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AML Update: The Rumors Are True – FinCEN Proposes Regulations That Will Require SEC Registered Investment Advisers to Adopt an AML Program and File Suspicious Activity Reports

What This Means for Investment Advisers

By András P. Teleki

On September 1, 2015, the Financial Crimes Enforcement Network (“FinCEN”) published in the Federal Register long-rumored proposed regulations that will require Securities and Exchange Commission (“SEC”)-registered investment advisers (and advisers that are required to be so registered) to adopt an anti-money laundering (“AML”) program and file suspicious activity reports, much like banks, broker-dealers, and mutual funds do today. The notice of proposed rulemaking is available [here](#). The comment period ends November 2, 2015, and the effective date by which an investment adviser must implement an AML program will be at least six months after the final rules are effective. FinCEN proposes to delegate examination authority for compliance with the proposed rules to the SEC.

In general, the proposed regulations are very similar to the rules applicable to mutual funds and broker-dealers, with the notable exception that FinCEN has yet to propose imposing the customer identification and verification regulations (known in the banking and financial services industry as “CIP”) on registered investment advisers. In a noteworthy development, FinCEN, in its current approach, has abandoned the rule, proposed in 2003 and subsequently withdrawn, which would have required unregistered investment companies to have their own AML programs. Although the abandoned rule also would have covered certain commodity pools, FinCEN has decided to defer discussion of such commodity pools for the time being.

As it did in the context of the AML regulations applicable to banks, broker-dealers, and mutual funds, FinCEN continues to advocate a “risk-based” approach for AML programs. 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.” In practice, this means that an adviser whose only clients are mutual funds, which are themselves subject to AML program requirements, would be expected to have a more rudimentary AML program than an adviser whose clients include separately managed accounts and/or unregistered investment companies. In developing an AML program, investment advisers will need to assess their client base, advisory services and size, and tailor their programs accordingly.

Any investment adviser that delegates the implementation and operation of aspects of its AML program to another financial institution, agent, third-party service provider, or other entity, will remain fully responsible for the effectiveness of the program, as well as for

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ensuring that FinCEN and the SEC are able to obtain program-related information and records.

Which Investment Advisers Are Covered by the New Regulations?

The proposed rules apply to SEC registered investment advisers. The definition of investment adviser in the proposed regulations is “[a]ny person who is registered or is required to be registered with the SEC under Section 203 of the Investment Advisers Act of 1940” and relies on the terms and definitions used in the Advisers Act and the regulations thereunder. Although the proposed rules are limited to SEC-registered investment advisers (or those subject to registration as investment advisers), future AML rulemaking may include other investment advisers such as state-regulated advisers or advisers that are exempt from SEC registration (such as private fund advisers and venture capital advisers).

Dually Registered Investment Advisers and Advisers Affiliated with Subsidiaries of Entities Required to Establish AML Programs

FinCEN is not requiring that dually registered investment advisers or investment advisers that are subject to an affiliate’s AML program establish separate or multiple AML programs to comply with the proposed rules. Rather, the overall AML program must be designed to address the different money laundering risks posed by different aspects of a dually registered entity’s businesses and satisfy each of the risk-based AML program requirements to which it is subject. FinCEN recognizes the importance of enterprise-wide compliance and, therefore, believes it would be beneficial and cost-effective for these types of entities to implement one comprehensive AML program, but it is not requiring them to do so.

Advisory Services and Client Considerations

An investment adviser’s AML program must cover all of its advisory activity, whether the adviser is acting as the primary adviser or a subadviser. FinCEN specifically notes that it expects an investment adviser to address in its AML program (i) all of its advisory activity, including activity that does not entail the management of client assets (e.g., pension consulting, securities newsletters, research reports, and financial planning), (ii) any subadvisory services it provides, and (iii) any advisory activity it provides to any publicly or privately offered real estate fund (i.e., the proposed regulations do not provide for any explicit limitations or exceptions for the advisory activity provided to a real estate fund).

FinCEN also describes its expectations under a “risk-based” approach for the following categories of clients:

- Non-Pooled Investment Vehicle Clients – an investment adviser’s assessment of the risks presented by the different type of advisory services it provides should take into account the types of accounts offered (e.g., managed accounts), the type of clients opening such accounts, and how the accounts are funded;
- Registered Open-End and Closed-End Fund Clients – FinCEN recognizes that the advisory activity provided to an open-end or closed-end fund may present a lower risk for money laundering, terrorist financing, and other illicit activity than other types of advisory activity;

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- Private Fund Clients/Unregistered Pooled Investment Vehicles – An investment adviser that is the primary adviser to a private fund or other unregistered pooled investment vehicle is required to make a risk-based assessment of the money laundering and terrorist financing risks presented by the investors in such investment vehicles by considering the same types of relevant factors, as appropriate, as the adviser would consider for clients for whom the adviser manages assets directly. FinCEN recognizes that certain private funds and other unregistered pooled investment vehicles may present lower risks for money laundering or terrorist financing than others. If any of the investors in such an entity are themselves private funds or some other type of unregistered pooled investment vehicle, the investment adviser will need to assess the money laundering or terrorist financing risks associated with the investing entities using a risk-based approach.
- Wrap Fee Programs – In instances where an investment adviser provides advisory services to a wrap fee program sponsored by an unaffiliated broker-dealer, FinCEN notes the adviser may have limited access to investor information and transactions that would enable identification of money laundering, terrorist financing, or other illicit activity.

The Proposed Regulations

Under the proposed regulations, the elements of an investment adviser's AML program include: (i) establishment and implementation of policies, procedures, and internal controls reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities; (ii) independent testing for compliance; (iii) designation of a person or persons (commonly known as the AML Compliance Officer) responsible for implementing and monitoring the operations and internal controls of the program; and (iv) ongoing training. The proposed rules also designate investment advisers as "financial institutions" for purposes of the implementing regulations under the Bank Secrecy Act. In practice, this means that investment advisers will become subject to the cash transaction reporting rules, rather than the IRS/FinCEN Form 8300 requirements, and to requirements of the "travel rules" applicable to the transmittal of funds over \$3,000 and other recordkeeping requirements.

In addition to the AML program requirement, the proposed rules will require investment advisers to file suspicious activity reports ("SARs"). The proposed SAR regulations for investment advisers track the requirement for broker-dealers and mutual funds. In general, a transaction would require reporting if it is conducted or attempted by, at, or through an investment adviser; it involves or aggregates funds or other assets of at least \$5,000 and the investment adviser knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):

- (i) Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;
- (ii) Is designed, whether through structuring or other means, to evade any requirements of this part or any other regulations promulgated under the Bank Secrecy Act;

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- (iii) Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the investment adviser knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or
- (iv) Involves use of the investment adviser to facilitate criminal activity.

As is the case for banks, broker-dealers, and mutual funds, 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. SAR filings are also subject to onerous confidentiality requirements, which limit the disclosure or sharing of SARs with others. Finally, the SAR rule, as proposed, does not permit investment advisers to share SARs within their corporate organizational structures in the absence of further guidance.

Enforcement Considerations

Since the passage of the USA PATRIOT Act in 2001, there has been a significant uptick in enforcement investigations and proceedings related to AML compliance. Given the “risk based” approach prescribed for such programs, coupled with regulations such as the SAR rules that may require a significant number of judgment calls, AML compliance can present formidable implementation and execution challenges and has historically drawn heightened scrutiny from regulators. As they are brought into the AML fold, investment advisers should be mindful of this enforcement threat and design *and implement* systems tailored to meet the new requirements and create an appropriate record of AML compliance.

Conclusion

Given that the proposed regulations are similar enough to the rules applicable to banks, broker-dealers, and mutual funds, it is reasonable to anticipate that these regulations, when adopted, will differ little from their proposed forms. This means that investment advisers need to start thinking about reviewing any AML programs they currently have to determine what changes, if any, will be necessary to bring the current program in line with the proposed rules and for those investment advisers that do not currently have an AML program to begin assessing what an AML program would look like based on assessment of their clients, advisory services, and size, as well as how suspicious activity would be identified and reviewed for SAR purposes.

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