimate business earnings through normal financial or commercial operations. For example, if a criminal establishes a discretionary investment management account with an investment adviser, the proceeds would appear to be legitimate from the point of view of any financial institution that subsequently receives the proceeds of the managed account.

The Role of Investment Advisers in Detecting and Preventing Money Laundering

Investment advisers may be vulnerable to money laundering or terrorist financing risks because they provide a service that would allow money launderers an opportunity to access the financial system. Thus, “investment advisers may be uniquely situated to appreciate a broader understanding of their clients’ movements of funds through the financial system because of the types of advisory activities in which they engage.”³

FinCEN notes that the services offered by investment advisers may be similar or related to those offered by broker-dealers, banks, or insurance companies, each of which is now covered under the law and which may compete directly with asset management services provided by those institutions.

Accordingly, FinCEN considers the activities of investment advisers to be similar to those of other institutions, and should thus be subject to Bank Secrecy Act (BSA)⁴ regulations.

Regulation of Anti-Money Laundering Activities

The regulation of anti-money laundering activities begins with the Currency and Financial Transactions Reporting Act of 1970. As amended, this legislative framework is commonly referred to as the “Bank Secrecy Act.”

Contrary to what its name suggests, the BSA and its related regulations do not promote confidentiality. Rather, among other things, these laws compel financial institutions to keep records and file reports that will help in criminal, tax, or regulatory investigations, or in intelligence activities to protect against terrorism.

The original focus of the BSA was on banks, and its regulations covered the activities of banks and other institutions that provided bank-like services. In 1986, Congress designated money laundering as a crime, and in 1992 it authorized the Secretary of the Treasury to adopt regulations requiring financial institutions to adopt AML programs.⁵

On October 26, 2001, the President signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001.⁶ Section 352 of the USA PATRIOT Act amended the BSA to require financial institutions to establish AML programs and to report suspicious activities, among other stipulations. The law delegates authority to the director of FinCEN to administer and enforce compliance with the BSA.

FinCEN required mutual funds to establish AML programs in 2002.⁷ The rules take a flexible approach, allowing funds to develop programs based upon their own business structures, taking into account their own risks and vulnerabilities.⁸ FinCEN applied several requirements on mutual funds, including, but not limited to:

- AML compliance programs;
- Customer identification programs;
- Monitoring, detecting and filing reports of suspicious activity;
- Due diligence for foreign correspondent accounts;
- Other reporting and recordkeeping requirements to file currency transaction reports in connection with foreign bank and financial accounts;
- Due diligence for private banking accounts; and
- Compliance with “special measures” imposed by FinCEN to address particular concerns.⁹

The BSA does not expressly cite investment advisers among the entities defined as “financial institutions” for purposes of the BSA, but authorizes FinCEN to include additional types of businesses in the BSA definition.

The Original Proposals for Investment Advisers and Unregistered Investment Companies

In 2003, FinCEN proposed rules that would require registered investment advisers to establish AML programs.¹⁰ This followed a similar proposal in 2002 for unregistered investment companies.¹¹ These two proposals languished while FinCEN evaluated how to ensure that BSA requirements would be applied effectively and efficiently across the various types of financial institutions covered by the BSA. In 2008, faced with significant opposition from private funds and their investment advisers, FinCEN withdrew both proposals from consideration.¹² It is by no means a coincidence that the withdrawal came soon after the Court of Appeals for the District of Columbia invalidated the SEC rule that would have required private fund advisers to register.¹³ The so-called Hedge Fund Rule eliminated the exemption from registration of advisers with fewer than 15 “clients.”¹⁴

The regulatory environment changed in 2010, however, after the enactment of the Dodd-Frank Act,¹⁵ which required many investment advisers of private funds to register with the SEC, thus

effectively eliminating a significant ground for objection to AML rules from private fund advisers.

August 25th, 2015, FinCEN Proposal

Three Regulatory Changes

Based on its evaluation of the potential AML risks to investment advisers, FinCEN proposed three regulatory changes:

- Including investment advisers within the general definition of “financial institution” in the regulations implementing the BSA;
- Requiring investment advisers to establish AML programs; and
- Requiring investment advisers to report suspicious activity.

Definition of “Investment Adviser”

FinCEN would define the term “investment adviser” to include investment advisers that are registered or required to be registered with the SEC. The FinCEN definition reflects the definition contained in the Investment Advisers Act of 1940, as amended (Advisers Act), and the SEC’s regulations adopting the Advisers Act. The definition would include both primary advisers and sub-advisers.

FinCEN acknowledged, however, that those at risk of abuse by money launderers and terrorist financiers may not be limited to registered advisers, and left the door open to future regulation of unregistered advisers.

Delegation of Examination Authority to the SEC

While FinCEN would retain overall authority, it would delegate the authority to examine investment advisers for compliance with FinCEN’s rules to the SEC.

Investment Advisers Defined as “Financial Institutions”

The rules would include investment advisers within the BSA’s definition of “financial

institutions.” If adopted, investment advisers would be required to comply with some of the BSA reporting requirements that now apply to mutual funds, banks, broker-dealers, insurance companies, and other financial institutions, to which they are not currently required to comply. These include:

- Currency Transaction Reports (CTRs). Advisers would be required to file a CTR for transactions involving a transfer of more than \$10,000 in currency conducted by or through the investment adviser during a single business day. Advisers would treat multiple transactions as a single transaction if they know that all of them were conducted by or on behalf of the same person.¹⁶
- Recordkeeping and travel rules and other recordkeeping requirements. As financial institutions, advisers would be required to create and retain records for transmittals of funds, and ensure that certain information relating to the transmittal of funds “travels” to the next financial institution in the payment chain. This rule would apply to transmittals of at least \$3,000 and would include transfers processed by banks and other financial institutions, subject to certain exceptions. Advisers also would be required to keep records of extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities, and credit in transactions exceeding \$10,000.

AML Programs

The USA PATRIOT Act amended the BSA to make AML programs mandatory for financial institutions. Registered investment advisers must comply with SEC requirements concerning books and records,¹⁷ and are now required to establish compliance policies and procedures that are reasonably designed to prevent violation of the federal securities laws.¹⁸ The Proposing Release anticipates that investment advisers would adapt their existing policies, procedures, and controls to comply with the new AML rules.

Scope of program. An adviser’s AML program would cover all of its advisory activity, whether the adviser is acting as the primary adviser or a sub-adviser. FinCEN expects advisers to address in their AML programs all of their advisory activity, “including activity that does not entail the management of client assets.” The requirement also extends to sub-advisory activities, and to advisory services provided to publicly or privately offered real estate funds. The rules would not extend to the real estate funds themselves, but only to their advisers that fall within FinCEN’s definition of “investment adviser.”

Risk-based analysis presented by advisory clients, including private funds. The rules would require investment advisers to analyze the money laundering and terrorist financing risks posed by their particular clients. For example, if the client is an individual, advisers would consider the source funds and the client’s jurisdiction; if the client is an entity, the adviser would consider the jurisdiction in which it is located and the local regulatory regime. In evaluating potential money laundering risk, advisers also could consider their past experience with the client.

FinCEN describes how it expects that advisers’ AML programs should address AML or terrorist financing risks involving: (a) non-pooled investment vehicle clients; (b) registered open-end investment companies (mutual funds); (c) registered closed-end funds; (d) private fund clients; and (e) other unregistered pooled investment vehicles.

Generally, mutual funds present the lowest risk because they are subject to a full set of AML rules. Similarly, FinCEN believes that registered closed-end funds present a lower risk because purchases and sales of shares of these funds are executed through broker-dealers or banks, which are subject to their own AML requirements. Private funds, however, present greater risks, because “there may be a lack of transparency regarding the entities” that invest in them.¹⁹ This lack of transparency, FinCEN says, may put private funds at risk for money laundering, terrorist financing, fraud, and other illicit activity. FinCEN says that it would not expect an investment adviser to risk-rate

advisory services it provides to private funds that the adviser believes involve lower risks as compared to other types of private funds that may be more attractive to money launderers or terrorist financiers. The Proposing Release contemplates that advisers may have to assess AML risks posed when investors in the private fund for which the adviser acts as the primary adviser are themselves private funds. The AML rules would apply uniformly to private funds organized inside or outside the United States.

FinCEN expects investment advisers that also are registered broker-dealers to address AML and terrorist financing risks of underlying clients of wrap account programs. When the wrap account sponsor is an unaffiliated broker-dealer, FinCEN acknowledges that the adviser may have less access to investor information.

Dually Registered Investment Advisers Affiliated with Other Financial Institutions

Investment advisers that also are registered as broker-dealers or affiliated with broker-dealers, banks, and insurance companies are not required to implement multiple or separate AML programs as long as the affiliated institution's AML program covers all activities and business that are subject to the BSA.

Delegation of Compliance

The Proposing Release contemplates that investment advisers may conduct some of their operations through agents or third-party service providers, such as broker-dealers, custodians, or transfer agents. Recognizing that some elements of the service providers' AML programs may address some of the adviser's activities, the adviser may delegate, by contract, implementation and operation of those aspects of its AML program to the third parties performing the service. Advisers, however, would be responsible for overall compliance.

Required Elements of an AML Program

The four required elements of an AML program are generally the same as those that apply to other financial institutions:

- Establish and implement policies, procedures, and internal controls. These are based on the adviser's assessment of the money laundering or terrorist financing risks particular to its business. Advisers would be required to assess their vulnerabilities to money laundering and terrorist financing activities, and develop policies accordingly.
- Provide for independent testing for compliance by employees or outside parties. An investment adviser would be required to provide for independent testing of its AML program periodically to ensure compliance with the rules.
- Designate an AML compliance officer. An investment adviser would be required to designate one or more persons to be responsible for implementing and monitoring the operations and internal controls of the AML program. The designated person should be an officer of the investment adviser, but need not be dedicated full time to BSA compliance.
- Provide for ongoing training. An investment adviser would be required to provide for ongoing training of appropriate persons.

Compliance Date

Advisers would be required to establish AML programs within six months from the effective date of the regulation, if implemented.

Suspicious Activity Reports

The Annunzio-Wylie Act, enacted in 1992, authorized the Secretary of the Treasury to require financial institutions to report suspicious transactions.²⁰ Under this authority, FinCEN has issued rules requiring banks, casinos, money services businesses, broker-dealers, mutual funds, insurance companies, futures commission merchants, and introducing brokers in commodities, among others, to report suspicious financial activity. FinCEN's proposed rules would add investment advisers to this laundry list of financial institutions.

As proposed, the rules would not allow investment advisers to share SARs within their corporate organizational structures without further regulatory guidance.

The rules would require investment advisers to report suspicious transactions that are conducted through or attempted by an investment adviser, and involve or aggregate at least \$5,000 in funds or other assets. Advisers would be required to report suspicious transactions whether or not they involve currency. They would parallel the rules that apply to other financial institutions.

The SAR requirement generally would apply when an investment adviser knows, suspects, or has reason to suspect that a transaction (or a pattern of transactions):

- Involves funds derived from illegal activity or is intended or concluded to hide or disguise funds or assets derived from illegal activity;
- Is designed, whether through structuring or other means, to evade BSA requirements;
- Has no business or apparent lawful purpose, and the 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.

Advisers would be required to determine whether or not to file a SAR based on all of the facts and circumstances at the time. They must file the SAR with FinCEN within 30 days of becoming aware of the suspicious transaction. Advisers and their employees generally would be prohibited from disclosing a SAR. Advisers would not be allowed to share a SAR, or the information contained in a SAR, with their affiliates, absent further regulatory guidance or FinCEN rules. The rules, however, would allow limited sharing of information between the government and financial institutions under certain circumstances.

Request for Comment

The Proposing Release asks for public comments in a number of areas, including, among others:

- The definition of investment adviser;
- Proposed AML program requirements;
- SARs; and
- Future consideration of additional BSA requirements for investment advisers.

Implications for Investment Advisers

If adopted as proposed, FinCEN's rules would have compliance and cost implications for many investment advisers.

FinCEN's 2015 proposals go beyond the rules proposed in 2002 and 2003. For example, if adopted, the rules would require investment advisers to file SARs. Also, as newly defined "financial institutions" for BSA purposes, investment advisers would be subject to many of the reporting and recordkeeping requirements that now apply to banks, broker-dealers, mutual funds, and insurance companies.

The new rules would empower the SEC's Office of Compliance Inspections and Examinations (OCIE) to examine investment adviser AML programs; OCIE effectively would have a dotted reporting line to FinCEN, which would retain overall responsibility for compliance with the BSA.

In any event, many investment advisers voluntarily have incorporated AML programs into their overall compliance programs. Voluntary or not, OCIE currently has the power to examine them, and thus a mandatory requirement would not change much for these advisers.

The potential for SEC enforcement proceedings is not clear because the SEC has not yet adopted AML rules for investment advisers. Recent enforcement actions highlighting shortcomings of AML programs inspired FinCEN to publish an "Advisory" urging financial institutions to adopt a "culture of compliance" to strengthen compliance with BSA obligations, and implicitly avoid FinCEN's enforcement hammer.²¹ This Advisory would apply to investment advisers, too, if the proposed rules are adopted.

Significantly, FinCEN has not yet proposed "know your customer" rules for investment advisers

like it has for broker-dealers and mutual funds, but we can expect to see those proposals in the future.²² Also, it would not be unreasonable to expect FinCEN, down the road, to propose rules that would include investment advisers that are not yet required to register with the SEC within the definition of “financial institution.”

In sum, the FinCEN proposals are further evidence of regulatory “convergence,” the phenomenon that regulation of traditionally distinct financial institutions is continuing to blend and blur as the services they provide continue to overlap in the eyes of both investors and regulators.

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NOTES

- ¹ US Department of the Treasury, Financial Crimes Enforcement Network; *Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 Fed. Reg. 52,680 (proposed Sept. 1, 2015) (to be codified at 31 C.F.R. Chapter X), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf> (Proposing Release).
- ² The Secretary of the Treasury *et al.*, “A Report to Congress in Accordance with § 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (U.S.A. Patriot Act)” 8 (2002), available at http://www.fincen.gov/news_room/rp/files/356report.pdf. (Section 356(c) Report).
- ³ *Proposing Release*, *supra* n.1, at 52,682.
- ⁴ The Currency and Foreign Transactions Reporting Act of 1970 (Bank Secrecy Act), Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.).
- ⁵ Money Laundering Control Act of 1986, Pub. L. No. 99-570, tit. I, §§ 1351-1352 100 Stat. 3207 (codified as amended at 18 U.S.C. §§ 1956, 1957 (1994 & Supp. III 1997); Annunzio-Wylie Anti-Money Laundering Act of 1992, Pub. L. No. 102-550, 106 Stat. 4044 (*Annunzio-Wylie Act*)).
- ⁶ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT ACT) of 2001, Pub. L. No. 107-56, 115 Stat. 272 (codified as amended in scattered sections of the U.S.C.) (*USA PATRIOT Act*).
- ⁷ US Department of the Treasury, Financial Crimes Enforcement Network; *Anti-Money Laundering Programs for Mutual Funds*, 67 Fed. Reg. 21,117 (Apr. 29, 2002) (codified at 31 C.F.R. pt. 103), available at <https://www.sec.gov/about/offices/ocie/amlmf67fr21117.pdf>.
- ⁸ See SEC, Anti-Money Laundering (AML) Source Tool for Mutual Funds, July 2, 2012, available at <https://www.sec.gov/about/offices/ocie/amlmfsourcetool.htm>.
- ⁹ For a more complete discussion of the AML requirements for mutual funds, see Jay G. Baris, “Anti-Money Laundering Rules for Investment Companies,” Vol. 36, No. 44 *The Rev. of Sec. & Commodities Reg.* 165 (Aug. 2003).
- ¹⁰ US Department of the Treasury, Financial Crimes Enforcement Network; *Anti-Money Laundering Programs for Investment Advisers*, 68 Fed. Reg. 23,646 (May 5, 2003), available at http://www.fincen.gov/statutes_regs/frn/pdf/352investmentadvisers_fedreg050503.pdf.
- ¹¹ US Department of the Treasury, Financial Crimes Enforcement Network; *Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60,617 (Sept. 26, 2002), available at http://www.fincen.gov/statutes_regs/frn/pdf/352unregistinvest.pdf.
- ¹² US Department of the Treasury, Financial Crimes Enforcement Network; *Withdrawal of the Notice of Proposed Rulemaking: Anti-Money Laundering Programs for Unregistered Investment Companies*, 73 Fed. Reg. 65,569 (Nov. 4, 2008), available at <http://www.gpo.gov/fdsys/pkg/FR-2008-11-04/pdf/E8-26202.pdf>; US Department of the Treasury,

Financial Crimes Enforcement Network; *Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers*, 73 Fed. Reg. 65,568 (Nov. 4, 2008), available at <https://www.sec.gov/about/offices/ocie/amll73fr65568-69.pdf>.

¹³ Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

¹⁴ For a discussion of the SEC's ill-fated Hedge Fund Rule, see Recent Cases, "District of Columbia Circuit Vacates Securities and Exchange Commission's 'Hedge Fund Rule,'" 120 *Harv. L. Rev.* 1394 (2007), available at http://harvardlawreview.org/wp-content/uploads/pdfs/goldstein_v_SEC.pdf.

¹⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

¹⁶ The CTR replaces file Form 8300, which covered certain negotiable instruments as well. Thus, the requirement to file a CTR reduces the regulatory burden in financial institutions.

¹⁷ 17 C.F.R. § 275.204-2 (2012).

¹⁸ 17 C.F.R. § 275.206(4)-7(a).

¹⁹ *Proposing Release*, *supra* n.1, at 52,688.

²⁰ *Annunzio-Wylie Act*, *supra* n.5.

²¹ See US Department of the Treasury, Financial Crimes Enforcement Network, *Advisory to U.S. Financial Institutions on Promoting a Culture of*

Compliance (Aug. 11, 2014), available at http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-A007.pdf.

²² The SEC and FinCEN jointly issued a no-action letter that would not recommend enforcement action if a broker-dealer relies on a registered investment adviser to perform all or part of its Customer Identification Procedures (CIP) (also referred to as "know your customer") responsibilities with respect to shared clients, subject to certain conditions. This letter implies that many advisers already comply with know your customer requirements. SEC, Division of Trading and Markets, Request for No-Action Relief Under Broker-Dealer Customer Identification Rule (31 C.F.R. § 1023.220) (Jan. 9, 2015), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma-010915-17a8.pdf>. "Know your customer" rules require a financial institution to establish procedures to allow them to form a reasonable belief that it knows the true identity of a customer. See, e.g., SEC *et al.*, *Customer Identification Programs for Mutual Funds*, 68 Fed. Reg. 25,131 (May 9, 2003), available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma-010915-17a8.pdf> (application of rules to mutual funds). Similar rules apply to banks, savings associations, credit unions, broker-dealers, futures commission merchants, and introducing brokers.

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