Proposed AML/CFT Program Rule for Covered Investment Advisers

6 Things To Know

On February 13, 2024, the Department of the Treasury's ("Treasury") Financial Crimes Enforcement Network ("FinCEN") released a notice of proposed rulemaking (the "Proposal") to make certain investment advisers, including advisers of many venture capital and private equity funds, subject to anti-money laundering regulation under the Bank Secrecy Act ("BSA"). The Proposal would, among other things, require such investment advisers to establish anti-money laundering/countering the financing of terrorism ("AML/CFT") programs and report suspicious activity to FinCEN. FinCEN also released a fact sheet on the Proposal.

Below are six key takeaways from the Proposal. Comments on the Proposal are due by April 15, 2024.

1

The Proposed Rule would require covered investment advisers to establish an AML/CFT program, report suspicious activity, comply with the Recordkeeping and Travel Rule, and fulfill other obligations applicable to financial institutions subject to the BSA and FinCEN's implementing regulations.

The Proposal would require covered investment advisers to establish a written risk-based AML/CFT program that is approved in writing by its board of directors or equivalent. As described below, the requirements under the Proposal for covered investment advisers parallel the requirements for broker-dealers under existing FinCEN regulations.

The AML/CFT program must include, at a minimum: (1) policies, procedures, and internal controls reasonably designed to prevent the investment adviser from being used for illicit activities and to achieve compliance with the BSA; (2) a designated, U.S.-based BSA/AML officer (or officers) responsible for implementing and monitoring the operations and internal controls of the program; (3) ongoing training on BSA/AML compliance; (4) risk-based procedures for conducting ongoing customer diligence, including developing customer risk profiles; and (5) independent testing of the AML/CFT program.

An investment adviser would apply the AML/CFT program to all advisory activities other than with respect to mutual funds that have established an AML/CFT program that complies with the applicable AML/CFT requirements in the Proposed Rule. Advisory activities would include, for example, management of customer assets, the provision of financial advice, the execution of transactions for customers, as well as other activities. The Proposed Rule, however, would not apply to non-advisory activities. For example, in the context of private equity funds, activities undertaken in connection with the management of portfolio companies, including managerial and operational decision-making for portfolio companies, would not be advisory activities subject to the BSA/AML program requirement.

Additionally, the Proposed Rule would make covered investment advisers subject to the existing recordkeeping and reporting requirements in FinCEN's regulations. Covered investment advisers would be required to file suspicious activity reports ("SARs") with FinCEN in similar circumstances to those that would require SAR filings by broker-dealers or banks. The Proposal also applies certain other law enforcement information-sharing requirements to covered investment advisers, and requires compliance with "special measures" imposed by FinCEN to restrict or condition the access of high-risk institutions and jurisdictions to the U.S. financial system.

Covered investment advisers would be required to comply within 12 months from the final rule's effective date.

2

The Proposal defines the term "investment advisers" to include SEC-registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs"), thus covering advisers to many hedge funds, private equity funds, and venture capital funds.

The Proposed Rule applies to RIAs and ERAs. The Proposal does not, however, apply to state-registered investment advisers.

RIAs that are dually registered with the SEC as investment advisers and broker-dealers would not be required to establish multiple or separate programs, provided that a comprehensive AML program covers the entity's advisory and broker-dealer activities.

Likewise, a covered investment adviser that is affiliated with, or a subsidiary of, an entity already required to establish an AML program may implement a single comprehensive AML program covering all the activities and businesses that are subject to the BSA and its implementing regulations.

3

The Proposed Rule does not extend Customer Identification Program ("CIP") and beneficial owner verification requirements to covered investment advisers.

While the Proposed Rule requires investment advisers to know their customers and develop customer risk profiles, it does not require investment advisers to comply with all aspects of the customer and beneficial ownership information collection and verification requirements that apply to banks and broker-dealers.

FinCEN anticipates addressing these requirements in future rulemakings. The CIP rulemaking may be undertaken jointly with the SEC. FinCEN is in the process of revising the beneficial ownership information collection and verification requirements for banks and broker-dealers in light of the 2020 Corporate Transparency Act, and it may issue a rule for investment advisers in parallel with this revision process.

4

The Proposed Rule largely mirrors the existing requirements for broker-dealers.

As described above, the Proposed Rule would not impose on covered investment advisers a CIP obligation to verify the identity of customers or an obligation to verify the beneficial owners of legal entity customers. However, in all other aspects, the requirements of the Proposed Rule are identical or highly similar to those imposed on broker-dealers under existing FinCEN regulations. This could help ease the compliance burden for investment advisers that are affiliated with broker-dealers that are already subject to these regulatory obligations.

The table below outlines the requirements applicable to broker-dealers and compares them to the Proposed Rule for investment advisers.

	Broker-Dealers	Investment Advisers (Proposed Rule)
Customer Identification	Must have a CIP for verifying the identify of customers.	Not included in Proposed Rule.
Customer Due Diligence	Must have CDD program for identifying beneficial owners of legal entity customers.	Not included in Proposed Rule.
AML Program	Must maintain a written AML program that satisfies certain minimum requirements.	Mostly the same. Differences: Specifies that an AML program must also cover CFT; must have written approval by board of

		directors or general partner; requirements are deemed satisfied where underlying mutual funds have compliant programs; and the duty to establish and maintain an AML program must remain with persons in the U.S.
Currency Transaction Reports	Subject to generally applicable rules at 31 C.F.R. Part 1010, Subpart C, requiring reporting of currency transactions of more than $10,000.	Same.
SAR Reporting	Required to file with FinCEN a report of suspicious transactions involving $5,000 or more.	Mostly the same. Differences: Specifies that prohibitions on disclosure extend to *former* directors, officers, employees.
Records Required to be Maintained	Subject to generally applicable rules at 31 C.F.R. Part 1010, Subpart D, requiring recordkeeping for extensions of credit and international funds transfers of more $10,000, and for funds transfers of $3,000 or more, except where solely involving financial institutions.	Same.
Special Information Sharing Procedures	Subject to generally applicable rules at 31 C.F.R. Part 1010, Subpart E, requiring financial institutions to provide information to FinCEN upon request for law enforcement purposes, and permitting information sharing amongst financial institutions to identify or report suspicious activity.	Same.
Special Standards of Diligence	Subject to generally applicable rules at 31 C.F.R. Part 1010, Subpart F, prescribing diligence standards for private banking accounts of foreign persons and correspondent accounts of foreign financial institutions.	Same.

5 FinCEN proposes to delegate its examination authority to the SEC, consistent with its existing delegation to the SEC of the authority to examine broker-dealers and mutual funds.

As FinCEN notes in the Proposal, delegation of examination authority to the SEC will result in the SEC incurring additional costs.

The Proposal states that any costs incurred would be paid for through the fees that the SEC receives from registrants and other market participants, but it is unclear whether the SEC may face resource constraints in exercising its examination authority.

6 The Proposed Rule is similar to previous proposals from FinCEN, but has a broader definition of investment advisers, motivated in part by the growth in private funds.

FinCEN has long been interested in extending AML program obligations to investment advisers. In 2015, FinCEN proposed a similar rule for investment advisers (FinCEN withdrew this prior proposal concurrent with the publication of the current Proposed Rule). Going back further, FinCEN also proposed rules in 2002 and 2003 – later withdrawn – that would have imposed AML program requirements on unregistered investment companies and investment advisers, respectively. Notably, the 2015 proposal did not include exempt reporting advisers in its definition of investment adviser, and so would have only applied to RIAs.

Revisiting and reviving the 2015 proposal has been a goal of the Biden Administration's AML and anticorruption strategy. FinCEN's fact sheet accompanying the Proposed Rule notes that the investment adviser sector has almost doubled in assets under management since the 2015 proposal was published and that "[t]he size and rapid growth of this sector underscore the importance of recalibrating the regulatory environment." In December 2021, the United States Strategy on Countering Corruption identified investment advisers as potential hole in the U.S. framework for identifying and mitigating money laundering risks, which "may allow corrupt actors to invest their ill-gotten gains in the U.S. financial system through hedge funds, trusts, private equity funds, and other advisory services or vehicles offered by investment advisers that focus on high-value customers."

More recently, at the beginning of February 2024, Treasury published its 2024 National Money Laundering Risk Assessment, which again identified investment advisers as critical financial intermediaries that are outside the AML/CFT legal framework. Treasury also published a 2024 Investment Adviser Risk Assessment that elaborated on the ways in which investment advisers may create illicit finance risks without the application of comprehensive AML/CFT programs. That risk assessment focused on private funds managed by investment advisers and, in particular, highlighted the risk of private funds being used as a U.S. entry point for illicit proceeds, the risk that funds managed by investment advisers may ultimately trace back to sanctioned entities, and the risk that China and Russia may use private funds to invest in and access technology with national security implications.

The Proposal reiterated these risks, and noted that while private funds may include restrictions on liquidity that deter criminals who need immediate access to illicit proceeds, they are unlikely to deter corrupt foreign actors who seek stable returns, have a medium- to long-term investment horizon, and do not need immediate access to capital. Bad actors can launder illicit proceeds through investment advisers and private funds by obscuring the illicit origins of funds and pooling them with legitimate funds to invest in U.S. securities, real estate, or other assets. The Proposal thus emphasizes the increasingly important role of private funds in the economy as a key reason for subjecting investment advisers to BSA/AML regulation.

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