Proposed AML Requirements for Investment Advisers

Introduction

New anti-money laundering programs will materially alter the business and compliance landscape for investment advisers. Currently investment advisers are not required to maintain an anti-money laundering program because they are not considered to be "financial institutions" under the Bank Secrecy Act of 1970, the Money Laundering Control Act of 1986 or the USA PATRIOT Act. However, investment advisers are subject to the rules promulgated by the Office of Foreign Asset Control ("OFAC"). OFAC administers and enforces economic and trade sanctions on behalf of the U.S., and maintains a list of Specially Designated Nationals and Blocked Persons ("SDNs"). Advisers are not permitted to conduct business with individuals and businesses on an OFAC list, must take reasonable steps to ensure that no such individuals or businesses become clients of the adviser, and must report any subject clients and transactions to OFAC. While many advisers choose to voluntarily implement an AML program because it is required by entities they do business with, AML programs could become mandated as a result of proposed rules issued by the Financial Crimes Enforcement Network ("FinCEN") on August 25, 2015.

Need for the Rule

According to the rule proposal, FinCEN believes that money launderers may see investment advisers as a low-risk way to enter the U.S. financial system, since they are not subject to AML program, customer identification procedures, or suspicious activity reporting requirements. In a press release accompanying the rule proposal the Director of FinCEN, Jennifer Shasky Calvery stated, "Investment advisers are on the front lines of a multi-trillion dollar sector of our financial system. 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." Although advisers work with financial institutions that are already subject to BSA requirements (e.g., trade execution through broker-dealers, use of custodial services), FinCEN believes that gaps exist that may allow money launderers to evade scrutiny by operating through investment advisers rather than through broker-dealers or banks directly.

Summary of Rule Proposal

First, the proposed rule would amend the definition of "financial institution," and make investment advisers subject to BSA requirements. The proposed definition of "investment adviser" would only include advisers registered, or required to register, with the U.S. Securities and Exchange Commission ("SEC"), or subject to a federal exemption. As a result, state registered investment advisers would not be subject to the new rules, unless states adopt them separately. The proposed rule would require investment advisers to comply with the requirements of the BSA, including filing Currency Transaction Reports ("CTR"s) for transactions of more than $10,000 in currency. Advisers would also be required to comply with the Recordkeeping and Travel Rules to keep a record of "transmittal of funds" in an amount equal to or greater than $3,000 and cross-border transfers and extensions of credit for amounts greater than $10,000. Furthermore, investment advisers would be subject to FinCEN's regulations implementing sections 314(a) and 314(b) of the USA PATRIOT Act, which address sharing of information with the government and among entities in order to detect money laundering and terrorist financing. FinCEN proposes to delegate authority to the SEC to examine investment advisers for compliance with the proposed rules.

Second, the rule would require defined investment advisers to, at a minimum, (1) establish and implement written AML programs, policies, and internal controls; (2) conduct periodic, independent testing; (3) designate an individual or committee responsible for AML compliance; and (4) provide ongoing training. The AML program would be required to encompass all advisory activity, including primary adviser and sub-advisory services, as well as services that do not pertain to managing a client's assets (e.g., issuing research reports). The proposal makes it clear that the AML program requirement is not a one-size-fits-all requirement but rather is "risk-based" approach 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.

FinCEN acknowledged that investment advisers are already required to implement programs, policies, and internal

controls in connection with federal securities laws, and these programs could be "adapted" to the requirements in this proposal. FinCEN also indicated that investment advisers could delegate the responsibilities for creating and implementing certain aspects of its AML program, to another financial institution, agent, third-party service provider, or other entity. However, the adviser will be fully responsible for the effectiveness of the program, as well as for ensuring that FinCEN and the SEC are able to obtain information and records relating to the AML program.

The proposed rule would require that each investment adviser's AML program be approved in writing by its board of directors or trustees, or if it does not have a board, by its sole proprietor, general partner, trustee, or other persons that have functions similar to a board of directors.

Third, the rule requires investment advisers to report suspicious activity, per the proposed standard, in connection with transactions of at least $5,000 in funds or other assets. The proposal states that in monitoring suspicious activity, investment advisers should evaluate the activities of their clients for money-laundering risks. For example, suspicious activity could include "unusual wire activity that does not correlate with a client's stated investment objectives" or "funding a managed account or subscribing to a private fund by using multiple wire transfers from different accounts maintained at different financial institutions." Investment advisers would also be subject to certain recording, filing, and confidentiality requirements.

FinCEN noted that investment advisers already have programs in place to comply with anti-fraud and manipulation provisions of the Advisers Act, which would need to be adapted to the requirements in the proposed rules if they were to go into effect. FinCEN would also allow investment advisers to delegate suspicious activity reporting to third parties, but the investment adviser would be ultimately responsible for the program.

Future Rulemaking

The request for comment section of the proposed rules hint at certain additional BSA regulations that FinCEN is considering to make applicable to investment advisers in the future. These include: implementing reasonable customer identification procedures; taking certain "special measures" against foreign jurisdictions, institutions, classes of transactions, or types of accounts the Treasury designates as a "primary money laundering concern;" performing due diligence and, in some cases, enhanced due diligence, with regard to certain correspondent accounts; not providing correspondent accounts to foreign shell banks, and in some cases taking reasonable steps to ensure that correspondent accounts provided to foreign banks are not used to indirectly provide banking services to foreign shell banks; and maintaining records of the ownership of foreign banks and their agents in the United States designated for legal service of process for records regarding these correspondent accounts, and require the termination of correspondent accounts for failure to properly respond to government requests for information.

Conclusion

If approved, investment advisers would be required to develop and implement an AML program that complies with the requirements of the rules within six months of the effective date. While most advisers already have some AML procedures included in their compliance program, all advisers will need to review their AML procedures and ensure that they include all of the requirements of these proposed rules if they become final.

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