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Client Alert

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FinCEN Proposes Anti-Money Laundering Requirements for Investment Advisers

The Financial Crimes Enforcement Network ("FinCEN") recently proposed rulemaking to prescribe minimum standards for anti-money laundering ("AML") programs to be established by registered investment advisers and to require such investment advisers to report suspicious activity to FinCEN and be subject to certain other requirements under the Bank Secrecy Act ("BSA"). A copy of the rule proposal is available here.

Background

FinCEN has the authority to implement, administer and enforce compliance with the Currency and Financial Transactions Reporting Act of 1970, as amended by the USA PATRIOT Act and other legislation under the BSA and associated regulations. FinCEN is also authorized to impose AML program and suspicious activity reporting requirements for financial institutions. FinCEN has done this with respect to a variety of institutions including broker-dealers, banks, insurance companies, casinos, mutual funds and others. In 2002 FinCEN proposed to require certain unregistered investment companies to establish AML programs and in 2003 proposed to require certain investment advisers to establish AML programs. Neither rule proposal was adopted and both were withdrawn in 2008.

Rule Proposal

FinCEN is now proposing rules changes requiring certain investment advisers to establish AML programs and report suspicious activity to FinCEN. FinCEN is also proposing to include investment advisers within the general definition of "financial institutions" under the BSA which would result in investment advisers being subject to a variety of other requirements.

Covered Advisers

FinCEN is proposing to define "investment adviser" for purposes of the proposal as any person registered or required to be registered with the Securities and Exchange Commission ("SEC"). The proposal specifically notes that both primary advisers and sub-advisers to accounts or funds could be covered by the definition. The proposal also notes that covered investment advisers would not be limited to those involved in the management of client assets. Registered investment advisers engaged in activities such as pension consulting, creation of securities news letters, management of certain real estate funds, generation of research reports and financial planning could also be covered. However, FinCEN also notes in the proposal that different types of investment adviser activities present different levels of money laundering and terrorism financing risks. Accordingly, the associated burdens of establishing an AML program and complying with other requirements would vary depending on the risks associated with a particular adviser's activities and clients.

AML Program Requirements

The rule proposal prescribes minimum standards for AML programs to be established by investment advisers. Among other things, the requirements would include:

- Adopting internal policies, procedures and controls designed to address AML issues that comply with the minimum standards set forth in the rule proposal approved in writing by its board of directors or trustees;
- Making an adviser's AML program available to FinCEN or the SEC on request;
- Conducting ongoing independent testing of the adviser's AML program;
- Designating an AML compliance officer; and
- Providing ongoing AML training for firm personnel.

The proposal notes that the AML program requirements are not one-sized-fits-all but are risk-based and depend on the specific risks of an adviser's activities and clients.

An adviser's AML program would be required to cover all of its advisory activities whether acting as a primary adviser or sub-adviser and including services not involving the management of assets. The proposal would also

require investment advisers to apply these AML program policies to investment funds managed by the adviser including registered funds, private funds and certain real estate funds.

FinCEN notes that certain advisers have already implemented AML programs either voluntarily or in conjunction with an SEC no-action letter permitting broker-dealers to rely on registered investment advisers to perform some or all aspects of broker-dealers' customer identification program obligations. FinCEN also acknowledges that certain investment advisers may be affiliated with, subsidiaries of or themselves financial institutions under the BSA in other capacities or otherwise required to establish AML programs (e.g. advisers that are also registered as broker-dealers). FinCEN is not proposing that such advisers establish multiple or separate AML programs so long as a firm's comprehensive AML program covers all of the entity's advisory, broker-dealer activities and other covered businesses and addresses the different risks posed by different business activities and client bases. FinCEN also acknowledges in the proposal that certain aspects of these compliance programs may be delegated contractually to third parties subject to certain conditions; however, the ultimate responsibility for the effectiveness of the program and ensuring FinCEN and SEC access to certain information and records would remain with the investment adviser.

Suspicious Activity Report Requirements

Investment advisers would also be required to report suspicious transactions to FinCEN in the form of suspicious activity reports ("SARs") pursuant to the BSA. Advisers would be required to report suspicious transactions that are conducted or attempted by, at, or through an investment adviser and involve or aggregate at least $5,000 in funds or other assets. An investment adviser would be required to report a transaction if it knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part): (1) involves funds derived from illegal activity or is intended or conducted to hide or disguse funds or assets derived from illegal activity; (2) is designed, whether through structuring or other means to evade the requirements of the BSA; (3) has no business or apparent lawful purpose, and the investment adviser knows of no reasonable explanation for the transaction after examining the available facts; or (4) involves the use of the investment adviser to facilitate criminal activity. A determination as to whether a SAR needs to be filed should be based on all the facts and circumstances relating to the transaction and the client in question.

Within 30 days after an investment adviser becomes aware of a suspicious transaction, the adviser would be required report the transaction by completing and filing a SAR with FinCEN. Supporting documentation relating to the SAR would be required to be collected and maintained by the investment adviser and made available upon request to FinCEN, the SEC or certain other specified law enforcement agencies. For situations requiring immediate attention such as suspected terrorist financing or ongoing money laundering schemes, investment advisers would be required to notify appropriate law enforcement authorities immediately in addition to making the timely filing of a SAR. Copies of all SARs and the underlying related documentation would need to be maintained by the investment adviser for at least five years from the date of filing.

Additionally, the proposed rules generally provide that no investment adviser, and no current or former director, officer, employee, or agent of any investment adviser would be permitted to disclose a SAR or any information that would reveal the existence of a SAR except under specificied circumstances.

Inclusion of Investment Advisers in the "Financial Institution" Definition and Related BSA Requirements

FinCEN is also proposing to include investment advisers in the general definition of "financial institution" in the rules implementing the BSA. As a result, investment advisers would be subject to various BSA requirements generally applicable to financial institutions including:

- The requirement to file FinCEN Currency Transaction Reports; and
- The requirement to create and keep certain records relating to the transmittal of funds (i.e. the BSA recordkeeping and travel rules and related recordkeeping requirements) and ensure that certain information pertaining to such transmittal of funds travels to the next financial institution in the payment chain.

Delegation of Authority to Examine Investment Advisers to the SEC

FinCEN is proposing to delegate its authority to examine investment advisers for compliance with these requirements to the SEC.

Future Related Rulemaking

FinCEN is not currently proposing a customer identification program requirement or including within the AML program requirements certain provisions recently proposed with respect to AML program requirements for other financial institutions. FinCEN has indicated that it anticipates addressing both of these issues with respect to investment advisers along with other issues in subsequent joint rulemaking. Customer identification program requirements are anticipated to be addressed via a joint rulemaking effort with the SEC.

What's Next?

Firms will have until November 2, 2015 to comment. Comments can be submitted 1) through the Federal eRulemaking portal at http://regulations.gov including 1506-AB10 in the submission and referring to Docket Number FINCEN-2014-0003 or 2) via mail. In general, FinCEN will make all comments publicly available by posting them on http://www.regulations.gov. FinCEN is proposing that an investment adviser must develop and implement an AML program on or before six months from the effective date of the regulations if they are adopted. The suspicious activity reporting requirements are also proposed to be effective as of the time of implementation of an adviser's AML program however firms would be encouraged to report voluntarily upon effectiveness of the rules. Investment advisory firms should begin preparing themselves for the increased compliance obligations associated with being directly subject to the proposed requirements.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.