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FinCEN Re-Proposes AML/CFT Requirements Covering Investment Advisers

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Overview

On February 15, 2024, the U.S. Department of the Treasury's (Treasury) Financial Crimes Enforcement Network (FinCEN) issued a long-anticipated Notice of Proposed Rulemaking (NPRM)[1] to impose comprehensive anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements on investment advisers within the asset management sector (the Proposed Rule). The NPRM represents FinCEN's third effort to subject investment advisers to AML program regulations.[2] By expanding the definition of "financial institution" in the Bank Secrecy Act's (BSA) implementing regulations to cover both investment advisers registered with the Securities and Exchange Commission (SEC) (RIAs) and exempt-reporting advisers (ERAs; together with RIAs, Investment Advisers), FinCEN's Proposed Rule would extend to this sector not only the AML compliance program and suspicious activity reporting requirements of the BSA but also the special information-sharing procedures established by Sections 314(a) and 314(b) of the USA PATRIOT Act as well as other requirements of the BSA's AML program framework.

In light of the Biden Administration's focus on illicit finance as a threat to national security in contexts as diverse as anti-corruption and China, and the fact that additional rulemaking relating to the Customer Identification Program (CIP) Rule and the collection of beneficial ownership information is all but certain to follow, it seems highly likely that this Proposed Rule will be finalized.

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[1] Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 12108 (Feb. 15, 2024), *available at* https://www.govinfo.gov/content/pkg/FR-2024-02-15/pdf/2024-02854.pdf (Rule Release).

[2] In 2002, FinCEN issued an NPRM to impose minimum AML standards on certain unregistered investment companies. FinCEN has previously attempted to impose such standards on investment advisers in its 2003 and 2015 NPRMs.

If it is, Investment Advisers will have 12 months (as of the current draft) to develop and implement programs that comply with the new rule.

While Investment Advisers have through April 15 to comment on the Proposed Rule, now is the time to start thinking about creating (or bolstering) risk-based AML/BSA compliance programs with robust internal controls and recordkeeping practices sufficient to meet the new rule's requirements and withstand regulatory scrutiny.

Déjà Vu?

Notwithstanding the significant asset base they manage, RIAs and ERAs historically have not been subject to the BSA's AML requirements—but not for lack of trying by regulators. First in 2003 and again in 2015,[3] FinCEN issued similar NPRMs that would have brought Investment Advisers within the bounds of the BSA. However, both attempts failed, and neither proposed rule became finalized.[4] Still, as a practical matter, many RIAs have already established at least the foundations of an AML program, often pursuant to contractual obligations with other regulated entities.

But unlike the policy and regulatory landscape during FinCEN's previous attempts to subject Investment Advisers to the BSA, the Biden Administration brings to the table a distinct strategic emphasis on addressing the threats to national security posed by illicit finance, articulated clearly at the outset of the Administration in the White House's 2021 U.S. Strategy on Countering Corruption.[5]

The emphasis on countering corruption overlaps with the "persistent and emerging money laundering risks related to," *inter alia*, "the lack of comprehensive AML[. . .] coverage for certain sectors, ***particularly investment advisers***," identified in the Treasury's 2024 National Money Laundering Risk Assessment.[6] From Treasury's perspective, these risks extend beyond money

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[3] *See* FinCEN, FinCEN Withdraws Dated AML Rule Proposals for Unregistered Investment Companies, Commodity Trading Advisors, and Investment Advisers (Oct. 30, 2008), https://www.fincen.gov/news/news-releases/fincen-withdraws-dated-aml-rule-proposals-unregistered-investment-companies; FinCEN, FinCEN Proposes AML Regulations for Investment Advisers (Aug. 25, 2015), https://www.fincen.gov/news/news-releases/fincen-proposes-aml-regulations-investment-advisers.

[4] Indeed, the 2024 NPRM was published concurrently with FinCEN's withdrawal of the 2015 NPRM.

[5] *See generally, e.g.*, White House, *United States Strategy on Countering Corruption* (Dec. 2021), https://www.whitehouse.gov/wp-content/uploads/2021/12/United-States-Strategy-on-Countering-Corruption.pdf.

[6] Dep't of the Treasury, *2024 National Money Laundering Risk Assessment* (Feb. 2024), https://home.treasury.gov/system/files/136/2024-National-Money-Laundering-Risk-Assessment.pdf.

laundering to include terrorist financing, fraud, and abuse and misuse of sensitive technologies, as "almost every form of crime and every threat to national security has some financial nexus."[7]

Additionally, on February 1, Treasury issued the 2024 Investment Adviser Risk Assessment[8] (the Risk Assessment)—its first such report—exploring the various risk typologies and vulnerabilities specifically associated with Investment Advisers, which may, in some cases, be used as "an entry point into the U.S. market for illicit proceeds associated with foreign corruption, fraud, and tax evasion." While certain Investment Advisers may already satisfy some AML/BSA requirements because they are affiliated with banks or are dually registered as broker-dealers, the Risk Assessment found the lack of comprehensive requirements across the sector—which has nearly doubled in assets under management (AUM) since the 2015 NPRM—represents a substantial vulnerability that requires "recalibrating the regulatory environment."[9] The publication of such a bespoke risk assessment along with the NPRM is likely intended in part to bolster the substantive case for the rulemaking, both as a matter of policy and in the event of any potential future litigation.

The Risk Assessment identifies private funds as especially susceptible to illicit activity due to the anonymity of their individual investors and beneficial owners and the possibility of higher returns relative to other investment opportunities.[10] In particular, Treasury warns, "Russian oligarchs have exploited this [compliance] gap . . . to profit from investments in U.S. hedge funds and private equity firms while undermining U.S. interests and allies around the world, and Chinese state actors are using investments in early-stage companies to access cutting edge technology [that] . . . undermine[s] our long-standing commitment to competitive innovation and fair play."[11]

Overview of the Proposed Rule

In light of these risks, the Proposed Rule would therefore require Investment Advisers to:

- develop written, risk-based AML/CFT programs that are approved by the board of directors or equivalent;

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[7] FinCEN, Statement of FinCEN Director Andrea Gacki before the House Committee on Financial Services (Feb. 14, 2024), https://www.fincen.gov/news/testimony/statement-fincen-director-andrea-gacki-house-committee-financial-services.

[8] Dep't of the Treasury, *2024 Investment Adviser Risk Assessment* (Feb. 2024), https://home.treasury.gov/system/files/136/US-Sectoral-Illicit-Finance-Risk-Assessment-Investment-Advisers.pdf.

[9] FinCEN, Fact Sheet: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers Notice of Proposed Rulemaking (NPRM) (Feb. 13, 2024), https://www.fincen.gov/news/news-releases/fact-sheet-anti-money-laundering-program-and-suspicious-activity-report-filing.

[10] Dep't of the Treasury, *2024 Investment Adviser Risk Assessment, supra* note 8.

[11] FinCEN, Statement of FinCEN Director Andrea Gacki before the House Committee on Financial Services *supra* note 7; *see also* Ted Bunker and Laura Kreutzer, "Sanctions on Russia Put Private Fund Backers Under the Microscope," WSJ (Mar. 6, 2022), https://www.wsj.com/articles/sanctions-on-russia-put-private-fund-backers-under-the-microscope-11646586001.

- adhere to the general AML/CFT program requirements of 31 CFR Part 1010, including reporting, recordkeeping and information-sharing requirements;
- adhere to suspicious activity reporting requirements;[12]
- participate in mandatory information-sharing procedures with FinCEN, law enforcement and government agencies, and would open the possibility of voluntary information-sharing with other financial institutions, as applicable;
- adhere to certain customer due diligence requirements;[13]
- adhere to the special diligence requirements in subpart F of 31 CFR Part 1010 (e.g., rules related to correspondent banking and private banking accounts, special measures against certain foreign banks);[14] and
- designate a U.S.-based person who assumes a duty for the establishment and implementation of the AML/CFT program.

Under the Proposed Rule, FinCEN will delegate examination authority for Investment Advisers to the SEC. It is worth noting that FinCEN excluded state-registered investment advisers from the proposed AML/CFT requirements because Treasury does not believe that the illicit finance risks posed by those actors are sufficient to justify including them in the rulemaking at this time.[15] The compliance date will be one year after the final rule's publication in the *Federal Register*.

FinCEN has indicated that it expects this rulemaking to serve as an initial foundation for imposing additional AML/CFT obligations on Investment Advisers upon which it expects to build. Certain program components are either omitted from the Proposed Rule or not developed to the extent FinCEN has indicated it intends to address them in future rulemaking. For instance, the Proposed Rule does not subject Investment Advisers to beneficial owner information reporting because FinCEN anticipates changes to the overall beneficial owner information reporting regime as part of required updates to the Customer Due Diligence (CDD) Rule. Nor does the Proposed Rule contain specific requirements for customer identification programs; both the Rule Release and the Proposed Rule's fact sheet explain that FinCEN "expects to address CIP requirements through a future joint rulemaking with the SEC."[16]

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[12] Proposed 31 CFR 1032.320(b)(4).

[13] In the Rule Release, FinCEN noted that it expects to address the customer identification and verification components of customer due diligence requirements in future rulemaking. *See* Rule Release at 12128.

[14] *See id*. at 12129.

[15] *See id*. at 12117.

[16] *See id*. at 12129; FinCEN, Fact Sheet: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers Notice of Proposed Rulemaking (NPRM), *supra* note 9.

Potential Impact of the Proposed Rule on Investment Advisers

The Proposed Rule would impact Investment Advisers regardless of size[17] or the types of clients they advise,[18] and without consideration for their various business models or the different investment program characteristics they have.[19] Currently the AML/CFT programs and processes employed directly by Investment Advisers vary widely depending on the size and scope of the advisers' business and the nature of their affiliation (if any) with banks and broker-dealers already subject to FinCEN's AML/CFT regulations. This means that the Proposed Rule will impact Investment Advisers differently and may require differing levels of attention, depending on the maturity level of their existing AML/CFT programs and processes.

In proposing the rule, FinCEN indicated that requiring RIAs to comply with its AML/CFT regulations is intended, in part, to align and leverage the existing compliance framework under the Investment Advisers Act of 1940 with FinCEN's regulatory framework. Since RIAs are subject to various SEC rules and regulations that may be similar to certain AML/CFT measures, RIAs would likely have more of a compliance infrastructure that could be modified or expanded to comply with the AML/BSA requirements of the Proposed Rule.[20] In comparison, ERAs are not required to conduct annual reviews of their policies and procedures related to their compliance program and some ERAs have less comprehensive compliance programs. Accordingly, ERAs may be more likely to have to develop a compliance infrastructure to support AML/CFT requirements from the ground up.[21]

In terms of the costs of the Proposed Rule, on one end of the spectrum, the costs will be low for Investment Advisers that are part of a Bank Holding Company structure that is regulated by the Federal Reserve or that are part of a financial institution structure that includes an FDIC-insured bank since they will likely already have an AML/CFT program that is consistent with FinCEN's current AML/CFT requirements. Similarly, the costs of complying with the Proposed Rule for Investment Advisers that are dually registered as a broker-dealer[22] or are affiliated with a broker-

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[17] As noted above, the proposed would not apply to advisers who have less than $100 million in AUM because they would be required to register under one or more states, unless they meet certain exceptions or their state does not supervise investment advisers. *See* Rule Release at 12110.

[18] The Proposed Rule would require Investment Advisers to develop AML/CFT programs that cover advisory activities except for activities with respect to mutual funds, which have their own obligations under the BSA. *See id*. at 12123. However, in the Rule Release, FinCEN requested comments on whether to exclude certain types of advisory services.

[19] The Rule Release notes that certain types of products may involve lesser risk, and requested comments on products that should potentially be exempted from the Proposed Rule. *See id.* at 12127.

[20] *Id*. at 12119.

[21] *See id*. at 12122.

[22] *See id*. at 12112. Some RIAs have already implemented voluntary AML/CFT programs pursuant to the Securities Industry and Financial Markets Association (SIFMA) No-Action Letter, where the SEC staff stated it would not recommend enforcement action if a broker-dealer relies on RIAs to perform some or all of its

dealer will likely also be a minimal to moderate expense, since they likely already have an AML/CFT program.[23]

On the other end of the spectrum, the costs for smaller Investment Advisers serving retail clients that presently have only rudimentary processes, which may include cross-checking any new clients against OFAC Sanctions Lists, will likely be significant since they will have to scale up their AML/CFT program. Similarly, for non-U.S. Investment Advisers, complying with the Proposed Rule likely will be costly if they do not already have a person based in the U.S. who can be designated to have the duty and responsibility to establish, maintain and oversee an AML/CFT program since they will need to hire and designate such a responsible party.[24]

Questions Regarding Certain Assumptions Within the Proposed Rule

While the Rule Release makes the case for why AML program rules are important for Investment Advisers, the Proposed Rule embeds several assumptions regarding an Investment Adviser's relationships and access to its end clients' transaction information, which would be necessary to conduct ongoing monitoring for suspicious activity under AML/CFT requirements. In some cases, however, these assumptions may not fully take into account limitations involved in the Investment Adviser-client relationship.

Investment Advisers have different types of clients, from large institutional clients to retail clients, and the ways they interface with clients and their access to comprehensive financial and transactional information varies widely. For example, in the institutional client context, Investment Advisers are often retained to manage only a small portion of the institution's overall investment portfolio. In such cases, Investment Advisers' access to full portfolio information and the rationale for asset allocation and investment decisions can be quite limited. Indeed, where investment

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CIP obligations or the portion of the CDD Rule regarding beneficial ownership requirements for legal entity customers, provided that, among other things, the RIA implements its own AML/CFT program. *See* SEC, Letter to Mr. Bernard V. Canepa, Associate General Counsel, SIFMA, Request for No-Action Relief Under Broker-Dealer Customer Identification Program Rule (31 CFR 1023.220) and Beneficial Ownership Requirements for Legal Entity Customers (31 CFR 1010.230) (Dec. 9, 2022), https://www.sec.gov/files/nal-sifma-120922.pdf.

[23] FinCEN notes that 20 percent of RIAs and 7 percent of ERAs are dually registered as a broker-dealer, licensed as a bank, or affiliated with a bank or broker-dealer. *See* Rule Release at 12118.

[24] Non-U.S. advisers are subject to SEC regulation under the Investment Advisers Act of 1940 (the Advisers Act) if they solicit or advise U.S. persons, although they may be exempt from SEC registration if they meet the "foreign private adviser" exemption. Non-U.S. advisers that are registered as RIAs or report as ERAs will be subject to the requirements of the Proposed Rule. FinCEN requested comments on the challenges for non-U.S. advisers in complying with the Proposed Rule's duty requirement to establish, maintain and enforce an AML/CFT program by a U.S.-based person. *See id*. at 12110, 30.

consultant firms[25] act as the interface between the Investment Adviser and the institutional client, the Investment Advisers' one-on-one communications with the clients may be infrequent.

Similarly in the retail advisory space, Investment Advisers that participate as advisers or sub-advisers in wrap fee programs sponsored by large broker-dealer firms may have little or no access to their clients' complete financial information because the program sponsor is responsible for the day-to-day client relationship and retains any suitability obligations regarding the recommendation to use a particular Investment Adviser. Notably, FinCEN requested comment on whether wrap fee programs should be exempted from an Investment Adviser's AML/CFT programs,[26] and we are of the view that such an exemption would be beneficial to Investment Advisers with respect to these programs.

Another assumption that FinCEN makes in the Proposed Rule is that the suspicious activity monitoring of custodians of fund assets is not sufficient to detect all instances of potentially reportable activity within funds. In the Rule Release, FinCEN provides a few examples of suspicious activity that increased monitoring by Investment Advisers (but not custodians) could catch: (1) an investor in a venture capital fund requesting access to detailed nonpublic technical information about a portfolio company that is inconsistent with a desire for economic return; or (2) a money launderer engaging in a placement by funding a managed account or investing in a private fund using wire transfers from different accounts at various financial institutions.[27]

Requiring extensive programs to be implemented by Investment Advisers would potentially be duplicative of the programs maintained by the custodians. Arguably, the examples cited above could be caught by custodians' monitoring of fund assets; example 1, specifically, is within the bounds of screenings done by most funds during their due diligence reviews of investors. Investment Advisers are generally required to hold client assets at a "qualified custodian," which must be a bank custodian, registered broker-dealer, futures commission merchant or foreign financial institution—entities that are already required to have full AML/CFT programs.[28] While FinCEN notes that qualified custodians may not have full visibility into a transaction lifecycle or into a customer's identifying information due to intermediation,[29] in many cases, the custodian, as the entity that has possession of the client funds, will possess the most pertinent information to prevent illicit activity.

For this reason, it will be important for FinCEN and the SEC to follow up this Proposed Rule with joint rulemaking to clarify which types of customer relationships of Investment Advisers will be

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[25] Investment consultant firms are firms that work with Investment Advisers to select third-party investment advisers, also known as sub-advisers, to manage a portion of the Investment Advisers' portfolios.

[26] *See* Rule Release at 12126.

[27] *Id*. at 12131-32.

[28] *See* 17 CFR § 275.206(4)–2.

[29] *See* Rule Release at 12113, 32.

covered under AML/CFT program requirements. As explained above, the rulemaking should clarify how suspicious activity monitoring would operate in the context of an Investment Adviser managing a portion of an institutional client's portfolio or participating in a large wrap fee program.

Conclusion

Today's policy and regulatory landscape is vastly different from 2003 or 2015, and the Biden Administration has made it a point of pride to address illicit finance concerns head-on. Given these strategic priorities, demonstrated by Treasury's 2024 National Money Laundering and Investment Adviser Risk Assessments, it is likely that FinCEN's latest NPRM with respect to Investment Advisers will, in fact, be finalized. Those operating in the asset management sector should therefore prepare to comply with the NPRM's requirements and with additional rulemaking expected to follow. WilmerHale stands ready to assist Investment Advisers in submitting comments to FinCEN on the Proposed Rule and in establishing—or strengthening—robust, risk-based and forward-looking AML/BSA compliance programs.

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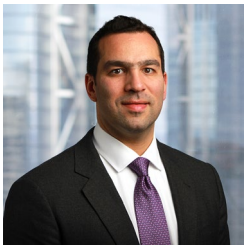

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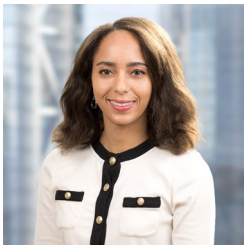

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