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FinCEN Issues Notice of Proposed Rulemaking that Would Extend AML Requirements to Registered Investment Advisers

On August 25, 2015, the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Department of the Treasury (Treasury), published a notice of proposed rulemaking (NPRM) that would extend anti-money laundering (AML) requirements to investment advisers registered with the US Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940. FinCEN states in the proposal that: "As long as investment advisers are not subject to AML program and suspicious activity requirements, money launderers may see them as a low risk way to enter the financial system. It is true that advisers work with financial institutions that are already subject to BSA requirements, such as when executing trades through broker-dealers to purchase or sell client securities, or when directing custodial banks to transfer assets. But such broker-dealers and banks may not have sufficient information to assess suspicious activity or money laundering risk. When an adviser orders a broker-dealer to execute a trade on behalf of an adviser's client, the broker-dealer may not know the identity of the client. When a custodial bank holds assets for a private fund managed by an adviser, the custodial bank may not know the identities of the investors in the fund. Such gaps in knowledge make it possible for money launderers to evade scrutiny more effectively by operating through investment advisers rather than through broker-dealers or banks directly."

The proposed rule would expand the general definition of "financial institution" in the regulations implementing the Bank Secrecy Act (BSA) to include registered investment advisers (RIAs). Consequently, RIAs would be subject to the BSA requirements generally applicable to financial institutions, including, the requirements to file Currency Transaction Reports (CTRs) and to keep records relating to the transmittal of funds. RIAs also would be required to respond to law enforcement requests regarding accounts or transactions for named suspects under Section 314(a) of the USA Patriot Act, and they would be permitted to participate in optional information sharing with other "financial institutions" under Section 314(b) of the Patriot Act. Additionally, the proposed rule would also require RIAs to establish AML programs and file suspicious activity reports (SARs).

In the notice of proposed rulemaking, FinCEN stated that it "is not proposing a customer identification program requirement or including within the AML program requirements provisions recently proposed with respect to AML program requirements for other financial institutions. FinCEN anticipates addressing both of these issues with respect to investment advisers, as well as other issues, such as the potential application of regulatory requirements consistent with Sections 311, 312, 313 and 319(b) of the USA PATRIOT Act, in subsequent rulemakings, with the issue of customer identification program requirements anticipated to be addressed via a joint rulemaking effort with the SEC."

FinCEN has previously attempted rulemaking efforts regarding investment advisers. In 2002, FinCEN proposed that unregistered investment companies establish AML programs. Similarly, in 2003, FinCEN proposed that certain investment advisers to establish AML programs. These proposals were limited to proposing AML program requirements only; they did not include additional proposed requirements to report suspicious activities to FinCEN. FinCEN withdrew both proposals in 2008 and suggested that it intended to propose a revised rule at a later date. At the time of withdrawal FinCEN noted that, since investment advisers conduct their activities through financial institutions that are subject to the BSA, investment adviser activities are at least indirectly subject to BSA requirements.

AML Program Requirement

A RIA's AML program needs to be tailored to the specific risks posed by the advisory services it provides and clients it advises. The AML program must cover all advisory activities of the investment adviser, regardless if the investment adviser is acting as a primary adviser or subadviser. Pursuant to the proposed rule, RIAs would be required 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. The AML program would need to be approved in writing by its board of directors or trustees, or if the investment adviser does not have a board, by its sole proprietor, general partner, trustee, or other persons that have functions similar to a board of directors. RIAs would also be required to make their AML program available to FinCEN or the SEC upon request.

At a minimum, an investment adviser's AML program must have the following requirements (with the manner in which each is implemented determined by its risk assessment):

- Establish and implement policies, procedures, and internal controls based on the investment adviser's assessment of the money laundering or terrorist financing risks associated with its business;
- Provide for independent testing of the AML program on a periodic basis to ensure that it complies with the requirements of the rule and that the program functions as designed;
- Designate a person or persons responsible for implementing and monitoring the operations and internal controls of the AML program; and
- Provide for training of appropriate persons.

RIAs that are duly registered as broker-dealers do not need to have separate AML programs, as long as the program covers all advisory and broker-dealer activities and business of the RIA. Additionally, pursuant to the proposed rule, RIAs may delegate the implementation and operation of the AML program to other financial institutions, agents or third-party service providers, but RIAs remain fully responsible for the effectiveness of the AML program, as well as ensuring that FinCEN and the SEC are able to obtain information and records relating to its AML program.

The proposed rule's requirement to designate a person or persons responsible for implementing and monitoring the operations and internal controls of the AML program is qualified in FinCEN's NPRM commentary.[1] The commentary states that, as to the compliance personnel responsible for implementing the program, "*the person or persons should be knowledgeable and competent regarding FinCEN's regulatory requirements and the adviser's money laundering risks, and should have full responsibility and authority to develop and enforce appropriate policies and procedures to address those risks*." Consequently, investment advisers should take careful considerations when selecting a person or persons to oversee the AML program. Additionally, the person or persons designated must also take into account the added responsibility of being held accountable for the investment adviser's AML program.

[1]This commentary is consistent with, though more emphatic than FINRA Rule 3310(d)'s requirement that a broker dealer designate and identify to FINRA (by name, title, mailing address, e-mail address, telephone number, and facsimile number) an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program (such individual or individuals must be an associated person of the member) and provide prompt notification to FINRA regarding any change in such designation(s).

SAR Requirements

The proposed rule would subject RIAs to file a SAR for transactions "conducted or attempted by, at, or through an investment adviser" (i) that involve at least $5,000; and (ii) for which the registered investment adviser "knows, suspects, or has reason to suspect" that the transaction is suspicious.

The proposed rule would not permit RIAs to share SARs with their controlling company or domestic affiliates, even if those affiliates are themselves subject to SAR obligations. Banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities may share SARs with these entities pursuant to FinCEN guidance. FinCEN noted that similar guidance for RIAs "may need to be issued in a timely manner following the issuance of any final rule," suggesting that FinCEN intends to allow RIAs to share SARs with eligible affiliates. The proposal also explicitly states that RIAs, broker-dealers and other financial institutions subject to a SAR rule may jointly file SARs, if certain conditions are met. The proposed rule requires RIAs, in circumstances that require immediate attention including suspected money laundering and terrorist financing schemes, to notify the appropriate law enforcement authority at once by telephone in addition to submitting a timely SAR.

The proposed rule expressly mandates that "*for situations requiring immediate attention, such as suspected terrorist financing or ongoing money laundering schemes, investment advisers are required to notify immediately by telephone the appropriate law enforcement authority in addition to filing a timely SAR*." This requirement reflects what has previously been an expectation and suggestion, but not an express FinCEN mandate. Thus, RIAs will need to make sure that they immediately notify law enforcement authorities via telephone of any instance(s) requiring immediate action regarding suspected terrorist financing or ongoing money laundering schemes.

Red Flags—Suspicious Activity

FinCEN stated that whether a SAR should be filed depends on all the facts and circumstances related to the transaction and the client in question. In this regard, FinCEN identified the following non-exclusive "red flags" that could be observed by an RIA and that may merit further investigation to determine whether a SAR should be filed:

- A client exhibits an unusual concern regarding the RIA'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;
- 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;
- A client's account has a pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives;
- A client requests that a transaction be processed in such a manner as to avoid the adviser's normal documentation requirements;
- A client exhibits a total lack of concern regarding performance returns or risk;
- A client's use of money orders or travelers checks in the context of private funds; or
- Use of multiple wire transfers from different accounts at different financial institutions or other unusual wire activity.

However, given the breadth of investment advisers covered by the NPRM, each investment adviser should be industrious in identifying the risks of its business model, and, while an AML risk assessment is not specifically required by the proposed rule, various parts of the commentary presume that the investment adviser is extremely familiar with its risks in order to be able to reasonable comply. This applies especially strongly both to due diligence and to suspicious activity monitoring.

Expected Future Rulemakings

The proposed rule does not require RIAs to implement a Customer Identification Program (CIP) or conduct customer due diligence (CDD). However, FinCEN states that it anticipates addressing both of these requirements through future joint rulemaking with the SEC and it has requested comment on whether RIAs should be subject to a CIP requirement. Additionally, the proposal indicates that future rulemaking may expand coverage of the new rules to investment advisers regulated by a state or those exempt from regulation. Notwithstanding this gap in the proposed rule (referenced by a "reserved" part F of the proposed rule), the commentary makes clear that at least for some advisers, most if not all of the CDD requirements being generally considered may be appropriate, on a risk basis.

Future rulemakings applicable to RIAs also will deal with the application of the requirements under USA PATRIOT Act Section 311 (special measures applicable to foreign jurisdictions, financial institutions, transactions or accounts of primary money laundering concern); Section 312 (enhanced due diligence for correspondent accounts for foreign financial institutions and private banking clients, i.e., high net worth non-US persons); Section 313 (prohibition on providing correspondent accounts to foreign shell banks); and Section 319(b) (requirement to maintain ownership records for foreign correspondent banks, identify a US agent for service of process for foreign correspondent banks, and provide access to foreign correspondent bank records through US financial institutions respondents).

Conclusion

In the proposal, FinCEN stated that "investment advisers have an important role to play in safeguarding the financial system against fraud, money laundering, terrorist financing, and other financial crime." Accordingly, FinCEN believes RIAs should be subject to certain AML requirements because money launderers and terrorist financers may be presently exploiting investment advisers to access the US financial system. RIAs compliance with the proposed rules would be assessed by the SEC through its examination process. Once the final rules are adopted, a RIA may be at risk for civil or criminal liability. Consequently, RIAs must make sure that they can comply with the requirements of the proposed rules. Lastly, although the proposed rule does not have CIP and CDD requirements, IAs may still need to implement these requirements to be able to fully comply with the proposed rule.

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