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FinCEN Proposes AML Requirements for Registered Investment Advisers

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The Financial Crimes Enforcement Network (FinCEN) has proposed long-expected regulations that would extend anti-money laundering (AML) requirements to federally registered investment advisers (RIA).[1] The August 25, 2015 proposal represents the agency's second attempt to bring investment advisers under AML regulations

FinCEN's proposal goes further than its prior attempt in that it would require RIAs to file suspicious activity reports (SAR) and comply with AML reporting and recordkeeping obligations as a "financial institution." Accordingly, the proposed rule may raise compliance expectations even for the many RIAs who currently maintain AML programs voluntarily. The proposal, however, would not require RIAs to implement Customer Identification Programs (CIP), despite calls by broker-dealers that FinCEN do so. FinCEN states that CIP for RIAs will be addressed in a future joint rulemaking with the SEC.

In addition, the new proposal should have examination and enforcement implications for RIAs. Once finalized, the SEC staff would be the front-line examiners for compliance with the new rules. Enforcement implications—other than exposure to FinCEN (a new regulator for RIAs)—are not yet clear because there is no SEC rule that applies AML requirements to RIAs.

Background

FinCEN first attempted to bring investment advisers under AML regulation in 2002 and 2003, when it proposed separate rules that covered unregistered and registered investment companies, respectively. Under the 2002 proposal, FinCEN used its general rulemaking authority to define unregistered investment companies as "investment companies," an existing subcategory of "financial institutions" covered by the Bank Secrecy Act (BSA).[2] Under the 2003 proposal, FinCEN used its authority under 31 U.S.C. § 5312(a)(2)(Y) to establish investment advisers as a new subcategory of "financial institutions."[3] Both proposals met heavy opposition from investment advisers and the private fund industry, and were withdrawn in 2008. FinCEN said it withdrew the proposed rules in light of "developments since [the proposal dates] in industry operations as well as functional and BSA regulations."[4] Another contributing factor may have been a 2006 case that invalidated the SEC's attempt to require SEC registration of hedge fund advisers.[5]

Since then, the 2010 Dodd-Frank Act has required many advisers to private funds to register with the SEC. The SEC has also reportedly urged FinCEN to extend AML requirements to investment advisers. As a result, industry participants have been expecting FinCEN to revive its investment adviser rules for some time. For this and other reasons, many investment advisers have already implemented some type of voluntary AML programs for several years.[6]

Coverage

The proposed rule would cover all investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940. Thus, the rule generally would apply only to advisers with $100 million or more in regulatory assets under management. With limited exceptions, smaller investment advisers generally need not register with the SEC and would not be subject to the proposed rule.

The proposed coverage of only larger RIAs contrasts with FinCEN's approach for banks, broker-dealers, money transmitters and other financial institutions, which are subject to AML requirements irrespective of size.[7] The proposed rule applies to all RIAs without regard to their client base or the money laundering risk of different categories of advisory activities. However, FinCEN has identified certain adviser activities as presenting lower money laundering risk (such as advising registered open- and closed-end investment companies and certain private funds), and it has requested comments on whether classes of RIAs should be excluded from the definition if they conduct low-risk activities.

AML Program Requirements

The proposed rule would apply standard AML program requirements to RIAs by mandating internal controls, independent testing, a designated AML compliance officer and AML training. An RIA's AML program would have to be risk-based according to the "types of advisory services these entities provide." RIAs with high-risk clients or activities would be expected to devote greater resources to identify, monitor and mitigate those risks, while those with lower-risk clients or activities may adopt less extensive monitoring or other AML procedures. FinCEN also clarified that RIAs dually registered as both investment advisers and broker-dealers with the SEC need not establish multiple or separate AML programs for each line of business. Instead, such entities could establish a single, enterprise-wide AML compliance program covering those and all other financial institutions within the corporate structure.

SAR Requirements

The proposed rule would subject RIAs to substantially the same SAR requirements applicable to broker-dealers. Specifically, RIAs would have 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.

SAR timing and confidentiality requirements would also be similar to those applicable to broker-

dealers. However, 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.[8] 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 rule 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.

Customer Identification and Due Diligence Expectations

FinCEN states that RIAs may be "uniquely situated to appreciate a broader understanding of their client's movement of funds through the financial system." Yet the proposed rule would not require RIAs to implement a CIP. Thus, unlike banks, broker-dealers and certain other financial institutions, RIAs would not be formally required to collect, and as appropriate verify, information on each customer that opens a new account.[9] FinCEN did not explain why the proposed rule lacks a CIP requirement, although the agency requested comment on that decision and indicated that CIP obligations would be extended to RIAs in a future joint rulemaking with the SEC.[10]

Even without a CIP requirement, the proposed rule strongly suggests that FinCEN will expect RIAs to perform other customer due diligence (CDD). For example, FinCEN notes that registered investment advisers "would need to analyze the money laundering and terrorist financing risks posed by a particular client." In FinCEN's view, such expectations are part and parcel of the obligation to file SARs. In its 2014 proposed CDD rule, FinCEN highlighted the importance of understanding the nature and purpose of customer relationships in order to identify and report suspicious activity.[11]

Beneficial Ownership Expectations

The proposed rule suggests that in some cases FinCEN may expect RIAs that advise funds to look beyond the nominal client into the client's underlying investors, at least for higher-risk entities such as private funds. For example, the proposed rule states that an RIA may be required to look at "the underlying investors of a client" to assess the money laundering risks of a private fund or other unregistered pooled investment vehicle. FinCEN also states that an RIA "should have access to information about the identities and transactions of the underlying or individual investors" in such entities. These statements contrast with FinCEN's position in its proposed CDD rule. There, FinCEN stated that for purposes of the beneficial ownership requirement, "if an intermediary is the customer" and the bank, broker-dealer or other covered financial institution "has no CIP obligation with respect to the intermediary's underlying clients pursuant to existing guidance" then the covered financial institution "should treat the intermediary, and not the intermediary's underlying clients, as its legal entity."[12]

Investment Advisers as "Financial Institutions"

FinCEN also proposes to incorporate RIAs into the AML regulations' definition of "financial institution." These financial institutions are subject to additional AML regulations beyond the core

AML program requirements. For example, as financial institutions, RIAs would be required to adhere to the Recordkeeping and Travel Rules. These rules require financial institutions to create and retain for five years records for transmittals of funds exceeding $3,000, and ensure that certain information pertaining to the transmittal of funds "travel" with the transmittal to the next financial institution in the payment chain.

As financial institutions, 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 Act. Finally, RIAs would be required to file currency transaction reports (CTR) instead of IRS Form 8300 (the current requirement) for certain currency transactions of more than $10,000.

Examination and Enforcement Implications

Because FinCEN does not have its own examination staff, it routinely delegates examination—but not enforcement—responsibilities to federal functional regulators and self-regulatory organizations (SROs).[13] The proposed rule adopts this traditional approach. However, unlike broker-dealers which are subject to examination by their SRO, the Financial Industry Regulatory Authority (FINRA), RIAs do not have an SRO. Therefore, SEC staff will be the sole examination authority for these new requirements.

It is not clear if this approach will provide effective coverage of the investment adviser sector. The rule proposal states that "the SEC is in the best position to act as the designated examiner" because it "has expertise in the regulation of investment advisers." However, RIAs are not under a mandatory examination cycle, unlike banks. And in 2014, the SEC was able to examine only 10 percent of RIAs.[14] The full enforcement implications of this proposal are likewise not yet known. FinCEN may impose civil penalties for violations of the proposed rule. However, unlike with broker-dealers, there is no SEC rule that applies AML requirements to RIAs.[15] Therefore, the SEC's enforcement authority for the proposed rule is at best uncertain.

Public Comments

FinCEN has invited public comments on all aspects of the proposed rule, but specifically seeks comment on several issues, including: the proposed definition of investment adviser; the application of CIP; the proposed AML programmatic requirements for investment advisers; and the proposed suspicious activity reporting requirement. Comments are due November 2.

Effective Date

The proposed rule states that covered RIAs will be required to develop and implement the requisite AML program within six months of the effective date of the final rule. Given the likely volume of comments to be submitted and other regulatory priorities, it may be some time before FinCEN adopts a final version of this proposal.

[1] *Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 Fed. Reg. 52,680 (Sept. 1, 2015).

[2] *See Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60,617 (Sept. 26, 2002).

[3] *See Anti-Money Laundering Programs for Investment Advisers*, 68 Fed. Reg. 23,646 (May 5, 2003).

[4] *See Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Unregistered Investment Companies*, 73 Fed. Reg. 65,569, 65,571 (Nov. 4, 2008); and *Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers*, 73 Fed. Reg. 65,568, 65,569 (Nov. 4, 2008).

[5] *Goldstein, et al. v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

[6] Some RIAs have voluntarily developed AML programs as part of their provision of services to mutual funds. Mutual funds are required to have AML programs and may "contractually delegate the implementation and operation of [the mutual fund's] anti-money laundering program to another affiliated or unaffiliated service provider . . . ." See 31 C.F.R. Part 1024 (AML Rules for Mutual Funds); *Anti-Money Laundering Programs for Mutual Funds*, 67 Fed. Reg. 21,117, 21,119 (Apr. 29, 2002).

[7] AML requirements for a few other types of financial institutions have size thresholds, but these are generally intended to exclude only the smaller such institutions. E.g., 12 C.F.R. Part 1021 (Casinos with gross annual gaming revenue exceeding $1 million must have an AML program); 12 C.F.R. Part 1022 (Dealers in foreign exchange in excess of $1,000 per person, per day must have an AML program).

[8] *See Sharing Suspicious Activity Reports by Securities Broker-Dealers, Mutual Funds, Futures Commission Merchants, and Introducing Brokers in Commodities with Certain U.S. Affiliates*, FIN-2010-G005 (Nov. 23, 2010) and Sharing Suspicious Activity Reports by Depository Institutions with Certain U.S. Affiliates, FIN-2010-G006 (Nov. 23, 2010).

[9] Such information includes, at a minimum, name, address and SSN/TIN, as well as date of birth for individuals.

[10] The set of requirements under the proposed rule is similar to AML requirements imposed on non-bank residential mortgage lenders and originators and the housing government sponsored enterprises. Requirements for those entities include AML program and SAR requirements, but do not include a CIP. *See* 31 C.F.R. Part 1029 (rules for non-bank residential mortgage lenders and originators) and 31 C.F.R. Part 1030 (rules for housing government sponsored enterprises).

[11] *See* 79 Fed. Reg. 45,151, 45,163 (Aug. 4, 2014).

[12] 79 Fed. Reg. at 45,161.

[13] 31 C.F.R. § 1010.810.

[14] Testimony of SEC Chairwoman Mary Jo White before the Subcommittee on Financial Services

and General Government Committee on Appropriations (May 5, 2015).

[15] 17 C.F.R. § 240.17a-8.

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