Davis Polk

FinCEN proposes new AML/CFT compliance requirements for investment advisers

February 21, 2024 | Client Update | 13-minute read

FinCEN issued its long-awaited proposed rule that would impose AML/CFT obligations on certain investment advisers, such as requirements to implement and maintain an AML/CFT compliance program and monitor for and report suspicious activity.

The Financial Crimes Enforcement Network (FinCEN) of the U.S. Treasury Department issued a proposed rule on February 13 that would apply comprehensive anti-money laundering and countering the financing of terrorism (AML/CFT) compliance requirements to certain investment advisers (the Proposed Rule). [1] These requirements closely track the existing AML/CFT rules for other financial institutions. AML/CFT regulations for investment advisers have been pending for over twenty years,[2] most recently with FinCEN's issuance of a similar proposal in 2015 (which has now been withdrawn).[3]

Under the Proposed Rule, investment advisers registered with the Securities and Exchange Commission (SEC) and investment advisers that report to the SEC as exempt reporting advisers will be required to, among other things, (1) develop, implement and maintain risk-based AML/CFT compliance programs (within 12 months after the effective date of the final rule) and (2) monitor for and report suspicious activity to FinCEN. Although many investment advisors currently maintain voluntary AML/CFT compliance programs, the Proposed Rule would require those programs to comply with the standards imposed by the Bank Secrecy Act (BSA) and its implementing regulations. Accordingly, investment advisers covered by the rule would be required to evaluate their programs to ensure that they align with regulatory requirements.

The Proposed Rule defers requirements to comply with the Customer Identification Program (CIP) Rule[4] to a forthcoming joint rulemaking with the SEC and the beneficial ownership requirements of the Customer Due Diligence (CDD) Rule[5] to the more general revision of the CDD Rule to reflect the Corporate Transparency Act.[6] Notwithstanding, covered investment advisers will still be required to collect sufficient information about their customers to comply with other CDD Rule requirements, such as forming accurate customer risk profiles and monitoring and reporting suspicious activity.

FinCEN is also proposing to delegate its examination authority to the SEC, which would be consistent with FinCEN's existing delegation to the SEC of the authority to examine broker dealers and mutual funds for compliance with the BSA and its implementing regulations. Finally, FinCEN has solicited comments on the Proposed Rule through April 15, 2024.

What would the Proposed Rule require?

Background

While FinCEN has, for years, highlighted the potential money laundering and illicit finance risks associated with the investment adviser sector, the agency's imposition of comprehensive AML/CFT compliance obligations on the industry has taken considerable time. FinCEN first proposed AML regulations for investment advisers in 2002 and 2003 but withdrew the proposals in 2008 in connection with a broader review of FinCEN's regulatory framework.[7] FinCEN revisited the issue with a 2015 proposed rule that would have required certain investment advisers to implement and maintain an AML/CFT compliance program and file suspicious activity reports (SARs) with FinCEN (the Second Proposed Investment

Adviser Rule).[8] The Second Proposed Investment Adviser Rule was never finalized and has now been withdrawn and replaced by the Proposed Rule. FinCEN notes in the Proposed Rule that since 2015, the investment adviser industry has grown substantially in assets under management, has expanded to include new products and services, and that the U.S. Government has developed a more detailed understanding of the AML/CFT risks associated with the investment adviser industry. As a result, FinCEN has now issued the Proposed Rule and has confirmed that finalizing the rule is a priority for the agency.

Overview of the Proposed Rule

Investment advisers covered by the Proposed Rule

The Proposed Rule would include "investment advisers" in the "financial institution" definition under the BSA and its implementing regulations. In turn, the Proposed Rule would define "investment advisers" as including:

1. a Registered Investment Adviser (RIA), which is defined as any person registered or required to register with the SEC under section 203 of the Investment Advisers Act;[9] and
2. an Exempt Reporting Adviser (ERA), which is defined as any person that is exempt from SEC registration under sections 203(l) or 203(m) of the Investment Advisers Act.[10]

In the Proposed Rule, FinCEN also confirms that the proposed definition of investment adviser would include non-U.S. investment advisers that are physically located abroad (e.g., foreign investment advisers that do not have a branch, office or staff in the United States), but are registered or required to register with the SEC or file a Form ADV with the Commission.

Requirements imposed on covered investment advisers

AML/CFT compliance program

FinCEN acknowledges that its definition of investment advisers includes different investment advisers that may have varying degrees of AML/CFT risks. As is more broadly the case under the BSA, the AML/CFT compliance program requirement is risk based, meaning that an AML/CFT compliance program should be commensurate with an adviser's risk profile. Put a different way, according to FinCEN, the AML/CFT program requirement is "not a one-size-fits-all requirement but rather is risk-based and is intended to give covered investment advisers the flexibility to design their programs to identify and mitigate the specific risks of the advisory services they provide and the customers they advise." Covered investment advisers will be expected to evaluate the specific risks associated with their activities and to tailor their programs accordingly.

Under the Proposed Rule, covered investment advisers' AML/CFT programs must be approved in writing by the adviser's board of directors (or sole proprietor, general partner, or trustee) and include, at a minimum, the following:

1. Policies, procedures, and internal controls reasonably designed to prevent money laundering, terrorist financing, and other illicit finance activities;[11]
2. Independent testing for compliance with the BSA and its implementing regulations, which must be conducted by an investment adviser's personnel or a qualified outside party;[12]
3. A designated person or persons that are responsible for implementing and monitoring the operations and internal controls of the AML/CFT compliance program;[13]
4. Ongoing training for appropriate personnel;[14] and
5. Ongoing customer due diligence (CDD) that includes: (a) understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and (ii) conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.

The Proposed Rule would not immediately require covered investment advisers to comply with the CIP Rule (i.e., procedures to verify the identity of customers), or the beneficial ownership requirements of the CDD Rule. However, those requirements will eventually be imposed through separate rulemakings, starting with a joint rulemaking with the SEC that will impose CIP requirements on covered investment advisers.[15] Following its CIP rulemaking, FinCEN will then impose beneficial ownership information collection and verification requirements on investment advisers. Even though covered investment advisers would not initially be directly subject to the CIP Rule and beneficial ownership requirements of the CDD Rule, FinCEN and the SEC would nevertheless expect a covered investment adviser to collect enough information from its customers such that the adviser can effectively discharge its general obligations to understand the nature and purpose of the customer relationship and conduct suspicious activity monitoring and reporting.

Notably, the Proposed Rule would not require covered investment advisers to apply their AML/CFT compliance program or SAR reporting requirements to advised mutual funds, because mutual funds are already subject to the requirements of the BSA and its implementing regulations.[16] Moreover, FinCEN acknowledges that some investment advisers have already implemented AML/CFT compliance programs, whether because they are dually registered as a broker-dealer, licensed as a bank, affiliated with a broker-dealer or bank, or operating in accordance with the Securities Industry and Financial Markets Association (SIFMA) No-Action Letter that permits broker dealers to rely on RIAs to perform some or all aspects of a broker-dealers' CIP obligations.[17] In these circumstances, FinCEN does not intend to require such an adviser to establish multiple or separate AML/CFT compliance programs, provided that an adviser's comprehensive AML/CFT compliance program covers all of the adviser's relevant business and activities that are subject to BSA requirements.

FinCEN also recognizes that the scope of the Proposed Rule includes investment advisers that are located and/or contract certain of their operations outside the United States. Notwithstanding, the Proposed Rule would require a covered investment adviser to establish an AML/CFT compliance program that is the responsibility of, and performed by, persons in the United States.[18] As a result, core functions of a covered investment adviser's AML/CFT compliance program, even foreign RIAs and ERAs, must be located in the United States. Under the Proposed Rule, however, FinCEN would permit a covered investment adviser to delegate contractually the implementation and operation of aspects of its AML/CFT program (e.g., to another financial institution, agent, fund administrator, or third-party service provider). In such cases, the investment adviser would remain fully responsible and legally liable for, and need to demonstrate, the program's compliance with AML/CFT requirements and FinCEN's implementing regulations.

Suspicious activity reporting

Under the Proposed Rule, FinCEN would require covered investment advisers to file SARs for any suspicious transactions that are conducted or attempted by, at, or through an investment adviser and involve or aggregate at least $5,000 in funds or other assets, as other financial institutions are. The SAR filing requirements are separate from, and would not relieve a covered investment adviser from compliance with any reporting responsibilities separately imposed by the SEC. The SAR reporting requirements imposed on covered investment advisers would be uniform with those imposed on other financial institutions.

Other key compliance requirements

In addition to the AML/CFT compliance program and SAR reporting requirements, the Proposed Rule would impose additional BSA compliance requirements on covered investment advisers, including (1) compliance with the Travel Rule and related recordkeeping requirements,[19] (2) filing currency transaction reports (CTRs) for transactions in currency of more than $10,000 conducted during a single day,[20] (3) compliance with special due diligence requirements related to correspondent accounts—redefined to include advisory relationships—for foreign financial institutions and private banking accounts,[21] and (4) compliance with certain special measures imposed by Treasury under Section 311 of the USA PATRIOT Act. As regulated financial institutions under the BSA, covered investment advisers would also be subject to FinCEN's rules implementing the special information-sharing procedures to detect money laundering and terrorist activity in sections 314(a) and 314(b) of the USA PATRIOT Act.[22]

Requests for comment

Throughout the Proposed Rule, FinCEN seeks comment to determine whether the Proposed Rule is appropriate in light of the AML/CFT risks associated with investment advisers. Comments on the Proposed Rule are due to FinCEN no later than April 15, 2024. Key questions posed for comment include:

1. Is the definition of ''investment adviser'' sufficiently clear?
2. Should ERAs be excluded from the proposed definition of investment adviser?
3. Which existing requirements under the Advisers Act or the regulations adopted thereunder, or other laws or regulations, could assist investment advisers in complying with the proposed AML/CFT Program requirements? Are any such existing requirements duplicative with any proposed requirements?
4. What challenges would arise for covered investment advisers located outside the United States, including conflicts of law?
5. Do you agree with the proposal to wait to apply the requirement to collect and verify the beneficial ownership information of legal entity accounts at § 1010.230 to investment advisers until at or after the CTA-mandated revisions to the CDD Rule, or should Treasury apply the existing requirement as soon as a CIP requirement for investment advisers is effective?
6. What types of information regarding private funds, other than beneficial ownership information, could an investment adviser collect to understand the nature and purpose of a customer relationship with a private fund and conduct

ongoing monitoring to identify suspicious transactions involving the private fund?

Investment advisers that will be covered by the Proposed Rule are encouraged to engage with FinCEN during the comment period.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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1 FinCEN, Press Release, FinCEN Proposes Rule to Combat Illicit Finance and National Security Threats in Investment Adviser Sector (February 13, 2024), https://www.fincen.gov/news/news-releases/fincen-proposes-rule-combat-illicit-finance-and-national-security-threats.

2 *See, e.g.,* FinCEN, Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60617 (Sept. 26, 2002).

3 *See* FinCEN, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680 (Sept. 1, 2015). Notably, FinCEN's 2015 proposed investment adviser rule was never finalized, and now has been formally withdrawn by FinCEN concurrently with the Proposed Rule.

4 *See, e.g.*, 31 C.F.R. § 1020.220.

5 31 C.F.R. § 1010.230.

6 For more information on the Corporate Transparency Act, please review our client update on the Beneficial Ownership Information Reporting Rule and our client update on the Access Rule.

[7] *See, e.g.,* FinCEN, Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60617 (Sept. 26, 2002); *see also*, FinCEN, Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23646 (May 5, 2003).

[8] FinCEN, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680 (Sept. 1, 2015).

[9] 15 U.S.C. § 80b–3(a).

[10] (15 U.S.C. §§ 80b–3(l), (m). An ERA is generally an investment adviser that would be required to register with the SEC but is statutorily exempt from the registration requirement because (1) it is an adviser only to one or more venture capital funds; or (2) it is an adviser only to one or more private funds and has less than $150 million assets under management in the United States.

[11] To effectively identify the AML/CFT risks associated with its business, FinCEN notes that an investment adviser would necessarily be required to review and assess, among other things, the types of advisory services it provides, the nature of the customers it advises, its investment products, distribution channels, intermediaries it operates through and geographic locations of its customers and business activities.

[12] FinCEN notes that independent testing can be conducted by an investment adviser's employees (or its affiliates or unaffiliated service providers), as long as those same employees are not involved in the operation and oversight of the adviser's AML/CFT compliance program. Moreover, the frequency of testing would depend on the investment adviser's AML/CFT risk profile and overall risk management strategy.

[13] FinCEN further states that the designated compliance /CFT officer should have full responsibility and authority to develop and implement appropriate policies, procedures and internal controls. Moreover, whether the designated compliance officer should be dedicated full time to AML/CFT compliance will depend on the size and type of advisory services the investment adviser offers and the customers it serves.

[14] FinCEN confirms that AML/CFT training can be conducted through outside or in-house seminars and include computer-based training. In addition, the nature, scope and frequency of the training program should be determined by the responsibilities of the relevant employees and the extent to which their functions include AML/CFT requirements and risks.

[15] *See* 31 U.S.C. § 5318(l).

[16] *See* 31 C.F.R. § 1010.100(t)(10).

[17] *See* SEC, Letter to Mr. Bernard V. Canepa, Associate General Counsel, Securities Industry and Financial Markets Association (SIFMA), Request for No-Action Relief Under Broker-Dealer Customer Identification Program Rule (31 C.F.R. § 1023.220) and Beneficial Ownership Requirements for Legal Entity Customers (31 C.F.R. § 1010.230) (Dec. 9, 2022), https://www.sec.gov/files/nal-sifma-120922.pdf (SIFMA No-Action Letter); *see also* 31 C.F.R. § 1023.220(a)(6) (CIP rule permitting a financial institution to rely on another financial institution to perform all or part of its obligations to verify the identity of its customers as required by 31 U.S.C. § 5318(h))

[18] FinCEN specifically notes that this requirement aligns with section 6101(b)(2)(C) of the AML Act of 2020, which provides that the duty to establish, maintain, and enforce a financial institution's AML/CFT compliance program must remain the responsibility of persons in the United States who are accessible to, and subject to oversight and supervision by, the Secretary of the Treasury and their appropriate Federal functional regulator.

[19] The Proposed Rule would require investment advisers to create and retain records for transmittals of funds of $3,000 or more and ensure that certain information "travels" with the transmittals to the next financial institution in the payment chain. The Recordkeeping Rule is codified at 31 C.F.R. § 1010.410(e). The Travel Rule is codified at 31 C.F.R. § 1010.410(f).

[20] Under the BSA and its implementing regulations, a wide range of persons, including investment advisers, are currently required to file reports for the receipt of more than $10,000 in currency and certain negotiable instruments using Form 8300. Under the Proposed Rule, FinCEN would require covered investment advisers to file CTRs instead of filing reports using Form 8300. As a result, covered investment advisers would be required to file CTRs in connection with transactions in currency of more than $10,000 conducted during a single day. *See* 31 C.F.R. §§ 1010.311, 1010.313(b).

[21] Under the Proposed Rule, investment advisers would be considered "covered financial institutions" for purposes of compliance with the special due diligence requirements related to correspondent accounts for foreign financial institutions and private banking account. *See* 31 C.F.R. §§ 1010.610 and 1010.620. FinCEN notes that it does not intend to amend the definition of ''private banking account'' at 31 C.F.R. § 1010.605(m).

[22] *See* 31 C.F.R. §§ 1010.520, 1010.540. In practice, this would allow investment advisers to share certain information with government agencies, law enforcement and other financial institutions to assist such parties with deterring illicit finance activities.