FinCEN's Proposed Rule to Require Investment Advisers to Establish AML Programs

September 16, 2015

Introduction

The U.S. Department of the Treasury's Financial Crimes Enforcement Network ("**FinCEN**") recently published a **Notice of Proposed Rulemaking** (the "**Proposed Rule**")[1] that would extend to certain investment advisers the requirement to establish anti-money laundering ("**AML**") programs and report suspicious activity to FinCEN under the Bank Secrecy Act (the "**BSA**"). The Proposed Rule would also include investment advisers in the BSA's definition of "financial institutions," which would require them to comply with the general BSA reporting and recordkeeping requirements applicable to financial institutions. The Proposed Rule has been many years in the making: FinCEN first proposed AML rules for unregistered investment companies in September 2002 and for certain investment advisers in May 2003.[2] However, FinCEN withdrew those proposals in November 2008, citing the passage of time as the principal reason for withdrawal.

The Proposed Rule would apply to investment advisers who are registered or required to be registered with the U.S. Securities and Exchange Commission (the "**SEC**") under the Investment Advisers Act of 1940 (the "**Advisers Act**").[3] FinCEN would delegate its authority to examine investment advisers for compliance with the Proposed Rule to the SEC. The requirement to establish an AML program would become effective six months from the date a final rule is issued, while the suspicious activity reporting requirement would apply to transactions initiated after the full implementation of an AML program.[4]

Written comments on the proposed rule must be submitted on or before November 2, 2015. Comments will generally be made available for public review at **www.regulations.gov**.

Overview of the Proposed Rule

As detailed below, the Proposed Rule would make three primary regulatory changes:

- include investment advisers (as defined in the Proposed Rule) within the general definition of "financial institution" in the regulations implementing the BSA;
- require investment advisers to establish AML programs; and
- require investment advisers to report suspicious activity.

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[1] 80 Fed. Reg. 169, 52680 (Sept. 1, 2015), available at: **http://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf**.

[2] *See* 68 Fed. Reg. 86, 23646 (May 5, 2003); 67 Fed. Reg. 187, 60617 (Sept. 26, 2002). FinCEN notes that the Proposed Rule for SEC-registered investment advisers will result in coverage substantially similar to what would have existed if the two previously proposed but now withdrawn rules for investment advisers and unregistered investment companies had been adopted prior to the Dodd-Frank Act amendments to the Advisers Act, which required certain previously unregistered advisers required to register with the SEC.

[3] As of June 2, 2014, approximately 11,235 investment advisers were registered with the SEC. 80 Fed. Reg. 169 at 52695.

[4] FinCEN notes, however, that investment advisers will be encouraged to begin filing suspicious activity reports ("**SARs**") as soon as practicable on a voluntary basis upon the issuance of the final rule.

According to FinCEN, the Proposed Rule addresses a present vulnerability under which illicit actors may attempt to access the U.S. financial system through investment advisers as a means to avoid detection of their activity which might otherwise be identified by financial institutions subject to AML program and suspicious activity reporting requirements. "Investment advisers are on the front lines of a multi-trillion dollar sector of our financial system," said FinCEN Director Jennifer Shasky Calvery. "If a client is trying to move or stash dirty money, we need investment advisers to be vigilant in protecting the integrity of their sector."[5]

The Proposed Rule does not include a customer identification program ("**CIP**") requirement for investment advisers, nor does it bring investment advisers within the scope of FinCEN's August 2014 **Notice of Proposed Rulemaking**, 79 Fed. Reg. 149, 45151 (Aug. 4, 2014), which would enhance customer due diligence requirements for financial institutions by, among other things, generally requiring covered financial institutions to identify, and verify the identity of, beneficial owners of their customers.[6] FinCEN anticipates addressing both of these issues (among others) with respect to investment advisers in future rulemakings, with the issue of CIP requirements to be addressed via a joint rulemaking with the SEC.

Discussion of Key Provisions of the Proposed Rule

Definition of "investment adviser"

The Proposed Rule would define an "investment adviser" as "[a]ny person who is registered or required to register with the SEC under section 203 of the [Advisers Act]," including advisers to certain hedge funds, private equity funds, and other private funds.[7] This definition includes advisers that are SEC registered or required to register with the SEC, regardless of whether they have a place of business in the United States. FinCEN has requested comments about whether there are other types of investment advisers, such as small and mid-sized advisers, exempt reporting advisers, and foreign private investment advisers, that do not meet the definition of investment adviser under the Proposed Rule but should be covered by future rulemaking. FinCEN has also requested comments on whether there are classes of investment advisers included in the definition of investment adviser that are not at risk, or present a very low risk, for money laundering, terrorist financing, or other illicit activity such that they could appropriately be excluded from the definition.

Including Investment Advisers within the definition of "financial institution"

General BSA reporting and recordkeeping requirements apply to entities that fall within the general definition of "financial institution" in the BSA and its implementing regulations. Investment advisers are not currently included among the entities defined as "financial institutions" (such as banks, broker-dealers, money services businesses, and casinos), and by adding investment advisers to the definition, the Proposed Rule would subject them to the general reporting and recordkeeping requirements of the BSA. Specifically, investment advisers would be required to comply with the following:

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[5] Press Release, FinCEN, FinCEN Proposes AML Regulations for Investment Advisers (Aug. 25, 2015), available at: **http://www.fincen.gov/news_room/nr/html/20150825.html**.

[6] *See* Davis Polk Client Memorandum, FinCEN's Proposed Rule to Enhance Customer Due Diligence Requirements for Financial Institutions (Sept. 31, 2014), available at: **http://www.davispolk.com/sites/default/files/9.30.14.FinCENs_Proposed_Rule.pdf**. While neither a CIP requirement nor a beneficial ownership requirement was included in the Proposed Rule, FinCEN has, as discussed in note 15, noted potential AML risks associated with certain private fund clients and unregistered pooled investment vehicles due to a possible lack of transparency about their underlying investors.

[7] 80 Fed. Reg. 169 at 52683.

- **Currency Transaction Report ("CTR") filing requirements**, pursuant to 31 C.F.R. § 1010.311, for a transaction involving a transfer of more than $10,000 in currency[8] by, through, or to the investment adviser. This requirement would replace investment advisers' current obligation to file Form 8300 reports for the receipt of more than $10,000 in cash and negotiable instruments.
- **Recordkeeping and Travel Rules** and other related recordkeeping requirements, subject to certain existing exceptions, pursuant to 31 C.F.R. §§ 1010.410 and 430. Under the Recordkeeping and Travel Rules, financial institutions must create and retain records for certain transmittals of funds and ensure that certain information pertaining to the transmittal of funds "travels" with the transmittal order through the payment chain.
- **Information sharing** pursuant to sections 314(a) and 314(b) of the USA PATRIOT Act. Section 314(a) provides for the sharing of information between the government and financial institutions, and allows FinCEN to require financial institutions to search their records to determine whether they have maintained an account or conducted a transaction with a person that law enforcement has certified is suspected of engaging in terrorist activity or money laundering. Section 314(b) provides financial institutions with the ability to share information with one another, under a safe harbor that offers protections from liability, in order to better identify and report potential money laundering or terrorism activities.

Requiring Investment Advisers to Establish AML Programs

The Proposed Rule would require investment advisers to "develop and implement a written AML program reasonably designed to prevent the investment adviser from being used to facilitate money laundering or the financing of terrorist activities and to achieve and monitor compliance with the applicable provisions of the BSA and FinCEN's implementing regulations."[9] At a minimum, the AML program would be required to include the following four pillars (which are the same minimum requirements that apply to other financial institutions under the BSA):

- **Development of internal policies, procedures, and controls.** The Proposed Rule would require an investment adviser's written AML program to establish and implement policies, procedures, and internal controls based upon the investment adviser's assessment of the money laundering or terrorist financing risks associated with the business.
- **Designation of a compliance officer.** The Proposed Rule would require that an investment adviser designate a person (or persons) knowledgeable and competent regarding FinCEN's regulatory requirements and the adviser's money laundering risks to be responsible for implementing and monitoring the operations and internal controls of the AML program.
- **Ongoing employee training program.** The Proposed Rule would require that an investment adviser provide for training of appropriate persons with respect to BSA requirements relevant to their functions and in recognizing possible signs of money laundering that could arise in the course of their duties. The nature, scope, and frequency of such training would be determined by the responsibilities of the employees and the extent to which their functions bring them in contact with BSA requirements or possible money laundering activity.

[8] Currency is defined as the coin and paper of the United States or of any other country that is designated as legal tender and that circulates and is customarily used as a medium of exchange in a foreign country. To the extent that many investment advisers only rarely transact in significant amounts of currency, CTR filing requirements for investment advisers may arise infrequently.

[9] 80 Fed. Reg. 169 at 52686.

- **Independent audit program to test functions.** The Proposed Rule would require that an investment adviser provide for independent testing by company employees or by a qualified outside party of the AML program on a periodic basis to ensure that it complies with the requirements of the Proposed Rule and that the program functions as designed.[10]

FinCEN notes that the AML program requirement is risk-based, rather than one-size-fits-all. The risk-based approach "is intended to give investment advisers the flexibility to design their programs to meet the specific risks of the advisory services they provide and the clients they advise."[11] That being said, the Proposed Rule details FinCEN's expectations with respect to coverage of three specific types of services:

- advisory services that do not include the management of client assets;
- subadvisory services; and
- advisory services provided to real estate funds;

as well as the following specific types of advisory clients:[12]

- non-pooled investment vehicle clients (e.g., individuals and institutions);[13]
- registered open-end fund clients;
- registered closed-end fund clients; and
- private fund clients/unregistered pooled investment vehicle clients.[14]

Generally, an investment adviser's program must cover all of its advisory activity, whether the adviser is acting as the primary adviser or a subadviser, and reflect the specific money laundering and terrorist financing risks presented by a particular client.

In addition, the Proposed Rule would require each investment adviser's AML program to be approved in writing by its board of directors or trustees (or other persons that have a function similar to a board of directors, if the investment adviser does not have a board). Each investment adviser would also be required to make its AML program available to FinCEN or the SEC upon request.

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[10] FinCEN explains that employees of the investment adviser, its affiliates, or unaffiliated service providers may conduct the independent testing, so long as those same employees are not involved in the operation and oversight of the AML program. The employees should be knowledgeable regarding BSA requirements. The frequency of the independent testing will depend upon the investment adviser's assessment of the risks posed. Any recommendations resulting from such testing should be promptly implemented or submitted to senior management for consideration.

[11] 80 Fed. Reg. 169 at 52686.

[12] The Proposed Rule also describes FinCEN's expectations under a risk-based approach regarding advisory services to wrap fee programs.

[13] FinCEN notes that advisers are vulnerable to AML or terrorist financing risks when managing the assets of non-pooled investment vehicle clients such as individuals and institutions, and that in assessing the risks presented by the advisory services it provides to such clients, it should consider the types of accounts offered (e.g., managed accounts), the types of clients opening such accounts, and how the accounts are funded.

[14] FinCEN states that when conducting its required AML risk assessment, an investment adviser that is the primary adviser to a private fund or other unregistered pooled investment vehicle should consider the same types of relevant factors discussed above. *See* note 13. FinCEN also notes that the possible lack of transparency regarding the entities that invest in private funds and other unregistered pooled investment vehicles may put these types of investment vehicles at risk for money laundering and terrorist financing. FinCEN states that under certain circumstances, an investment adviser may be required to assess the money laundering and terrorist financing risks associated with the underlying investors of a client that is a private fund or other unregistered pooled investment vehicle using a risk-based approach.

FinCEN recognizes that registered investment advisers – which are currently subject to Federal securities laws that require the establishment of various policies, procedures, and controls – may be able to adapt existing programs in order to comply with the Proposed Rule.[15] In addition, the Proposed Rule would not require an investment adviser that is dually registered with the SEC as a broker-dealer to establish multiple or separate AML programs so long as a comprehensive AML program covers all of the entity's advisory and broker-dealer activities and businesses. Similarly, an investment adviser affiliated with, or a subsidiary of, an entity required to establish an AML program in another capacity would not be required to implement multiple or separate programs so long as the program covers all of the entity's activities and businesses that are subject to the BSA. Indeed, FinCEN states that it believes it would be beneficial and cost-effective (although not required) for these types of entities to implement one comprehensive AML program. In addition, FinCEN acknowledges that some aspects of the AML program may be contractually delegated to third-party service providers, provided that the registered investment adviser remains fully responsible for the AML program's effectiveness.

Requiring Investment Advisers to Report Suspicious Activity

The Proposed Rule would also require investment advisers to report suspicious transactions, pursuant to the BSA. FinCEN already requires many other financial institutions, including banks, casinos, money services businesses, broker-dealers in securities, mutual funds, insurance companies, futures commission merchants, and introducing brokers in commodities, to report suspicious activity. FinCEN states that such reporting provides highly useful information, and that requiring suspicious activity reporting by investment advisers is "similarly expected to provide useful information for investigations and proceedings involving domestic and international money laundering, terrorist financing, fraud, and other financial crimes" and will narrow the regulatory gap, which money launderers may seek to exploit.[16]

The Proposed Rule would require investment advisers to file SARs in the same circumstances as required for other financial institutions; that is, when:

- a transaction or pattern of transactions is conducted or attempted by, at, or through an investment adviser;
- the transaction(s) involve or aggregate at least $5,000 in funds or other assets; and
- the investment adviser knows, suspects, or has reason to suspect that the transaction(s):
  - involve funds derived from illegal activity or are intended or conducted to hide or disguise funds or assets derived from illegal activity;
  - are designed to evade the requirements of the BSA;
  - have no business or apparent lawful purpose, and the investment adviser knows of no reasonable explanation for the transaction(s) after examining the available facts; or
  - involve the use of the investment adviser to facilitate criminal activity.

[15] FinCEN further notes that some investment advisers have already implemented AML programs voluntarily or in conjunction with an SEC No-Action letter permitting broker-dealers to rely on registered investment advisers to perform some or all aspects of broker-dealers' CIP obligations, even though investment advisers are not currently subject to an AML program rule, under certain conditions. *See* SEC, Division of Trading and Markets, Request for No-Action Relief Under Broker-Dealer Customer Identification Rule (Jan. 9, 2015) available at: **http://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma-010915-17a8.pdf**. Upon adoption of a final rule, the SEC No-Action Letter would appear to become moot, although FinCEN does not discuss whether the Proposed Rule would replace the SEC No-Action letter.

[16] 80 Fed. Reg. 169 at 52690.

When an investment adviser becomes aware of a suspicious transaction, the adviser must report the transaction within 30 days by filing a SAR with FinCEN.[17] FinCEN notes that a determination as to whether a SAR must be filed should be based on all the facts and circumstances relating to the transaction and the client in question, and the Proposed Rule includes a non-exhaustive list of examples of money laundering red flags likely to be observed by an investment adviser.[18] When more than one investment adviser, or another financial institution with a separate suspicious activity reporting obligation, is involved in the same transaction, only one report is required to be filed. Regardless of which entity files the report, supporting documentation relating to each SAR must be collected and maintained for a period of five years from the date of filing, and such documentation must be made available upon request to FinCEN (and certain other Federal, State, and local government bodies). The Proposed Rule also discusses the confidentiality of SARs, which closely parallels the rules for other financial institutions.

Under the Proposed Rule, investment advisers – unlike banks, broker-dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities – would *not* be permitted to share SARs, or any other information that would reveal the fact that a SAR has been filed, within their corporate organizational structures.[19] (This prohibition does not apply to the disclosure of the underlying facts, transactions, and documents upon which a SAR is based.) FinCEN notes, however, that it is interested in hearing from investment advisers on this specific issue, and that it understands that guidance on this topic may need to be issued in a timely manner after the issuance of any final rule.

Conclusion

We expect that FinCEN will move forward with requiring investment advisers to establish AML programs and procedures as discussed above, although it may take FinCEN some time to issue a final rule after it reviews and considers comments. FinCEN has requested comments on all aspects of the proposed definition of "investment adviser," the proposed AML program requirement for investment advisers, and the proposed suspicious activity reporting rule (among other things). Investment advisers that already have AML programs in place should consider whether their programs meet the requirements of the Proposed Rule, while investment advisers without such programs should begin planning to develop and implement them. In addition, although FinCEN is not currently proposing CIP requirements, the Proposed Rule indicates that FinCEN anticipates addressing such requirements in future rulemakings, and we expect to see express CIP requirements applied to investment advisers in the future.

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

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[17] However, if the investment adviser does not identify a suspect at the time it detects the suspicious activity, it may delay the filing of the SAR for up to 30 additional calendar days in order to identify the suspect. In no case, however, may it delay the filing more than 60 days after the date of initial detection.

[18] The red flags include: (i) a client exhibits an unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspicious identification or business documents; (ii) a client appears to be acting as the agent for another entity but declines, evades, or is reluctant to provide any information in response to questions about that entity; (iii) a client's account has a pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives; (iv) a client requests that a transaction be processed in such a manner as to avoid the adviser's normal documentation requirements; or (v) a client exhibits a total lack of concern regarding performance returns or risk. FinCEN notes that the list was submitted by a commenter to the 2003 proposed rule for investment advisers.

[19] When conducing AML compliance training, investment advisers should include instruction regarding the confidentiality of SARs.

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